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The Forward View: Australia Feb-2023

Rising rates to see slower growth ahead

NAB Group Economics

Overview

- The economy looks to have remained resilient in Q4 with real retail sales declining by only a small amount, business conditions remaining well above average and the labour market remaining strong. We see a Q4 GDP print of around 0.9% supported by strong net exports, still rising consumption and marginal gains and dwelling investment and public spending. Key partials will be released later this week and next week.
- Looking forward, we see growth slowing sharply as consumer spending comes under pressure from both higher rates and inflation. Dwelling construction and business investment are also expected to fall modestly this year. Public spending and net exports will partially offset this weakness, in the near term at least.
- On GDP, we see the quarterly rate of growth slowing to around 0.1% in mid-to-late 2023. That sees through the year growth slow to just 0.7% in 2023 and 0.9% in 2024 before around trend growth of 2.2% in 2025.
- The unemployment rate is expected to drift up to 4% by end 2023 and 4.7% by end 2024. That said, the level of employment is expected to keep growing. Wage growth is expected to reach around 4% before easing off as unemployment rises.
- Inflation looks to have peaked in Q4 at almost 8% in headline terms and 7% in underlying terms. The easing in global pressures should flow through to prices in 2023. However, how quickly and where inflation settles will depend on domestic inflationary pressure which is building – a key component of that being wage growth. We see inflation falling to 4.25% by end 2023 and back to the top of the RBA's target band of 2-3% by end 2024.
- We recently revised up our outlook for the cash rate in the near-term and now expect it to peak at 4.1% in May 2023 and stay there until the RBA begins cutting in early 2024. We see neutral as broadly around 3% and therefore expect rates to drift back towards this level as the economy slows.
- The key macro dynamics this year will be how households respond to higher interest rates, how quickly inflation moderates, and relatedly, how labour market dynamics flow through to wage growth. Population growth is also elevated at present and will likely continue to support to activity.

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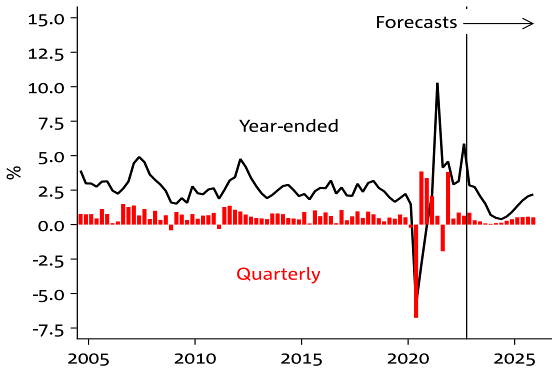
Key Economic Forecasts

	2022-F	2023-F	2024-F	2025-F
Domestic Demand (a)	5.0	1.1	-0.2	1.6
Real GDP (annual average)	**3.7**	**1.7**	**0.6**	**1.8**
Real GDP (year-ended to Dec)	**2.8**	**0.7**	**0.9**	**2.2**
Terms of Trade (a)	5.1	-6.7	-2.9	-1.1
Employment (a)	4.0	2.0	0.6	1.4
Unemployment Rate (b)	3.5	4.0	4.7	4.7
Headline CPI (b)	7.8	4.4	2.9	2.7
Core CPI (b)	6.3	4.5	3.0	2.8
RBA Cash Rate (b)	3.10	4.10	3.10	3.10
$A/US cents (b)	0.68	0.78	0.80	0.77

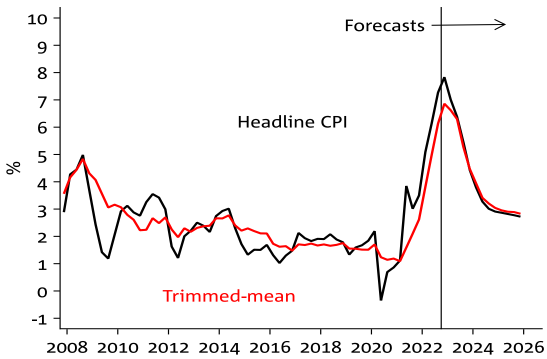
(a) annual average growth, (b) end-period, (c) through the year inflation

Chart 1: GDP forecasts



Source: ABS, NAB

Chart 2: CPI forecasts



Source: National Australia Bank, <Property Source not found.>

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Labour Market and Wages

Unemployment rose in January, but this partly reflected data volatility and the underlying labour market remains very tight. This is driving stronger wage growth, likely 3.5% to the end of 2022 and above 4% in 2024. Further out, we expect the labour market and wages to ease somewhat as the economy slows.

Employment fell by 11k in January after a 20k fall in December – though it remains higher in trend terms. The fall was enough to see the unemployment rate rise from 3.5% to 3.7%. However, under the surface there was a large rise in people "waiting to start work", enough to have kept the unemployment rate at 3.6% if counted as employed.

More broadly, the labour market remains very tight with job vacancies still elevated and around 50% of firms reporting difficulty finding suitable labour as a significant constraint in the NAB Quarterly Business Survey for Q4. There has been some moderation in job ads, with the SEEK job ads measure down 18% from its May 2022 peak, but it remains 39% above pre-pandemic levels and actually rose 2.8% in January.

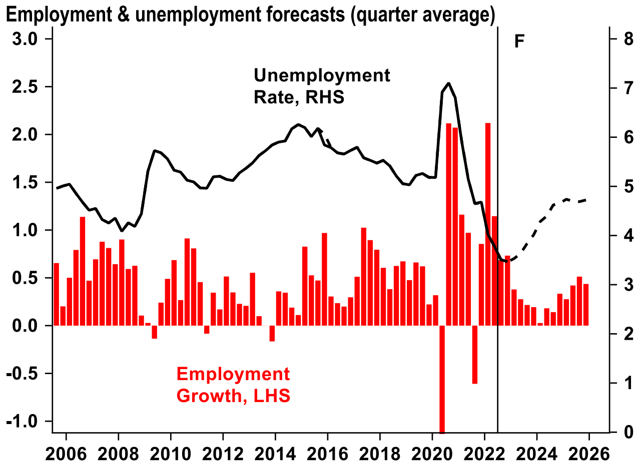
At the same time, there has been significant pickup in population growth, annualising at around 2.3%, well above the pre-pandemic norm of 1.6%. This largely reflects a strong rebound in migration with the net inflow of permanent and long-term overseas arrivals to Australia now above its pre-COVID rate. This is helping to ease some labour shortages, especially in lower-skilled roles.

We expect labour demand growth to soften, with employment growth unlikely to keep up with population growth over the coming year. As such we see the unemployment rate rising to around 4% by end-2023. Further out, as the effect of higher rates and inflation sees the economy slow more materially, we expect the unemployment rate to drift higher to be at around 4¾% by late-2024 and through 2025. This would still be below pre-COVID levels although likely marginally above a 'full employment' level.

The very tight labour market is supporting a lift in wage growth and we expect the Q4 Wage Price Index data will show hourly wage growth was around 3.5% across 2022. Broader measures of wages income released in the Q4 national accounts at the beginning of March likely show even stronger growth than base wages

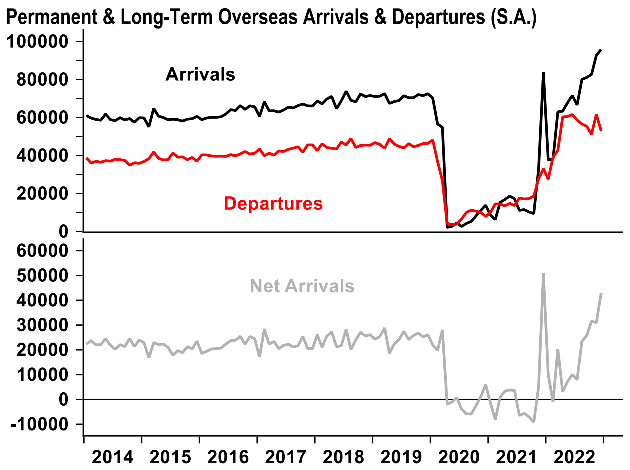
We expect this dynamic to continue in 2023 with wage growth to reach 4% y/y later in the year. This would be the highest rate of hourly wage growth since the mining boom and likely at the upper limit of what the RBA would judge to be consistent with inflation in the target band. However, with the unemployment rate expected to rise over the next two years, some of this wage pressure should gradually ease and we see wage growth easing back into the mid-3% range by the end of our forecast horizon in 2025.

Chart 3: Unemployment rate still expected to gradually rise to 4¾% in 2024



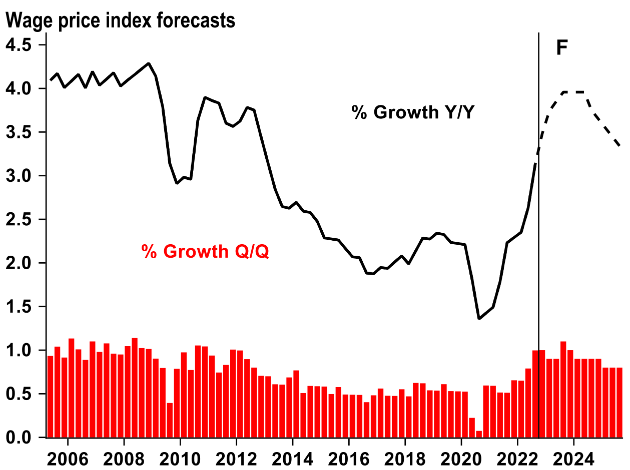
Source: National Australia Bank, Australian Bureau of Statistics

Chart 4: Migration has rebounded strongly and net arrivals are now above pre-COVID rates



Source: National Australia Bank, Australian Bureau of Statistics

Chart 5: Wage growth now running at over 3% y/y and set to rise to 4% in 2023



Source: National Australia Bank, Australian Bureau of Statistics

Consumption and Savings

We expect real household consumption rose by around 0.6% in Q4, following the strong rebound earlier in 2022. NAB's internal data suggests consumer spending remained resilient through January and we have revised up our expectations for consumption growth in the first part of 2023. However, we continue to expect a material slowing in consumption growth later in 2023 and into 2024.

Monthly nominal retail trade declined in December in seasonally adjusted terms after rising strongly in November – a pattern largely attributable to changing seasonality as more spending moves into November due to the growing importance of Black Friday sales.

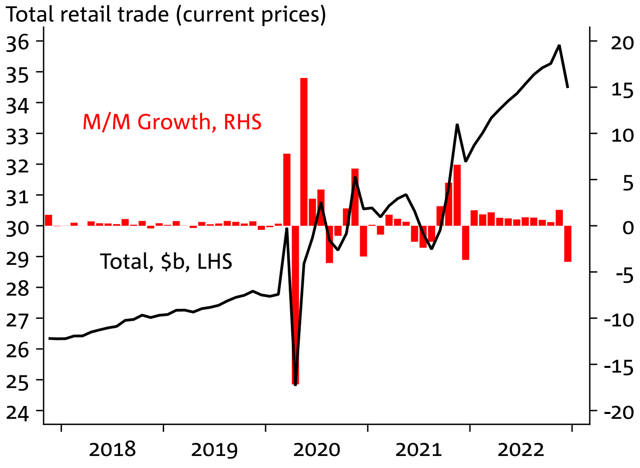
In real terms, retail spending declined slightly across Q4, down 0.2%. Still, retail spending is at a very high level relative to pre-COVID and the softening in Q4 likely reflects, in part, a long-expected normalisation in goods consumption rather than a substantial decrease in the underlying strength of spending.

More broadly, NAB's analysis of internal transaction data, released in our *Monthly Data Insights* note, showed total consumer spending rose 1.6% in nominal terms across Q4, supported by strong growth in services including increases of 9% in arts, recreation & travel and 5.6% in transport & postal services. This highlights the strong rebound in services consumption that was ongoing through Q4, though strong price increases likely contributed to this strength. On balance we expect real consumption grew around 0.6% across Q4.

More recently, NAB's data showed that nominal retail spending rose 2% m/m in January, while conditions in the NAB Business Survey also picked up in January, further supporting the interpretation that underlying spending remains resilient. This suggests consumption growth is yet to full reflect the impacts of monetary policy tightening, and we forecast consumption growth to remain positive through Q1 and Q2, supported by strong population growth, a tight labour market and the stock of savings built up during the pandemic.

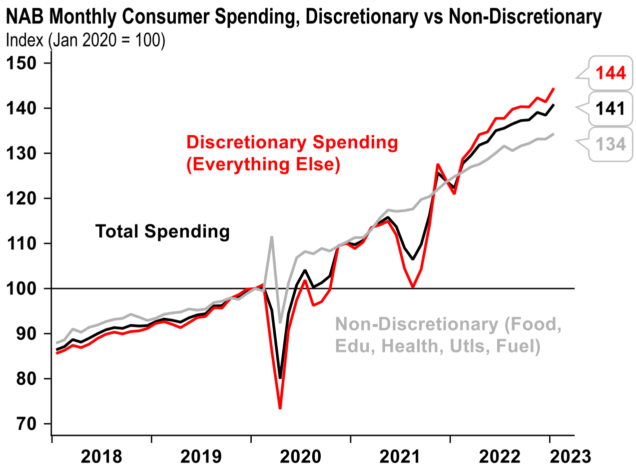
However, with rates expected to rise to 4.1% by May we expect consumption to pull back further, with flat or slightly negative real consumption growth through the second half of 2023 and into 2024. The extent of this slowdown remains uncertain, and the degree to which households draw on savings buffers will be important. Continued strong population growth will also provide upward support for consumption (though the current elevated rate of inward migration is unlikely to be sustained). Further out, consumption growth should resume as rates normalise close to neutral.

Chart 6: Retail sales fell in December but this partly reflected changing seasonality



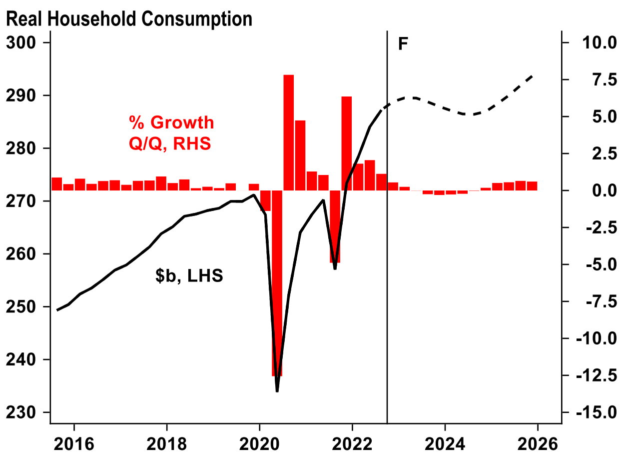
Source: National Australia Bank, Australian Bureau of Statistics

Chart 7: NAB's internal data suggests consumption remained resilient through January



Source: National Australia Bank, <Property Source not found.>

Chart 8: Real household consumption is expected to materially slow later in 2023 and into 2024



Source: National Australia Bank, Australian Bureau of Statistics

Housing and Construction

We expect the housing market to continue to adjust to the impact of higher rates through 2023 but with a relatively strong recovery in population growth and tight rental market, prices may see some offsetting support.

House prices continued to decline through late 2022 and into 2023 with the CoreLogic and PropTrack 8-capital city dwelling price indexes now around 9% and 6% lower than their peaks respectively. The rate of price declines appears to be slowing in monthly terms but with the impact of rates still flowing through and more to come, it is likely we will see an ongoing period of adjustment.

We expect house prices to decline by another 11% over 2023 for a total peak to trough decline of 18%. We still see the adjustment as orderly, driven by a response to weaker affordability as borrowing power is reduced. Accordingly, areas where affordability is most binding will likely see the largest declines. Consistent with this Sydney has seen the largest declines of around 14% while Melbourne has declined 10%. That said, the smaller capitals have also declined by a solid amount, down 12% in Brisbane and Hobart. To date, the impact on Perth and Adelaide has been more modest.

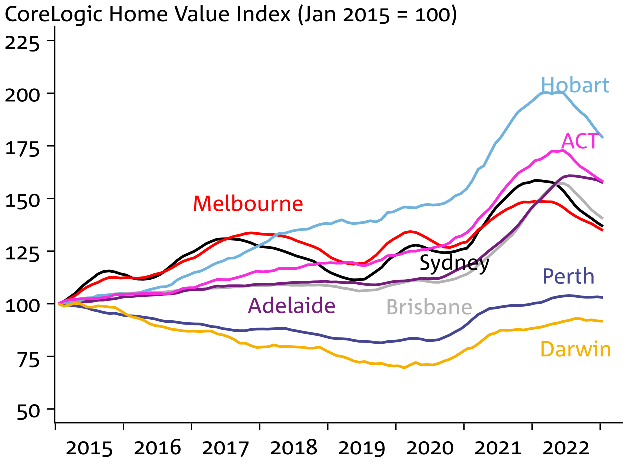
Consistent with historical episodes of price declines and rate rises, activity in the housing market has fallen sharply. Both new sales and sales of the existing stock are now at low levels and lending and building approvals for new dwellings have declined.

That said, while approvals have fallen, the pipeline of outstanding work remains elevated. Though dated, the latest ABS building activity survey shows that the number of dwellings under construction or yet to be started is around 274k, including 116k houses and 158k high density dwellings. Completions have fallen sharply over the last year or so, with availability of materials and labour as well as weather disruptions likely weighing.

This pipeline of work is likely to support construction activity in the near term as supply constraints ease but we expect dwelling investment to slow in the second half of 2023 and drag on activity in 2024 as the flow of new approvals is unable to offset relatively high rates of work done. At current rates of work done, there are around 3-4 quarters of outstanding work to be completed.

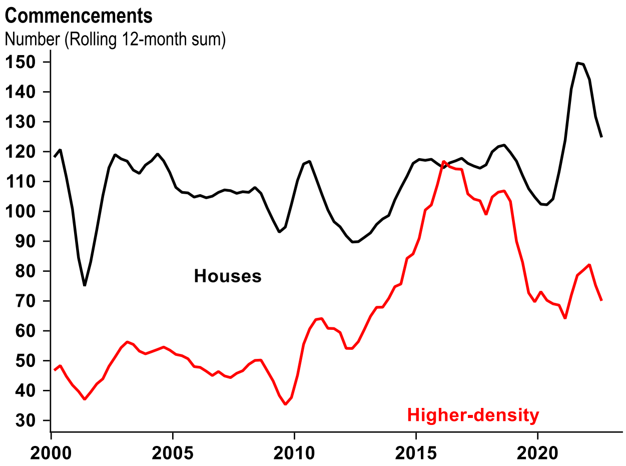
The rental market also remains very tight with vacancy rates falling to very low levels and advertised rents growing at around 10% y/y across the states.

Chart 9: House prices still falling but the pace of decline has moderated



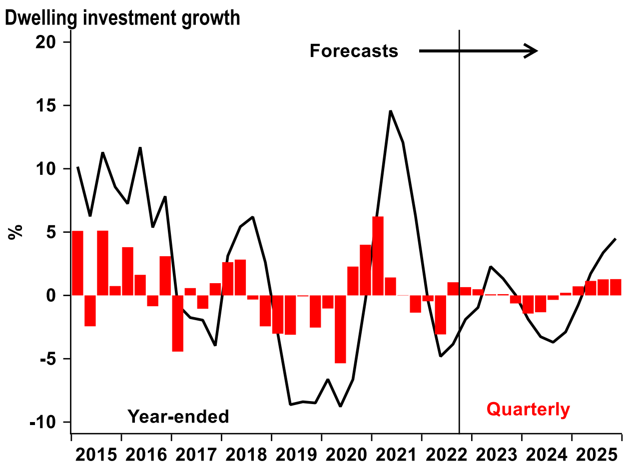
Source: National Australia Bank, CoreLogic, Macrobond

Chart 10: Housing starts have fallen despite a large pipeline



Source: National Australia Bank, Australian Bureau of Statistics

Chart 11: Dwelling investment is likely to fall as the pipeline of outstanding work is completed



Source: ABS, National Australia Bank

Business and Trade

Business conditions picked up in January after three months of easing in late 2022, and confidence is also back around the long-run average. Higher rates are slowing business credit and investment is unlikely to increase over the coming year, though businesses continue to be capacity constrained.

Business conditions in the NAB Monthly Business Survey rose 5pts in January to +18 index points – a very high level. Confidence also rose, up 6pts to +6 index points, to be around the long-run average and back in positive territory after turning negative late in 2022. The pickup suggests demand remained resilient at the start of the year and firms were more optimistic as concerns about global growth eased. Forward orders also picked up, in line with the more optimistic sentiment.

Businesses continue to report very high levels of capacity utilisation and cost pressures remain elevated, with purchase cost growth rising to 3.2% in quarterly terms in January and labour costs to 2.7%. The Q4 Quarterly Business Survey showed the share of firms reporting labour as a constraint remained around 90%.

Elevated capacity utilisation and a pickup in confidence should support investment, but firms will be wary about the likely slowing in demand ahead. Business credit growth has slowed from very high rates seen in mid-2022 and we expect business investment to weaken across 2023 and 2024 due to higher rates and slower growth.

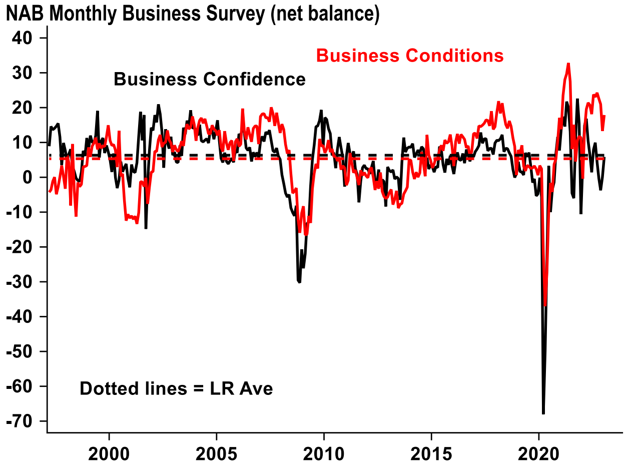
The trade surplus fell to $12.2bn in December but November was revised upwards, and price movements mean net exports are likely to provide a strong boost to GDP for Q4. Further ahead, slowing consumption should weigh on imports as exports continue to recover, supporting growth.

In nominal terms, exports fell in December and imports rose (including increased outbound travel), causing the trade surplus to decline by $1.2bn. However, the decline in exports was led by key resources (LNG, iron ore and coal) and likely reflected declining prices rather than volumes. Freight services costs also fell sharply, reflecting supply chains normalising.

Across Q4 as a whole, the nominal trade balance increased from $29bn to $38bn and with prices coming down for key exports, this implies that net exports will make a significant contribution to Q4 GDP growth of well over 1%.

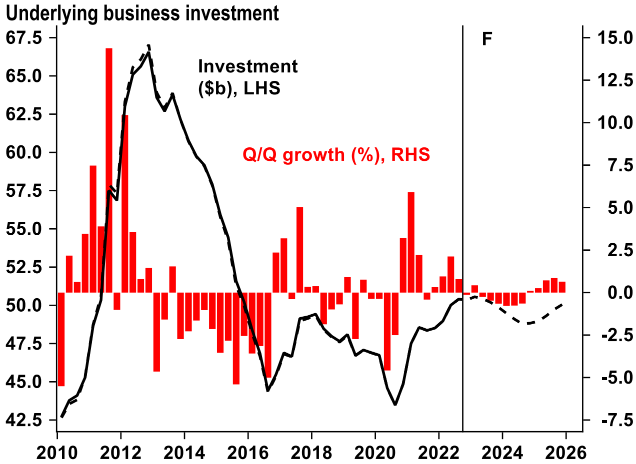
For 2023, we expect net exports to continue to provide some support for growth as global trade in goods and services normalises and exports recover, while imports will likely be weaker due to the expected slowdown in consumption growth.

Chart 12: Business conditions remain strong and confidence is back around average



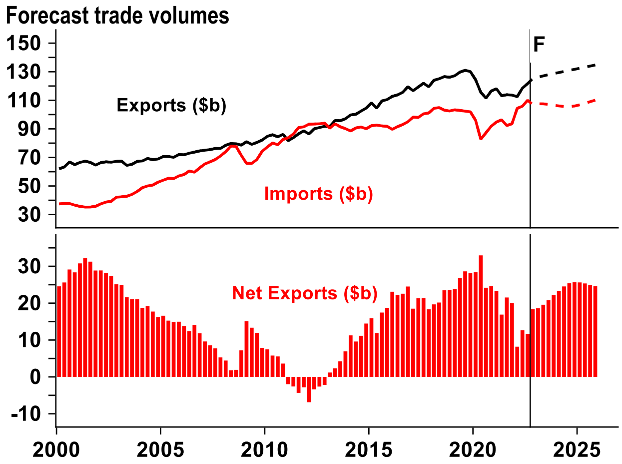
Source: National Australia Bank, National Australia Bank

Chart 13: Business investment is likely to weaken over 2023 and 2024



Source: National Australia Bank, Australian Bureau of Statistics

Chart 14: Net exports rose in Q4, while imports are likely to be flatter as consumption softens



Source: Macrobond, NAB Economics

Monetary Policy, Inflation and FX

The RBA increased the cash rate by 25bps in February to 3.35% and signalled that there will likely be further increases in coming months. We have upped our rate call and now see the RBA taking the cash rate to 4.1% by May.

The post meeting statement, February SoMP and the Governor's appearances before the senate and parliamentary committees all point to a hawkish shift by the RBA. This shift follows the Q4 CPI (released in late January) that showed domestic demand is becoming increasingly important in driving prices rises.

In terms of forecasts, there has been an upward revision to underlying inflation in the near term but a relatively unchanged outlook further out. Importantly, the RBA doesn't see inflation returning to the target band until 2025 and continues to note that it is currently too high.

More broadly, the RBA's outlook for GDP growth and the labour market were unchanged. Forecasts for wage growth were upped to just above 4% y/y –around the upper limit considered consistent with at target inflation.

Based on the ongoing resilience in the economy and the RBA's hawkish shift, we have upped our rate call – now seeing a peak of 4.1% in May, where we expect the RBA will hold rates there until easing in early 2024.

Inflation rose to 7.8% (6.9% underlying) in Q4 and remains broad-based.

The Q4 CPI surprised slightly to the upside, with large price rises in the quarter for domestic travel and accommodation (up 13% q/q, 4/.1% seasonally adjusted). That said, price pressures remain broad with around ¾ of the CPI basket annualising to above 3%. Both tradables and non-tradables inflation are elevated as are both goods and services inflation – signalling that there are indeed growing domestic pressures.

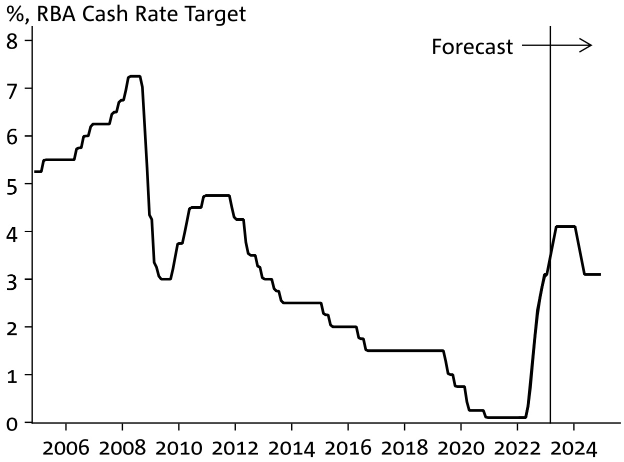
There were early, but encouraging signs that some price pressures are beginning to ease, with a fall in fruit & vegetables reversing some of the earlier price rises and a slowing in new dwelling construction costs.

We see inflation moderating relatively quickly through 2023, tracking at 4.3% y/y by Q4 before easing back into the target band by end 2024. For us, the big risk factor will be whether wage growth is contained to around 4% or less given the added uncertainty of an exceptionally tight labour market. Goods prices may well correct as demand cools and discounting emerges.

We see the AUD/USD rising to around US78c by end 2023 and US80c by end 2024.

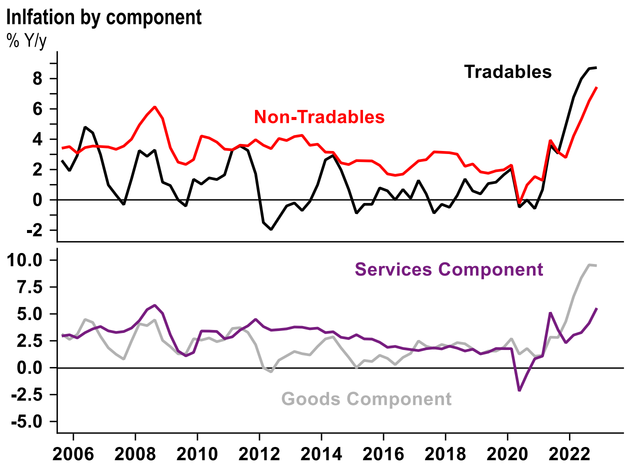
This view is largely predicated on a longer-term depreciation of the USD while a reopening in China is a positive for global commodity demand.

Chart 15: Cash rate expected to rise to 4.1% by May



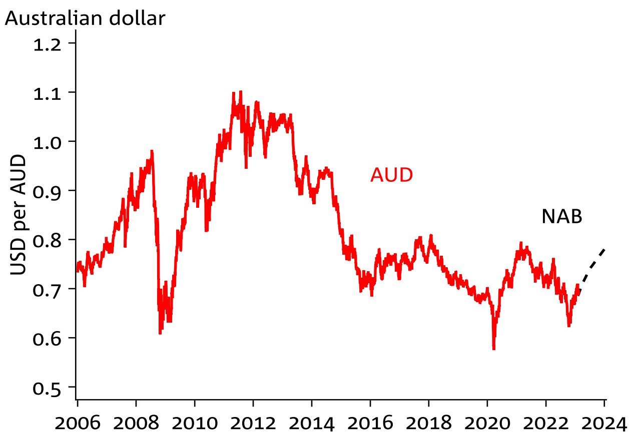
Source: Macrobond, NAB Economics

Chart 16: Inflation is high and broad-based



Source: National Australia Bank, Australian Bureau of Statistics

Chart 17: AUD/USD to drift higher over coming years, reaching US80c by end 2024.



Source: National Australia Bank, Macrobond Financial AB

Theme of the Month: The RBA Forecasts and Monetary Policy

The February SMP includes a new set of staff forecasts, that include a higher track for inflation in the near term but broadly unchanged activity and labour market forecasts. The RBA remains more optimistic on growth and the labour market than we do but shares a similar inflation outlook.

The RBA sees GDP growth of 1.6% during both 2023 and 2024 (NAB: 0.7 and 0.9%) – an unchanged view from the November SMP. Consumption (around 60% of GDP) is expected to grow by 1.6% in 2023 and a broadly similar 1.8% in 2024. Business investment is forecast to see moderate growth of around 3.7% and 3.0% in each year, respectively. Dwelling investment is expected to be a key detractor from growth, falling 1.3% in 2023 and a further 5.7% in 2024, while government spending is expected to stay high, but not rise further from here. On trade, the RBA expects the rise in imports to outpace the lift in exports in 2023, which would see net exports make a small subtraction from growth before a more neutral contribution in 2024.

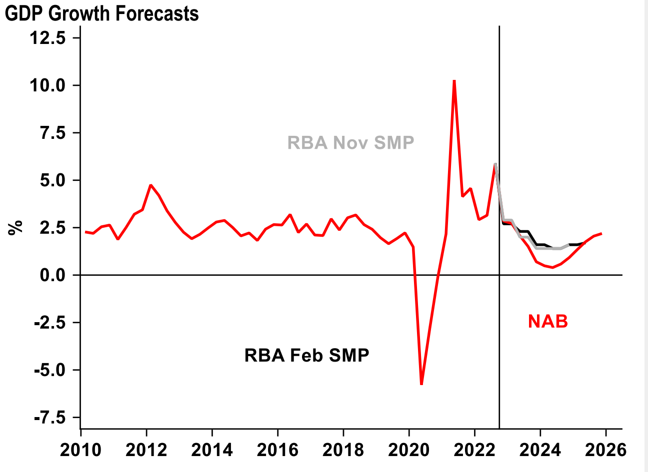
On the labour market, the RBA sees unemployment rising to 3.8% by the end of this year and to 4.3% by end 2024 (NAB: 4% and 4.7%). Importantly, like us, the RBA continues to see growth in labour demand remain positive, with employment rising 1.5% this year and 1.0% in 2024. Therefore, the rise in the unemployment rate is mostly a result of slowing labour demand being unable to meet the rise in labour supply, driven by a rebound in population growth rather than an outright fall in employment.

Wage growth has been revised higher by 0.1-0.3ppts y/y across 2023 and 2024, with growth in the WPI now expected to peak at around 4.2% in late 2023. That said, the RBA expects wage growth to remain relatively strong at 4.0% for most of 2024 given unemployment is forecast to remain at or below a level consistent with full employment – around 4.25% over that time.

For inflation, the near-term outlook was revised higher on the back of a stronger than expected Q4 CPI. Trimmed mean inflation is now expected to be tracking at 4.3% by end 2023 (was 3.8%) while forecasts for end 2024 are broadly unchanged at 3.0% y/y (NAB: 4.5% and 3.0%).

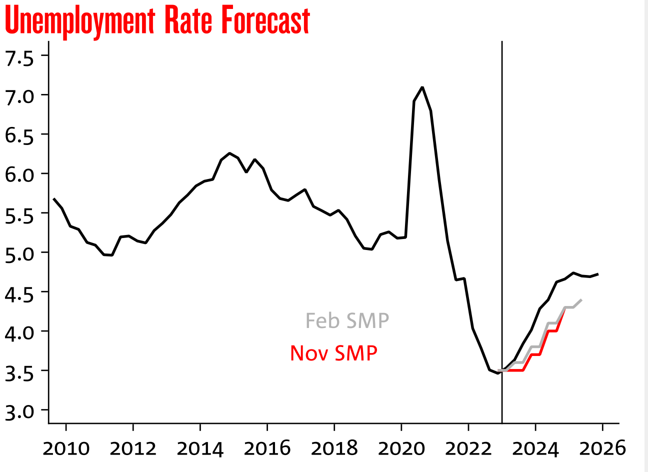
Importantly, underlying the RBA forecasts is a technical assumption for interest rates based on market pricing and market economist expectations. At the time of the RBA board meeting in February, these measures likely incorporated a cash rate peak of 3.5-3.75% in 2023 and some degree of easing through 2024.

Chart 18: GDP Growth Forecasts



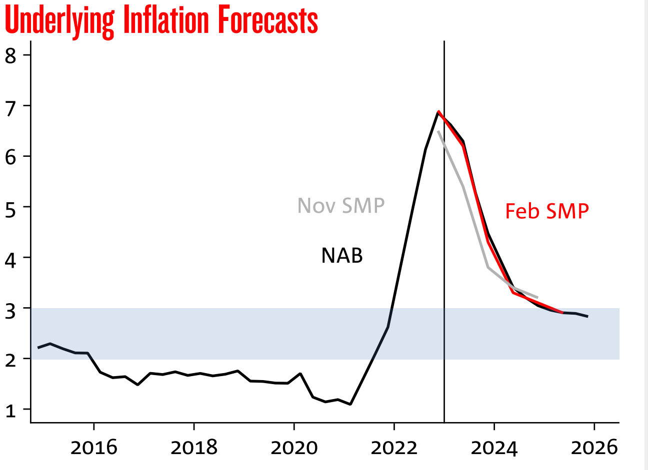
Source: ABS, National Australia Bank

Chart 19: Unemployment Rate Forecasts



Source: ABS, National Australia Bank

Chart 20: Inflation Forecasts



Source: ABS, National Australia Bank

Therefore, while the RBA forecasts for growth and the labour market are more benign than ours, the difference in part reflects a higher cash rate view (on our part) – and how consumers react to a world of sharply reduced cash flow at a time of falling housing prices.

That said, we also expect a larger consumer response to the impact of higher rates with much flatter outcomes for consumption through 2023 in particular – how this difference is resolved will be important not just for overall growth but for how quickly demand driven inflation moderates.

On risks, the RBA continues to reiterate the narrow path for policy and the economy in bringing inflation down. While the “narrow” path is framed in terms of risks – inflation becoming sticky and requiring a bigger policy response, or the impact of lags seeing a bigger than expected slowing – growth of 1.5% and unemployment rising to only 4.25% could be considered a “goldilocks” scenario.

The path could also be considered narrow should the RBA consider 2.5 years above target too long, especially if more evidence emerges that higher inflation is becoming entrenched. In such a scenario, the RBA could reasonably be expected to lift the cash rate higher and more quickly which would necessarily see a down grade to the activity and labour market forecasts.

Ultimately, the key swing factor for the activity forecasts (and with flow on impacts to inflation) is how consumer spending evolves through 2023. The household interest burden is rising rapidly, while high inflation continues to weigh on real incomes and consumer confidence has weakened significantly. We also know that the full impact of increasing rates to date is yet to flow through.

Key offsetting factors has been the ongoing normalisation in the household savings rate, the accumulated stock of excess savings built up through the pandemic (including mortgage buffers) as well as a strong labour market (offsetting some of the negative confidence impacts with ongoing expectations of healthy employment levels). House prices have also declined and will also weigh on consumption through wealth effects, but the declines to date have been small relative to the increase seen in prices since 2020.

Ultimately, how consumers respond in a behavioural sense will likely swamp many of these factors. How far they choose lower savings rates or consume buffers (as compared to banking the savings) will be important.

Key Domestic Forecasts:

	% Growth q/q				% Growth y/y			
	Q1-22	**Q2-22**	**Q3-22**	**Q4-22 (f)**	**2021**	**2022 (f)**	**2023 (f)**	**2024 (f)**
GDP and Components								
Private Consumption	1.8	2.1	1.1	0.5	3.5	5.6	-0.3	-0.3
Dwelling Investment	-0.5	-3.1	1.0	0.7	6.3	-1.9	0.0	-2.9
Underlying Business Investment	1.0	2.1	0.8	-0.1	8.2	3.8	-0.9	-2.1
Underlying Public Final Demand	2.6	0.4	-0.6	0.7	5.5	3.1	2.2	2.0
Domestic Demand	**1.7**	**1.0**	**0.6**	**0.4**	**5.2**	**3.8**	**0.1**	**0.2**
Stocks (Cont. to GDP)	0.5	-0.9	0.4	-0.5	0.4	0.3	-0.6	0.0
Gross National Expenditure	**2.5**	**0.0**	**0.8**	**-0.1**	**5.8**	**3.2**	**0.0**	**0.3**
Exports	-0.9	5.3	2.7	3.0	-2.4	10.3	2.7	2.3
Imports	11.5	1.4	3.9	-2.8	1.9	14.3	-0.4	-0.5
Net Export (Cont. to GDP)	-2.2	0.8	-0.2	1.2	-0.9	-0.3	0.7	0.6
Real GDP	**0.4**	**0.9**	**0.6**	**0.9**	**4.6**	**2.8**	**0.7**	**0.9**
Nominal GDP	4.1	4.1	0.8	1.9	10.3	11.2	3.1	3.9
External Account								
Current Account Balance ($b)	50.7	46.4	24.0	18.9	68.1	18.9	2.6	3.1
Current Account Balance (% of GDP)	2.3	2.0	1.0	0.8	3.1	0.8	0.1	0.1
Terms of Trade	8.2	4.8	-6.7	-1.6	9.0	4.2	-6.6	1.0
Labour Market								
Employment	2.1	1.1	0.7	0.7	2.4	4.8	1.1	0.7
Unemployment Rate (End of Period)	4.0	3.8	3.5	3.5	4.7	3.5	4.0	4.7
Ave. Earnings (Nat. Accts. Basis)	-0.3	1.6	2.5	1.0	3.1	4.8	4.0	3.6
Wage Price Index (WPI)	0.7	0.8	1.0	1.0	2.3	3.5	4.0	3.6
Prices and Rates (end of period)	**Year-ended**							
Headline CPI	5.1	6.1	7.3	7.8	3.5	7.8	4.4	2.9
Trimmed-mean CPI	3.8	5.0	6.1	6.9	2.6	6.9	4.5	3.0
RBA Cash Rate	0.10	0.85	2.35	3.10	0.10	3.10	4.10	3.10
10 Year Govt. Bonds	2.79	3.69	3.96	4.04	1.68	4.04	3.65	3.50
$A/US cents	0.75	0.69	0.65	0.68	0.73	0.68	0.78	0.80

Data are percentage growth rates over the quarter or year as noted, except where specified otherwise.

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Important notice