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THE BIGGER PICTURE – A GLOBAL & AUSTRALIAN ECONOMIC PERSPECTIVE

National Australia Bank

The conflict between Russia and Ukraine has caused a significant spike in energy prices – reflecting the importance of Russia in the production and export of oil, natural gas and coal, in combination with limited additional supply elsewhere. In addition, the conflict triggered a broad decline in equity markets, along with increased volatility in financial markets more generally, with expectations of global monetary policy also shifting since mid-February. The duration of the conflict, and the resulting impact on energy prices, is highly uncertain – however it is clear that energy prices will remain elevated in the near term.

- **Financial markets** were significantly impacted by Russia's invasion of Ukraine – highlighting the fact that the risk of open conflict had not been fully priced ahead of the event. The response in equity markets – which had already retreated in January on expectations of tightener monetary policy – varied somewhat, with non-US advanced economies (led by Europe) and emerging markets down around 5%. In contrast, US market responses have been relatively muted.
- In contrast, **commodity prices** have trended substantially higher, with the Refinitiv Core Commodity CRB Index rising in March to its highest level since September 2011. Since the start of the Russia-Ukraine conflict, energy prices have risen rapidly, with WTI oil prices moving above US$120 a barrel (at the time of writing) – from around US$90 in early February. Russia is a major supplier of crude oil, coal and natural gas – particularly into Europe – but also a range of metals.
- Volatility has also been evident in expectations for **monetary policy** – which had ramped up considerably in early 2022 due to rising inflation. Market expectations for the US Fed, Bank of England and European Central Bank were pared back considerably at the start of March in response to the Russia-Ukraine conflict. At the time of writing, expectations for both the Fed and BoE have largely retraced, however expectations for the ECB now represent one typical rate hike by the end of 2022 (compared with two prior to the Russia-Ukraine conflict).
- It is important to note that the **COVID-19 pandemic** continues, and remains a major risk to economic activity – particularly in emerging markets (where vaccine coverage is generally lower). As highlighted by the rapid emergence and spread of the Omicron variant, additional highly infectious variants of COVID-19 can not be ruled out.
- Q1 data for **major advanced economies** (AE) have been consistent with our expectation of a substantial slowdown. However, with the latest COVID-19 wave fading, Q2 GDP growth should rebound. At this stage, we expect this to remain the case despite Russia's invasion of the Ukraine, although there is significant uncertainty how the conflict (and the international response) will unfold from here. While higher energy costs (oil and, outside the US, natural gas) are an obvious channel which will slow growth, sanctions and companies own decisions to cease interacting with Russia, and the resulting trade and financial market disruptions, will also act as a drag. Possible risk aversion by consumers and businesses along with wealth impacts from falling equity markets may also hit activity.
- The **Emerging market** (EM) composite PMI was a little stronger in February – up to 51.3 points (from 50.8 points in January) – with an uptick in manufacturing the key driver, driven primarily by China, while Russia's manufacturing PMI was weaker – although this result came ahead of the Russia-Ukraine conflict. Higher energy prices will have a mixed impact on emerging market economic growth – depending largely on whether countries are net exporters or importers of energy. Net exporters in the Middle East and parts of western Asia and Africa are likely to benefit from higher oil prices, while India and China are among the EMs negatively impacted.
- Overall, we have substantially cut our **global forecasts** this month – largely reflecting the impact of the Russia-Ukraine conflict – down to 3.7% in 2022 (previously 4.2%) and 3.5% in 2023 (previously 3.6%). The main contributor to this downturn is Russia – which is likely to suffer a deep recession as a consequence of sanctions imposed by a wide range of countries. It is worth noting that there is a high degree of uncertainty around this forecast, given that the duration, and ultimate extent, of the conflict and sanctions is unknown. The forecasts are based on an oil price of around $US110/barrel (through to Q2) but, at times, the price has moved well above this in recent days, signalling downside risk to our projections.
- For more detail on the global outlook, please see the Forward View – Global, released yesterday.

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For Australia, based on recent upside surprises in the data, we now expect a lower unemployment rate and higher inflation in the near-term, while our forecasts for activity remain broadly unchanged. The Q4 national accounts confirmed that consumption rebounded very strongly as the Delta lockdowns eased. We expect ongoing strength in overall consumption spending (albeit slightly disrupted in Q1 by Omicron and, more recently, floods). We continue to see dwelling and business investment as well as government spending supporting growth in the near term, while trade is expected to be a small drag on growth. Overall, that sees growth of 3.4% during 2022 and closer to trend growth of 2.1% in 2023. The strength in activity and strong labour demand points to the unemployment rate declining further. We now see the unemployment rate falling below 4% by March and reaching 3.5% by mid-2022. This will eventually see a strengthening in the pace of wage growth. We also expect strong inflationary pressure to persist in the near-term and have revised up our forecasts for the CPI to around 1% in both Q1 and Q2 – taking the year-ended rate to 3.7% by mid-year. As a result, we have also brought forward our cash rate profile, with the RBA expected to lift the cash rate by 15bps in August, with 25bp follow ups in September and November. With the war in Europe posing risks on both the activity and nominal sides of the economy, uncertainty is now highly elevated – but the central-case for Australia's economy largely remains strong.

- **The labour market remained strong through the Omicron outbreak, despite disruptions, setting up a potentially record-breaking year ahead as focus turns to wages.** The surge in case numbers in January caused a significant fall in hours worked but this should rebound in February, and the unemployment rate was steady at 4.2%. With labour demand still strong, we now expect unemployment to fall below 4% by March and reach around 3.5% in the second half of the year. In terms of wages, the December quarter WPI showed solid gains with annual wage growth back around pre-COVID levels. We expect gradual progress as the labour market tightens further, with the WPI reaching around 3% in the second half of 2022.
- **Household consumption rebounded dramatically in Q4 and high savings should support spending in 2022**. Consumption rose 6.3% in the quarter as major states reopened, pushing consumption above pre-COVID levels for the first time. The combined effect of Omicron and now flooding will likely result in more modest consumption growth in Q1. The savings ratio remains elevated at 13.6% and households have built up a considerable savings buffer, which will support spending in 2022. Weighing against will be the threat of higher prices including, potentially, some dampening impact from higher petrol prices,
- **House price growth continues to slow and dwelling investment fell in Q4 despite a large backlog of work.** Capital city dwelling prices grew by 0.3% m/m in January, the slowest rate of growth since late 2020. Our expectation remains for capital city price growth to ease in 2022 ahead of falls later in the year and into 2023; with an overall price decline (to end-2023) of around 10%. Dwelling investment fell in Q4 2021 by 2.2% q/q with Labour and materials shortages a factor. Building approvals also plunged in January as rising construction costs, depressed population growth, and increases in fixed rate mortgages weighed. However, the large pipeline of work to be completed should support activity, although how quickly supply constraints will ease is uncertain.
- **Business conditions have improved after the Omicron-impacted January in a positive sign for investment.** The NAB Monthly Business Survey for February showed conditions back above average – led by gains in NSW and Vic – as well as a broad-based pickup in confidence and a rebound in forward orders. Capacity utilisation is also back above average, indicating a potential lift in business investment which disappointed in Q4. The ABS Capex Survey also points to a pickup although supply chain disruptions and construction costs may weigh on investment in the near-term.
- **We have brought forward our call for the first RBA rate hike to August on the back of our updated forecasts for unemployment and CPI.** The RBA's March post-meeting statement continued to emphasise a wait and see approach as evidence accumulates on whether inflation has sustainably returned to the target band. We expect the trimmed-mean measure of CPI for both Q1 and Q2 to print around 1% which would see underlying inflation tracking around 3.7%. With the unemployment rate set to be around 3.5% and signs that wages are picking up, we expect an August hike of 15bps following the Q2 CPI, with further rises in September and November.
- **Net exports subtracted 0.2ppts from growth in Q4 and will likely continue to weigh on growth as trade normalises over the year.** Both imports and exports were weaker in Q4. Going forward, services trade should recover with the international border now fully opened. The relative pace of the recovery in services imports and exports remains uncertain, with a slightly faster recovery in imports pencilled in for now.
- **Russia's invasion of Ukraine has raised the level of uncertainty around the outlook.** Australia's direct trade with both Russia and the Ukraine is very limited, but the economy will be affected by the increase in commodity prices, trade and finance disruptions, risk aversion and any wealth impacts. At this stage we expect around a ½ppt reduction in global growth with potential for financial system shocks and new supply chain disruptions. Still, as a commodity exporter, higher prices will boost Australia's national income. Central banks are likely to look through any temporary impact of higher oil prices on inflation unless higher inflation expectations become embedded, and some could slow the pace of rates normalisation until the situation is clearer. These risks add to the existing mix of uncertainties around COVID-19, supply chains, and consumption behaviour.
- For more detail on the Australian outlook, please see the Forward View – Australia, released on Wednesday.

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