July 2022

THE BIGGER PICTURE – A GLOBAL & AUSTRALIAN ECONOMIC PERSPECTIVE

National Australia Bank

Major central banks continue to tighten monetary policy in response to the highest inflation in decades, thereby straining household finances and leading to falls in asset prices. The duration and severity of the Russia-Ukraine conflict remains uncertain – negatively impacting energy and agricultural markets with the latter having the potential for prolonged impacts in low-income economies. Similarly, China's public health response to COVID-19 presents ongoing risks to supply chains. Our forecasts are consistent with mild recessions in the US, UK and the Euro-zone. Overall, we see the global economy expanding by 3.2% in 2022 (previously 3.4%) and 2.9% in 2023 (was 3.2%). In 2024, we see a modest pickup, back up to 3.0%, however global growth is set to remain below the long run average of 3.4%.

- **Global inflation remains high**. Large scale fiscal transfers during the pandemic and supply side constraints have been major factors. The latter reflects the shortages of labour and various key inputs, the impact of China's COVID-19 policies and the Russia-Ukraine conflict as well as various disruptions to the global transport and logistics sector. Global producer prices rose by just over 18% yoy in May, remaining at levels that are high by historical standards. Soaring producer prices have flowed through into consumer prices as well – with our global measure increasing by just over 8% yoy in May and, among the largest advanced economies, consumer prices rose by their fastest pace since mid-1982. That said, global commodity prices peaked in early June and have subsequently declined in part due to concerns around slowing in the global economy.
- A broad range of central banks started to tighten **monetary policy** from late 2021 – initially led by emerging markets. Advanced economy central banks were slower to respond, but generally have adjusted rapidly (albeit excluding the European Central Bank and Bank of Japan) – particularly in the case of the US Federal Reserve. The rapid change in monetary policy expectations has resulted in a substantial repricing of financial assets, with **equity and bond prices** well below late 2021 highs. At the time of writing, the MSCI US index was just below its level at start of 2021, while the indices for other advanced economies and emerging markets are well below this mark (down over 15% and 20% respectively).
- Among the **major advanced economies** (AEs), we have made major downward revisions to our economic growth forecasts for the US, Euro-zone and the UK, with each likely to enter into a (mild) recession. The revisions in part reflect a more aggressive than previously expected Federal Reserve policy tightening and weak recent partial data for the US. The US (on a common currency basis) is the largest economy in the world and a downturn there can have large spill-over impacts on other economies. The Euro-zone and UK are also exposed to the fall-out from the Ukraine/Russia conflict. There are concerns over natural gas supply to Europe and so, after a Q2 bounce back from an easing in COVID-19 restrictions, we expect Euro-zone growth to slow with a small contraction in Q4 factored in reflecting at least some energy disruptions in winter. However, the risk is that further constraints on natural gas flows from Russia to Europe could negatively impact Europe far more severely than our forecasts allow for. A complete cut-off of gas supplies would likely lead to a major recession.
- There was a sizeable rebound in **emerging market** PMIs in June largely due to China. The EM services PMI surged to 55.6 pts (47.3 pts in May). The increase in the EM manufacturing PMI was more modest – pushing up to 51.7. China's PMI readings were considerably stronger in June (particularly for services) as COVID-19 restrictions were eased in both Shanghai and Beijing. However, high frequency data for China suggest that there is still some way to go before there is a full recovery. At the time of writing, authorities in Xi'an were commencing a lockdown following a fresh COVID-19 outbreak. China's public health stringency remains in stark contrast to the more open approach – similar to most advanced economies – across the rest of East Asia.
- **Global business surveys** were stronger in June but with marked differences between advanced economies, where trends have softened since March, and emerging markets (due to the China rebound). COVID-19 continues to present substantial uncertainty to the global outlook; the BA.5 subvariant of the Omicron variant (responsible for the lockdown in Xi'an) is more transmissible and faster spreading than earlier subvariants increasing the risk of COVID-19 related supply disruptions. While we have made significant downward revisions to the outlook for a range of advanced economies, our forecast for China is unchanged; Q2 national accounts data will be released shortly after the release of this report, and risk is likely weighted to the downside, which would further impact growth in East Asia. Overall, we see the **global economy** expanding by 3.2% in 2022 (previously 3.4%) and 2.9% in 2023 (was 3.2%). In 2024, we see a modest pickup, back up to 3.0%, however global growth is forecast to remain below the long run average of 3.4% (from 1980 onwards).
- For more detail on the global outlook, please see the Forward View – Global, released yesterday.

Alan Oster (Group Chief Economist), M: +(61 0) 414 444 652
Alt: Antony Kelly (Senior Economist); Gareth Spence (Senior Economist); Brody Viney (Senior Economist)

For Australia, we have nudged up inflation in the near term, further front-loaded our rate track and softened growth in both 2022 and 2024. That sees unemployment slightly higher at the end of 2024. We have not changed our view on the underlying trajectory for the economy but see greater risk for household consumption on the back of higher rates and inflation. GDP is expected to grow by around trend pace over 2022 – 2.3% before moderating to 1.8% in each of 2023 and 2024. Both headline and trimmed-mean are expected to be slightly higher in 2022 with a very high 1.5% print for trimmed-mean likely in Q2. Both measures are expected to peak in Q2 at 7.2% and 5.4%, respectively, before easing through 2023. Consequently, we have included an additional 25bp increase in September for an earlier peak in early 2023. Below trend growth over the next two years sees unemployment rise to 4.3% after troughing in 2022 at a relatively low level. Global uncertainty remains elevated and a significant global downturn in 2023 would likely most directly impact through financial channels and trade – though the latter would be dependent on trading partner impacts. On the monetary policy front, inflation expectations remain a key risk to needing to move more quickly towards neutral.

- **The RBA lifted the cash rate to 1.35% in July,** with the post meeting statement not changing our view that the RBA will again lift rates by 50bps in August. We have further front-loaded our rate track, now expecting a 25bp increase in September where we had previously expected the RBA to pause, followed by an increase in November and February. This still sees the cash rate peak at 2.6% but earlier than previously expected. We see the RBA as largely arming to "normalise" policy by reaching neutral. A key risk remains that inflation expectations strengthen more materially, and the RBA will have to normalise more quickly or even move into restrictive territory. However, with a weaker global outlook and the challenges faced by households weighing on growth in 2023 we see the RBA holding at 2.6% for now.
- **The labour market tightened further in June, with the unemployment rate falling 0.4ppt to 3.5%.** Employment grew by a strong 88k in May. Labour force participation continues to track at record levels suggesting that there has been some supply response to the elevated labour demand but the labour market is now very tight, and job vacancies and our survey suggest demand will remain strong. This points to an ongoing pick-up in wage growth while higher inflation expectations may be beginning to feed back into the wage-bargaining process. With growth slowing in 2023 we see the unemployment rate drifting up but broadly remaining around a level consistent with full employment – reaching around 4.3% by end 2023.
- **Consumption is likely to remain strong in Q2, but then moderate in the face of several strong headwinds.** Retail sales increased by 0.9%m/m in May (as in April) continuing the strong growth seen this year. The average of retail sales over April and May is around 3% above its Q1 average. This remains the case even if our estimate of a -0.1% m/m decline in ABS June retail sales (based on NAB's Cashless retail index) is realised. While much of this reflects price growth, it still suggests solid volume growth. Accordingly, we continue to expect strong consumption growth in Q2. Beyond Q2, consumption growth is likely to become more moderate. This reflects the impact of high inflation, rising interest rates, and negative wealth effects.
- **House prices continued to decline in June with falls expected to accelerate in coming months.** Both the CoreLogic and PropTrack capital city indexes show that the falls in prices continue to be led by Sydney and Melbourne. Across the two measures, prices have also slowed in the other capitals – though Adelaide continues to out-perform. We expect house prices will fall by around 18% by the end of 2023 before leveling off. We don't see a fundamental oversupply of housing and see these falls as adjustments to affordability. Construction work done will likely remain elevated with a large outstanding pipeline of work but the national accounts measure of dwelling investment will likely remain volatile with capacity constraints and supply issues ongoing in the sector.
- **Business confidence has softened and sees the outlook for business investment deteriorating.** That said, business conditions have held up at well above average levels and forward orders suggest that the near-term outlook remains healthy. Input cost pressures continue to be a key challenge with both purchase and labour cost growth reaching new survey highs in June. Conditions have remained strong across most industries and states, though construction is notably weaker – where cost pressures have had a greater impact on margins and profits. For now we see business investment eking out a gain in 2022 but elevated uncertainty and a slowdown in activity pose a risk.
- **The trade surplus reached set a new record in May, widening to $16bn on the back of a large rise in coal export values.** Trade, especially in value terms will likely remain volatile as disruptions to energy prices and fears over global growth impact prices. Services trade remains heavily depressed despite some gains over recent months – while the Australian border fully opened in early 2022, there have been ongoing disruptions to travel and some international borders have remained closed. We expect the recovery will be gradual.
- **A weaker global outlook, if realised would impact Australia as a small open economy through a number of channels.** The most immediate impact would likely come via financial channels and confidence, though a slowing in global demand could also weigh through the trade channel – particularly if our major trading partners such as China bore the brunt of the slowdown.
- For more detail on the Australian outlook, please see the Forward View – Australia, released on Wednesday.

Group Economics

Alan Oster
Group Chief Economist
+(61 0) 414 444 652

Jacqui Brand
Executive Assistant
+(61 0) 477 716 540

Dean Pearson
Head of Behavioural & Industry Economics
+(61 0) 457 517 342

Australian Economics and Commodities

Gareth Spence
Senior Economist
+(61 0) 436 606 175

Brody Viney
Senior Economist
+(61 0) 452 673 400

Phin Ziebell
Economist – Australia
+(61 0) 475 940 662

Behavioural & Industry Economics

Robert De Iure
Senior Economist – Behavioural & Industry Economics
+(61 0) 477 723 769

Brien McDonald
Senior Economist – Behavioural & Industry Economics
+(61 0) 455 052 520

Steven Wu
Economist – Behavioural & Industry Economics
+(61 0) 472 808 952

International Economics

Tony Kelly
Senior Economist
+(61 0) 477 746 237

Gerard Burg
Senior Economist – International
+(61 0) 477 723 768

Global Markets Research

Ivan Colhoun
Chief Economist
Corporate & Institutional Banking
+(61 2) 9293 7168

Skye Masters
Head of Markets Strategy
Markets, Corporate & Institutional Banking
+(61 2) 9295 1196

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