August 2022

THE BIGGER PICTURE – A GLOBAL & AUSTRALIAN ECONOMIC PERSPECTIVE

National Australia Bank

We now forecast the global economy to expand by 3.0% in 2022 (down from 3.2% previously) before slowing to 2.5% in 2023 (was 2.9%). Several advanced economies are at heightened risk of recession. Tighter financial conditions and the fallout from the Ukraine-Russia conflict (including for European energy supply) are impacting activity in advanced economies. This will in turn put pressure on emerging market economies via financial market, currency and trade channels. It remains too early to suggest that inflationary pressures have subsided with global consumer price growth accelerating through to June, although recent commodity price falls, if sustained, should provide some relief.

- It remains too early to suggest that **global inflationary pressures** have subsided; global consumer price inflation accelerated to 8.7% yoy in June (8.2% yoy in May). Recent falls in oil prices, if sustained, will provide some relief (highlighted by 0% m/m growth in the US CPI in July). Among the largest advanced economies, June CPI inflation was at its highest level since mid-1982. Global producer price growth slowed marginally from peaks in April but remains close to 18% yoy. This suggests ongoing risks of a more aggressive than expected central bank policy tightening. However, there are signs that some of the supply side inflationary pressures may be easing. Container shipping costs have fallen significantly in recent months, while commodity prices (though still high in recent history) are well off the recent cycle peaks of June 2022. That said risks remain – particularly from China's zero-COVID public health policies, tensions regarding Taiwan and the ongoing Russia-Ukraine conflict.
- **Financial markets** have been relatively volatile in recent months. The combination of weaker growth prospects and a downward shift in policy rate expectations contributed to a retreat in government bond yields across July from recent peaks in June. However, yields have started to move slightly higher once again – as hawkish commentary from Federal Reserve board members and a strong US jobs report saw policy rate expectations shift higher once again. Equity markets saw a modest recovery in the second half of July, led by the advanced economies (particularly the US). Gains in emerging markets have been much more muted – in part reflecting the recent trend of capital outflows from these economies.
- We have again marked down our **major advanced economy** (AE) growth forecasts, mainly due to disappointing US data and a worsening European energy outlook. US GDP declined by 0.2% q/q in Q2 after a 0.4% fall in Q1. We continue to expect the US will go into a recession (one with rising unemployment), most likely in 2023 but with the risk that it may occur sooner. A US downturn will also impact Canada (which is also experiencing a rapid monetary policy tightening). While Euro-zone Q2 GDP growth was robust at 0.7% q/q, energy supply issues are expected to weigh even more heavily on the economy following recent Russian supply cuts. The severity of the downturn in the Euro-zone will depend on what happens next – for example, a complete halt to Russian energy exports to the EU could lead to a severe recession. Higher energy costs are also negatively impacting the UK (also expected to go into recession). Japan is experiencing its largest COVID wave by some margin, and while the government has not re-introduced restrictions, it will still likely curb activity.
- **Emerging market** business surveys highlighted diverging conditions in July. The manufacturing PMI eased somewhat in July, down to 50.8 points from 51.7 points in June, with China the primary driver of this trend. In contrast, the manufacturing PMI for India was considerably stronger. The EM services PMI remained strong – unchanged at 55.5 points. The comparative strength of services PMIs (when compared with manufacturing) reflects the larger negative impact on this sector from China's earlier COVID-19 measures. The rapid tightening in AE monetary policy is impacting financial conditions in emerging markets, with the longest run of monthly capital outflows since the start of 2005 (when the data commenced). Capital flight from EMs has seen borrowing costs rise and currencies depreciate – with considerable pressure on smaller economies.
- China's economy contracted more rapidly than anticipated in Q2 (-2.6% q/q) due to COVID-19 health measures and we have lowered our 2022 growth forecast to 3.5% (4.2% previously). We have also lowered our forecasts for the US, Japan, Canada and the Euro-zone. Weaker demand in these economies will also negatively impact China, India and East Asia in 2023. We now forecast the **global economy** to expand by 3.0% in 2022 (3.2% previously) before slowing to 2.5% in 2023 (was 2.9%). This is well below the long run average growth rate (3.4% since 1980) and, outside of the global financial crisis and COVID-19 lockdowns, would be the weakest growth since 2001. Risks around our forecasts include how the Russia-Ukraine conflict evolves, COVID-19 (e.g., through further lockdowns in China or more transmissible variants), geopolitical tensions around Taiwan, and the risk that, if inflation does not slow, central banks will raise rates even higher than currently expected.
- For more detail on the global outlook, please see the Forward View – Global, released yesterday.

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For Australia, we have pulled back our near-term growth forecasts with high frequency data showing a slowing in consumption growth. Following growth of 2.2% during 2022, we continue to see below-trend growth of 1.6% through 2023 and 1.8% through 2024. With GDP growth slowing we continue to see the unemployment rate drifting up over the next two years – ending 2024 at around 4.3%. The Q2 CPI was in line with our expectations and our forecasts for inflation are unchanged. We continue to see headline inflation peaking at around 7.5% in Q4 and underlying at around 5.5% before easing back to around 3% by end 2023. Following the 50bp increase in the cash rate to 1.85% in August, we expect another 50bps increase in September and 25bp increases at each of the October and November meetings taking the target cash rate to 2.85% where we expect the RBA will pause as growth slows and inflation begins to moderate in 2023. Globally, uncertainty remains high with a series of very large shocks continuing to play out. Global growth remains a key risk with higher inflation likely to weigh on real incomes while global banks also tighten monetary policy at a rapid pace. For Australia, inflation itself remains a key risk. While some indicators are starting to point to an easing inflationary pressure, official measures are yet to have conclusively peaked and ongoing passthrough to domestic prices may continue.

- **Consumption looks to have recorded another quarter of solid growth in Q2, but high frequency data shows a slowing in Q3.** Real retail sales rose 1.4% in Q2, though underlying trends were more mixed. Hospitality spending continued to rebound – up 8.6%, while clothing and department stores also recorded gains. Food spending pulled back and goods spending showed some signs of normalising, down 1.8% in the quarter. Beyond Q2, we expect the impact of high prices and rising interest rates to weigh on consumption growth, while the normalisation in goods spending is also expected to continue. Indeed, our cashless retail sales measure and internal transaction data point to a slowing in consumer spending growth. That sees a substantial slowing in our forecasts for consumption for H2 2022 compared with the first half.
- **Housing market conditions continue to soften with both prices and approvals trending down.** The CoreLogic 8-capital city index fell 1.4% m/m in July and the capital city PropTrack home price index declined 0.5%. While Sydney and Melbourne initially led the falls, prices are now falling in most capital cities. Only Perth and Adelaide (on both measures) recorded increases in July but at a slower pace. Sales volumes have also declined by around 16% over the past year, while auction clearance rates remain soft. On the construction side, building approvals have continued to trend down but at a slower rate, after the HomeBuilder scheme ended in 2021. Nonetheless, the pipeline of construction work remains elevated.
- **The labour market continues to tighten with ongoing strength in labour demand driving the unemployment rate to a 50-year low in June.** Employment rose by a strong 88k in the month alongside further gains in labour force participation which is now at a fresh record of 66.8%. With the unemployment rate now at 3.5% and vacancies remaining high, we continue to expect the tightness in the labour market to feed through to stronger wage growth. We see a print of around 2.7% y/y for Q2 WPI later this month (up from 2.4% in Q1). However, as indicated in the NAB Quarterly Business Survey, larger wage increases are likely to follow in the year ahead as the minimum wage decision takes effect and contracts and enterprise agreements roll over. We see wage growth rising to around 3.5% y/y over the next year or so, its strongest pace in around a decade.
- **Business confidence rallied in July despite a range of headwinds both globally and domestically.** Business conditions also rose and remain strong across most industries and states. Of note was a pickup in the construction sector in July. The ongoing strength in activity saw further gains in capacity utilisation which rose to a new survey record of 86.4%. Overall, the ongoing strength in activity/conditions in the survey as well as very high capacity utilisation points to the risk that the economy is running up against capacity constraints. Cost and price growth measures in the survey also strengthened further in the month, from already very high rates – suggesting that inflationary pressure continues to build. Nonetheless, reported capex remains healthy ahead of updates on business investment data from the ABS due in late August and early September.
- **Next exports are expected to make a positive contribution to growth in Q2 with monthly trade data showing record trade surpluses during the quarter.** While much of the increase in export values was likely driven by higher commodity prices – particularly for energy - we expect that overall exports growth outpaced that of imports in the quarter. Services trade, particularly on the imports side (outbound tourism) continues to show signs of recovery but remains well below pre-pandemic levels. We expect an ongoing gradual recovery in services trade.
- **The RBA lifted the cash rate to 1.85% in August, and we continue to expect a further 100bps of tightening from here.** We see a 4th straight 50bp increase in September and 25bp increases in October and November, taking the cash rate target to 2.85%. We see the RBA pausing there as growth slows and inflation begins to moderate globally.
- **Inflation dynamics remain a key risk both globally and for Australia.** While some indicators show a potential easing in inflationary pressure, official measures are yet to clearly peak. For Australia any ongoing passthrough as businesses reset prices at still higher levels will be important for how quickly inflation moderates in 2023 even if global inflation begins to moderate.
- For more detail on the Australian outlook, please see the Forward View – Australia, released on Wednesday.

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