June 2022

THE BIGGER PICTURE – A GLOBAL & AUSTRALIAN ECONOMIC PERSPECTIVE

National Australia Bank

Global inflation remains high and showing no signs of easing, placing pressure on household finances. Together with central bank interest rate rises, this is likely to slow growth. The speed and degree of policy tightening may prove too much for economies to handle, particularly given the commodity price shock currently in play. As a result, recession risk for several of the major advanced economies, including the US, is uncomfortably high. China is also starting to see a recovery in activity as restrictions have been eased although there is considerable uncertainty around the outlook given the continuation of zero-COVID health policies. Our forecast for global growth is 3.4% in 2022, 3.2% in 2023 (previously 3.4%), and 3.1% in 2024; note, however, that we are currently reviewing our US forecast in the light of this week's Fed meeting.

- In response to the surge in inflation, **central banks are continuing to lift interest rates**. Emerging market central banks rates are now above their pre-pandemic levels. The major advanced economy central banks were slower to move but there is now a rapid adjustment underway. Between March and June, the policy rate was increased 150bp by the Fed and 125bp by Bank of Canada while the Bank of England has raised rates by 90bps since late 2021. The ECB has announced it will lift rates by 25bp in July. The rapid shift to tighter policy is set to continue. Following its meeting this week, we now expect the Federal Reserve to lift rates by a further 150bp this year and for the fed funds rate target range to peak at 3.25-3.50% in early 2023 (previous expected peak was 2.50-2.75%).
- Advanced Economy (AE) rate increases can result in **capital flows** from emerging markets to AEs, and IIF data showed this occurred in March and April (following generally large EM inflows between April 2020 and February 2022). Further outflows could destabilise EM financial markets. **Global equity markets** have also moved lower as AE monetary policy has tightened and they are currently well below their 2022 peaks.
- **Global inflation** has continued to accelerate. Producer prices rose by almost 19% yoy in April, reflecting increased commodity prices, shortages of various key inputs and labour, the impact of the Russia-Ukraine conflict and China's COVID-19 policies and disruptions to global transport and logistics. Several of these factors are likely to persist across the remainder of the year – in particular global food prices are likely to climb due to fertiliser shortages, while China's zero-COVID approach could lead to further lockdowns. These inflationary pressures are flowing through into consumer prices – our global measure increased by almost 8% yoy in April and CPI inflation in the G7 economies is at its highest level since late 1982.
- **Major advanced economy** (AE) GDP growth slowed to a crawl in Q1 2022 (0.1% q/q). A factor behind this was the COVID-19 wave that peaked during the quarter. Since the wave peaked, mobility data have moved higher and the business PMI survey readings have remained solid, consistent with stronger growth in Q2. However, overall the AE business surveys are trending down, pointing to a fading tailwind from re-opening and growing headwinds. Supply issues remain a constraint on growth (with the risk of further China lockdowns a concern), along with tighter financial conditions, as central banks move to lift rates, and the impact of high inflation on household budgets. Savings accumulated over the pandemic by AE households will help absorb some of these pressures but for how long is unclear given low consumer confidence, falling equity prices, and talk of recession.
- While **emerging market** PMIs improved in May, they remained in negative territory, reflecting the ongoing impact of China's COVID-19 public health response. While the China services reading improved in May, it was the third weakest reading on record. In contrast, the equivalent services measures in both India and Brazil remain strong, while Russia's was less negative. China's PMI readings are likely to strengthen considerably in June due to the easing of restrictions in Shanghai and Beijing; however, there are concerns at the time of writing that some restrictions may be re-imposed following another increase in COVID-19 case numbers, highlighting the uncertainty around China's economic outlook.
- We have revised our global economic forecasts, with the most significant changes coming in 2023 and reflects lower forecasts for the United States, Euro-zone and Japan. For the US, this in part reflects a greater than expected tightening in financial conditions, while lower US growth will also spill over to other countries. Overall, we see the global economy growing by around 3.4% in 2022 (unchanged) and slowing to 3.2% in 2023 (down from 3.4%) and 3.1% in 2024. For 2023 and 2024 forecast global growth is below the long run average of 3.4% (since 1980). The change to our Fed funds rate profile has negative implications for US and global growth; we are still working through the implications for the US economy, but US 2023 growth is likely to be revised down to something closer to 1% (current forecast 1.6%) which would also lower 2023 global growth to 3.1%.
- For more detail on the global outlook, please see the Forward View – Global, released yesterday.

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For Australia, we have lowered our GDP forecast for this year and next, upped our near-term inflation outlook and incorporated a new, front loaded rate track for the RBA. Our outlook for the labour market is broadly unchanged in the near term, with unemployment expected to continue to decline and wage growth to pick up, but we have increased the unemployment rate profile further out. GDP is expected to now grow at 2.7% this year, a below trend 1.8% in 2023 and around 2.0% in 2024. The strength in labour demand indicators still provides us confidence that the unemployment rate will decline in the near-term, though a weaker growth outlook in the out years sees unemployment back up to around 4% by end 2024. We have also upped our inflation forecast over the next two quarters, which sees headline CPI peak at around 6.3% in Q3 and trimmed-mean inflation at around 5%. This, in combination with the RBA's post meeting statement mean we now expect a front-loaded rate track, with 50bp hikes expected at each of the next two meetings with a 25bp follow up in November. We see the cash rate at around 2.6% by end 2023.

- **The RBA surprised by lifting the cash rate target by 50bps to 0.85% in June,** pointing to a faster than expected normalisation of rates. The RBA has also upped its headline CPI forecast to 7% y/y by December, where it expects inflation to peak and reiterated that it will do what is necessary "to chart a course back to 2-3%". Consequently, we have front-loaded our rate track, now expecting two further 50bp hikes in July and August, with a follow up 25bp hike in November – taking the cash rate target to 2.1% by years end. We then see the RBA approaching neutral but taking the cash rate to 2.6% by end 2023.
- **The labour market remains strong with the unemployment rate now below 4%.** Employment grew by a strong 61k in May (after a softer April rise of 4k), reflecting the strength of labour demand, and hours worked have also rebounded strongly after flood impacts in March. Participation is also up to a record high of 66.7% with both male and female participation rising in May. The unemployment rate remains at 3.9% for the third straight month and is low in every state, with underemployment also down to its lowest level since 2008. We expect the unemployment rate to decline to around 3.5% in 2022 on the back of still strong labour demand indicators but rise to around 4.0% as growth slows in 2023 and 2024. Nonetheless, a tight labour market should see wage growth continue to rise gradually, reaching 3.5% y/y by end 2023, with this week's minimum wage increase of 5.2% (4.6% for awards) providing support to wage growth in the second half of the year.
- **Consumption growth continued at a robust pace in Q1, despite the disruptions from Omicron and floods.** The 1.5% q/q/ rise was driven by an ongoing rebound in services – with travel rising 60% and increases of around 5% in recreation & culture and accommodation & food services. Goods consumption also rose but notably food spending pulled back as households returned to eating out. High frequency indicators point to consumption holding in up in nominal terms in Q2 – but stronger price pressure and the impact of higher rates will begin to weigh on spending in real terms going forward. A high savings rate and large buffers built up during the pandemic will provide some ongoing support but ultimately a slowing in disposable income growth will slow the rate of consumption.
- **The housing market is expected to soften and we now expect house prices to fall 15-20%.** The CoreLogic capital city dwelling price fell by 0.3% m/m in May – its first decline since September 2020 – driven by faster falls in Sydney and Melbourne as growth slowed in the other capitals. More generally the housing market continues to cool with new listings slowing, and time on market returning to more normal levels. Building approvals have also fallen back to pre-pandemic levels, but a large pipeline of construction work remains. However, as observed in the Q1 accounts, dwelling work done may remain volatile as capacity and price constraints bind – but is generally expected to remain at a high level through 2022.
- **Business investment was mixed in Q1,** with a 3.6% rise in equipment spending offset by weakness in buildings & structures investment. The rise in equipment investment follows two consecutive declines and overall, investment remains low as a share of GDP. However, we remain optimistic that investment will rise through 2022 with both the ABS capex survey and the NAB Quarterly Business survey pointing to an increase. Indeed, the monthly business survey shows that conditions have held at a relatively high level and capacity utilisation and forward orders also remain high. Confidence has softened over the past two months but remains around its long-run average.
- **Net exports made a substantial subtraction from GDP in Q1 – with imports rising strongly while exports were slightly softer.** A strong run up in consumer goods drove the increase on the imports side which we expect to moderate in Q2. The weakness in exports was driven by softness in both rural and non-rural commodities which we expect to rebound. Indeed, monthly trade data in nominal terms shows the trade balance widened in April. Services trade is starting to recover but remains depressed.
- **The impact of higher rates and price increases will likely weigh on consumer spending but be offset by a declining savings rate and large buffers built up by households during the pandemic.** The likely hit to real spending power from higher interest rates and elevated inflation, as well as our consumption forecasts, imply that the savings rate could fall to around 6% by mid-2023.
- For more detail on the Australian outlook, please see the Forward View – Australia, released on Wednesday.

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