Embargoed until 11:30am AEDT, 21 March 2023

The Forward View: Australia Mar-2023

Australia passing through a possible turning point

NAB Group Economics

Overview

- Our forecasts for the economy are broadly unchanged this month. Following a relatively healthy outcome for growth of 2.7% over 2022 – which saw GDP rise 7.2% above its pre-COVID level – we expect growth to slow sharply to 0.7% in 2023 and 0.9% in 2024, well below trend.
- Slower growth should see labour demand growth soften and the unemployment rate drift up to around 4.7% over the next two years. While the labour market is currently tight, and wage growth is likely to accelerate to around 4%, the rise in the unemployment rate will eventually see an easing in wage growth.
- Inflation is expected to continue to moderate over the next two years – but only reach the top of the RBA's target band by late 2024. Wage growth and other domestic pressures will increase in importance as global factors wane. For now, despite the tight labour market, wage growth and broader labour cost measures do not look inconsistent with at target inflation. Inflation expectations will continue to be a risk as inflation remains high.
- We still expect the RBA to lift rates at each of the next two meetings, taking the cash rate to 4.1%, and holding there until cutting in early 2024. There is some near-term downside risk to this view with the RBA becoming increasingly data dependent as it nears the peak.
- The economy is now entering a more challenging phase, but it does so from a position of strength. Activity has recovered strongly, and the labour market is still very tight. Our business survey and official labour market data suggest that the economy has remained resilient through the early part of 2023.
- Uncertainty remains elevated. How quickly inflation moderates is a key unknown, as domestic pressures – including wage and rents growth continue to build. On the other hand, the full impact of the rapid tightening in monetary policy is yet to be seen, and there is a risk that activity could slow more sharply than expected.
- These risks are common across many advanced economies. With inflation remaining sticky and central banks moving further into restrictive territory volatility remains high. This is highlighted by the recent ructions in the US banking sector and at Credit Suisse – with potential spillovers for Australia via lending conditions and confidence.

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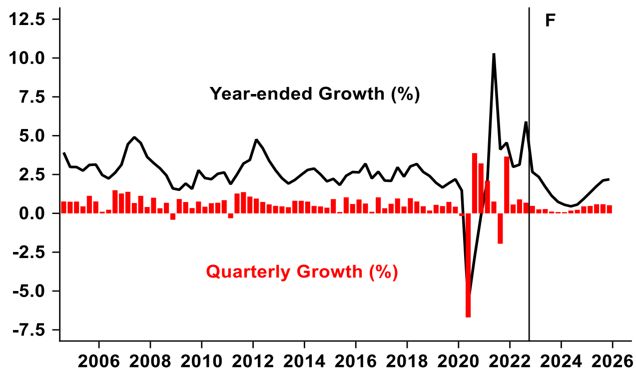
Key Economic Forecasts

	2022-F	2023-F	2024-F	2025-F
Domestic Demand (a)	4.9	0.7	-0.2	1.7
Real GDP (annual average)	**3.7**	**1.5**	**0.6**	**1.9**
Real GDP (year-ended to Dec)	**2.7**	**0.7**	**0.9**	**2.2**
Terms of Trade (a)	6.0	-4.4	-2.8	-1.1
Employment (a)	4.0	1.9	0.7	1.4
Unemployment Rate (b)	3.5	4.0	4.7	4.7
Headline CPI (b)	7.8	4.7	2.9	2.7
Core CPI (b)	6.3	4.7	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

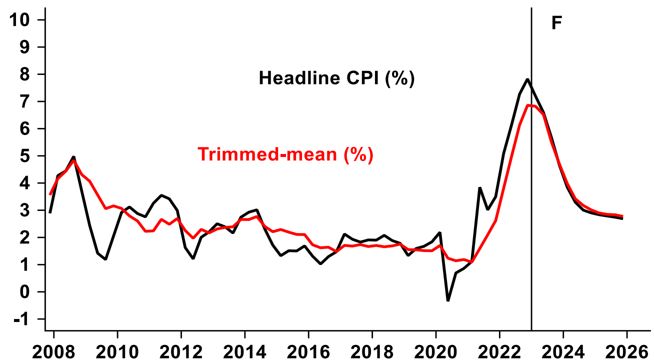
(a) annual average growth, (b) end-period, (c) through the year inflation

Chart 1: GDP forecasts



Source: Macrobond, NAB Economics

Chart 2: CPI forecasts



Source: Macrobond, NAB Economics

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Labour Market and Wages

As expected, employment rebounded strongly in February and the labour market remains very tight as a result. Wage growth continues to pick up although the Q4 WPI print tempered concerns about wage growth becoming unsustainable.

Employment rose by 65k in February, unwinding softer prints in December and January which were in part affected by unusual seasonal effects. The rebound was accompanied by an uptick in participation and was enough to drive the unemployment rate back down to 3.5% - a level around which the labour market has oscillated since mid-2022.

There have been some signs of modest moderation in labour demand, including a decline in the SEEK job ads measure, but most indicators remain elevated. The next ABS job vacancies release, due later in March, will provide a more comprehensive picture alongside data on labour constraints in the next NAB Quarterly Business Survey.

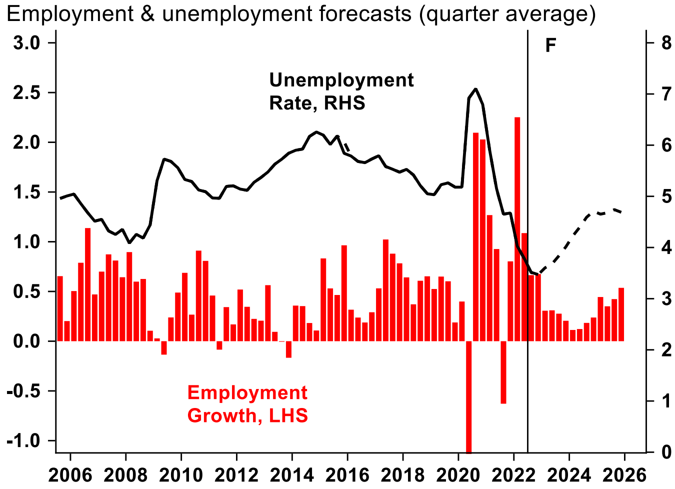
At the same time, the latest ABS population estimates – now available to Q3 2022 – confirm that a significant rebound in population growth is underway with net migration rising strongly. The population grew 1.6% over the year to September and quarterly population growth is running at an elevated 0.5% q/q. While there is a long way to go to close the 'population gap' that opened during the pandemic, the pickup is likely helping to address some labour shortages.

We expect population growth to continue to outstrip employment growth as the economy slows, with the unemployment rate likely rising to around 4% by end-2023 and 4¾% by late-2024 and through 2025. Importantly, this would still be below pre-COVID levels and would likely not see any outright falls in the level of employment.

The very tight labour market is supporting wage growth, with the WPI rising to 3.3% y/y (its highest rate since 2013). However, the 0.8% q/q was slightly below expectations and showed an easing in momentum. Labour cost measures in the Q4 national accounts paint a similar picture: average compensation per employee rose by 1% (down from 2.5% in Q3) and hourly compensation rose just 0.4%, while real unit labour costs were basically flat. Together, these results show that wage growth is indeed stronger than pre-pandemic, but that a tight labour market and high capacity utilisation have not pushed wage growth to excessive levels.

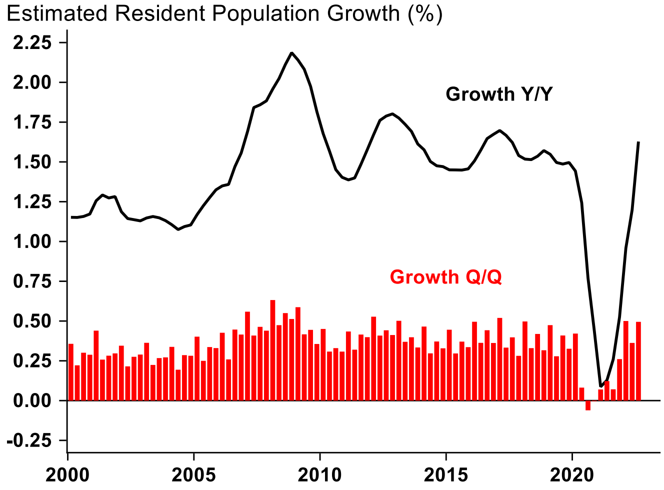
Our expectation remains for wage growth to continue to pick up in 2023, with the WPI to rise 4% over the year – a rate not seen since prior to the GFC. Further out, wage pressure should moderate over the coming years as the current tightness in the labour market eases. A rate of hourly underlying wage growth in the mid-3% range by 2025 would represent a strong outcome, providing some real underlying wage growth to households after a period of real income declines due to elevated inflation.

Chart 3: Unemployment rate back to 3.5%, still expected to gradually rise to 4¾% in 2024



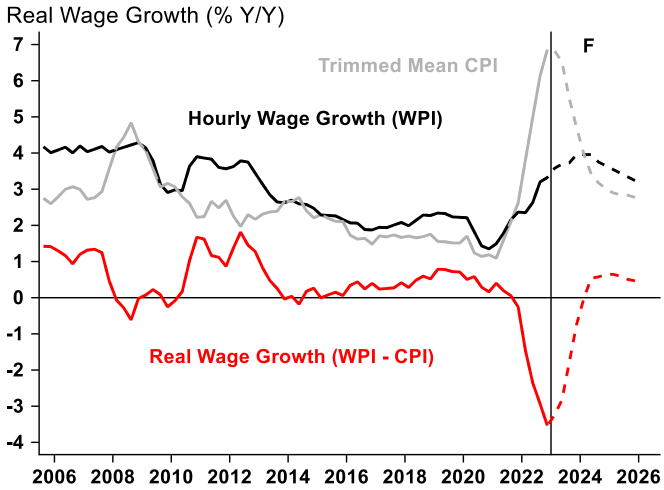
Source: Macrobond, NAB Economics

Chart 4: Strong migration has supported a rebound in population growth to above pre-pandemic rates



Source: Macrobond, NAB Economics

Chart 5: Wage growth now running at over 3% y/y but real wages are unlikely to be growing again for some time



Source: Macrobond, NAB Economics

Consumption and Savings

Household consumption rose 0.3% q/q in Q4 2022 – slightly below NAB's expectations – as consumption continued to rebalance from goods to services. NAB's internal data suggests consumer spending remained resilient through January and February in nominal terms but we continue to expect a more material slowing later in the year.

The Q4 consumption result in the national accounts release was the weakest quarterly outcome since the end of lockdowns. Still, both discretionary and non-discretionary spending rose in real terms, with the easing in growth largely reflecting the rebalancing of goods and services consumption.

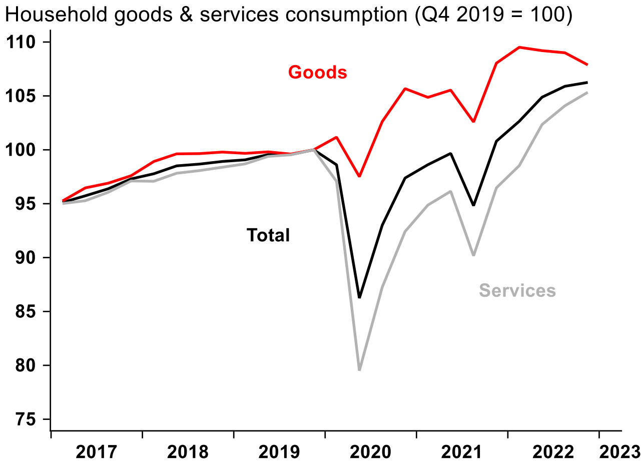
Goods consumption fell 1% in the quarter – from a high level – led by falls in discretionary items like clothing & footwear (down 2.7%) and household goods (down 1.2%). At the same time, services continued to recover, up 1.2% with growth in discretionary categories like hotels, cafes & restaurants (up 1.6%) and transport (up 5.7%), though recreation & culture consumption eased (down 1.4%).

The national accounts also showed the savings rate falling to 4.5% – around 2ppts below the pre-pandemic average after a protracted period of normalisation. The decline in the savings rate reflects the impact on real disposable incomes of inflation and higher interest payments. In aggregate, households still have a large stock of savings built up through the pandemic period, but these savings are not evenly distributed.

Higher frequency data suggest consumption has held up into 2023 in nominal terms, but may be approaching a turning point. Nominal retail sales rose 1.9% in January and NAB's internal transaction data – released in the *Monthly Data Insights* note last week – suggest nominal spending remained flat at around the same level through February. With prices still rising, these nominal data indicate another weak quarter of consumption growth in real terms but for now we continue to see a small positive for Q1 2023 overall, likely in the order of 0.2% q/q.

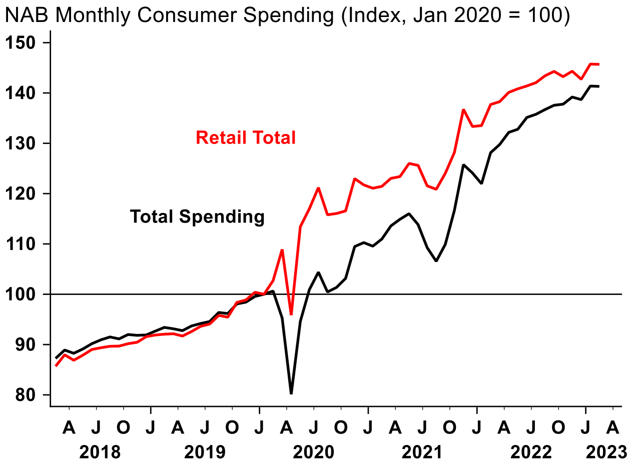
However, with rates expected to rise to 4.1% by May we continue to expect consumption to pull back further as the year goes on, with flat or negative real consumption growth through the second half of 2023 and into 2024. Considerable uncertainty remains around the outlook, including how savings behaviour evolves. A tight labour market is still supporting incomes and population growth is also strong, providing upward support for consumption for the time being. Further out, consumption growth should resume as rates normalise closer to neutral in 2024.

Chart 6: Goods consumption fell in Q4, while services consumption increased



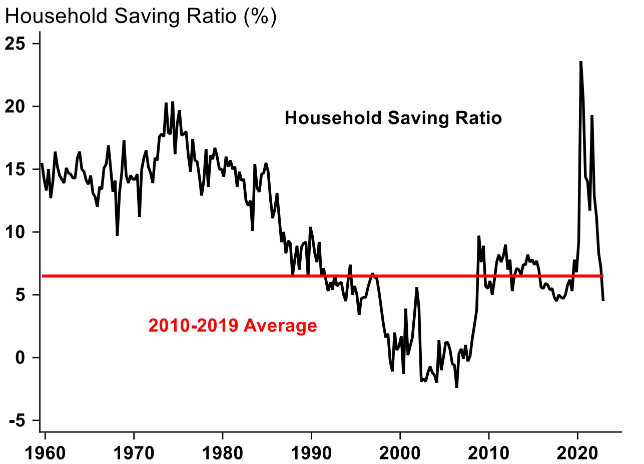
Source: Macrobond, NAB Economics

Chart 7: NAB's internal data show spending was broadly flat in February in nominal terms



Source: Macrobond, NAB Economics

Chart 8: The household savings ratio fell below its pre-pandemic level



Source: Macrobond, NAB Economics

Housing and Construction

House prices appear to have stabilised somewhat in early 2023 after declining by around 9% from their peak in early 2022. However, we continue to expect further declines alongside falls in housing construction through H2 2023 and early 2024.

The CoreLogic 8-Captial Cities index showed a decline of 0.1% in February while the PropTrack equivalent showed a 0.2% gain in the month. With the full impact of rates yet to fully flow through (and the RBA still hiking), the rough stabilisation in prices is somewhat surprising, especially in the context of the very sharp run up in recent years.

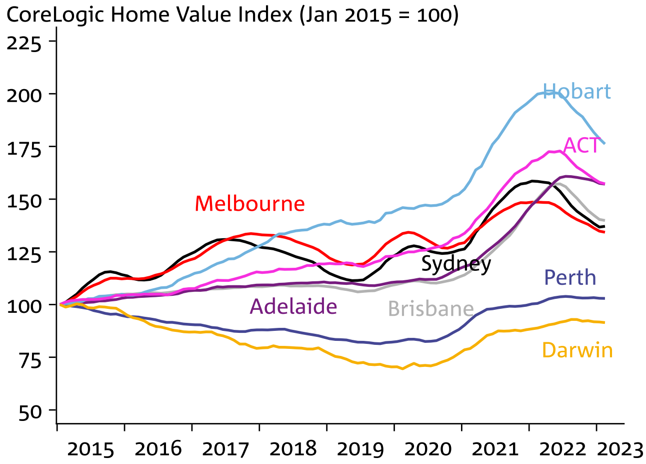
For now, we continue to see an ongoing price adjustment with the impact of rates to continue to flow through. The stabilisation in prices comes at a point in the year where seasonally prices are usually higher, and volumes have dropped away significantly. However, eventually turnover will need to rise and we will likely see a greater adjustment in prices with the rapid increase in rates to date seeing borrowing power decline by above 25%.

That said, a key support at present in the housing market is the rapid recovery in population growth. This has contributed to a sharp tightening in the rental market where vacancy rates have fallen to around or below 1% in most cities. Rents growth is now tracking at around 11% y/y in aggregate across the capitals. The strong rental market, strong population growth and a healthy labour market are all likely offsetting some of pressure from reduced borrowing capacity. This is also consistent with the fact that only around 10% of borrowers take their maximum available loan size.

That said, approvals for new borrowing have declined sharply. Loan approvals fell 5.3% in the month and are now 35% lower than a year ago. Average loan size has held broadly stable reflecting the fact that the fall in new lending has come about largely as a result of falling turnover rather than the decline in the value of properties. Lending for new construction fell 8.9% in the month, while borrowing for newly erected dwellings also fell further, down 7.3%.

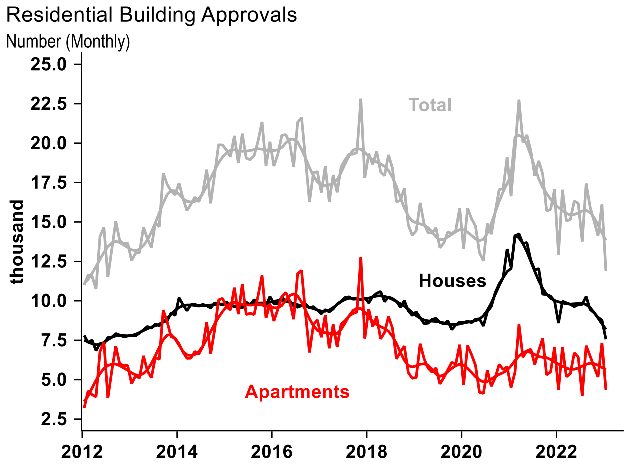
The supply side of the housing market also looks increasingly challenging. Building approvals continued to decline in January (falling 27% m/m) and are now at their lowest level since 2012. While the stock of work yet to be done remains relatively high (around 275k dwellings), work done also remains elevated and therefore the pipeline of work will be rapidly eroded if new approvals remain low. Assuming household sizes remain unchanged, the most recent population data implies the need for around 160k new dwellings annually compared with a current but declining completion run rate of about 170k annually.

Chart 9: House price falls have slowed in early 2023



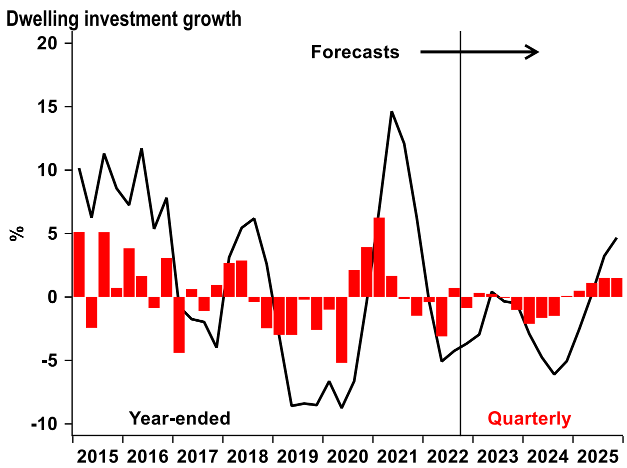
Source: National Australia Bank, CoreLogic, Macrobond

Chart 10: Building approvals have fallen sharply



Source: Macrobond, NAB Economics

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 remained strong in February, although confidence fell into negative territory. With rising rates and ongoing uncertainty, investment is likely to remain subdued.

Business conditions in the NAB Monthly Business Survey edged down 1pt in February to +17 index points, still a very strong level in the history of the survey. At the same time, confidence fell 10pts to -4 index points, with the fall driven by wholesale, recreation & personal services, and finance, business & property. Business confidence is now clearly below average after trending down since mid-2022, signalling that businesses are increasingly pessimistic about the outlook – despite conditions remaining robust.

Capacity utilisation remains elevated and while input cost growth has eased since the mid-2022 peak, it remains high, with purchase cost growth running at 3.1% in quarterly terms and labour costs at 2.8%. Price growth also remains elevated, although retail price inflation was lower in February.

We expect ongoing elevated uncertainty and the expectations of a slowing economy to weigh on business investment. This will have implications for business credit growth, which has slowed considerably since mid-2022 after very strong growth during the pandemic.

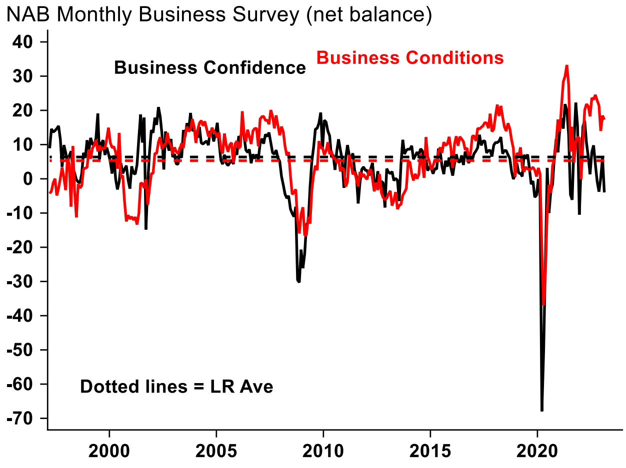
As expected, net exports made a large positive contribution to GDP in Q4 2022, reflecting both increased exports and a fall in imports. While volatility is likely in the short term, easing consumption will likely weigh on imports in 2023 as exports continue to recover.

Net exports added a large 1.1 ppts to quarterly GDP growth. Exports increased 1.1% q/q mainly due to a 2.5% increase in resources exports (after Q3 was affected by port disruptions) and travel credits (tourism, overseas students). The latter increased 18.9% q/q but remains 40% below its pre-COVID level. There was a large fall in non-monetary gold exports but the impact of this looks to have been partially offset by a resulting rise in public inventories.

The 4.3% q/q fall in imports was broad based. This included a 6.2% q/q fall in travel debits – which the ABS attributed to a preference for cheaper, short-haul destinations, ending a run of very large increases – and it is almost 50% below its pre-COVID level.

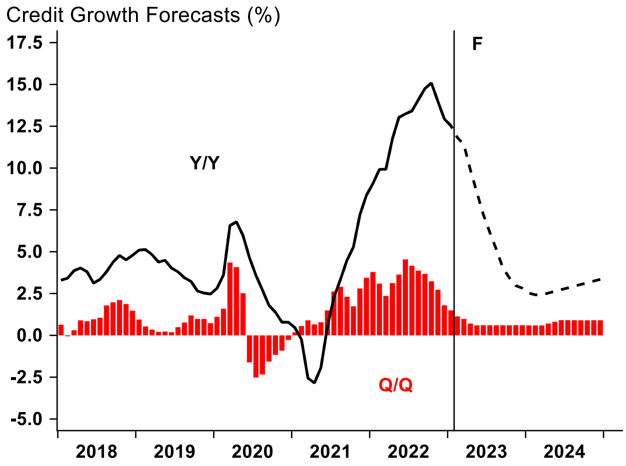
We continue to expect net exports to provide some support for growth across 2023 as global trade in goods and services normalises and exports recover, while the expected slowdown in consumption growth will likely weigh on imports.

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



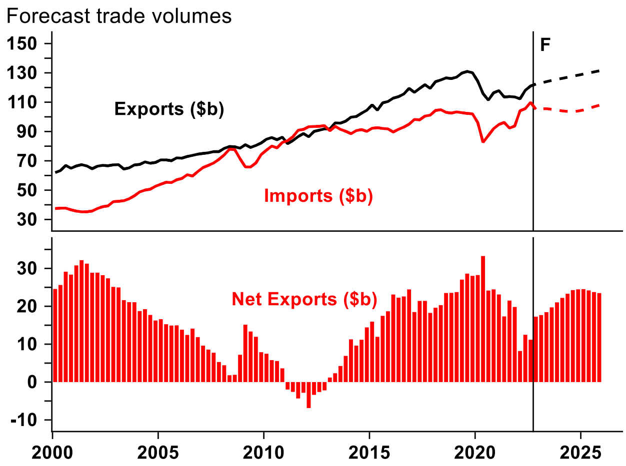
Source: Macrobond, NAB Economics

Chart 13: Business credit growth has slowed over recent months to below 2% q/q



Source: Macrobond, NAB Economics

Chart 14: Net exports contributed 1.1 ppts to GDP growth in Q4, and should continue to provide support



Source: Macrobond, NAB Economics

Monetary Policy, Inflation and FX

The RBA lifted the cash rate to 3.6% in March – its 10th consecutive increase but turned dovish following a weaker string of data prints – particularly the WPI and national accounts measures of labour costs.

This followed the hawkish tone in both post meeting statement for February and the Governor's appearances before the parliament which followed the stronger than expected Q4 CPI and the strong WPI print and higher forecasts for near-term inflation in the February SMP.

The RBA remains committed to bringing inflation down but continues to walk a narrow path, with global pressures easing while domestic pressures build against a backdrop of a weaker outlook for growth and the labour market. It also remains cognizant of lagged impact of the very significant increase in rates to date and as it nears the peak in rates, decisions will become increasingly data dependent while it assesses in real time the impact of the rapid tightening in policy to date.

We continue to see the RBA lifting the cash rate to 4.1% - increasing the cash rate by 25bps at each of the next two meetings. From there we expect the RBA to remain on hold as it assesses the flow through of interest rates to the economy. Ultimately our forecasts see growth slowing sharply, inflation returning to the band by end 2024 and unemployment rising relatively quickly. This will keep the RBA on hold until early 2024 before they begin easing policy back towards neutral.

Inflation looks to have peaked in Q4 but price pressures picked up in our Monthly Business Survey and there is still considerable uncertainty about how quickly inflation will moderate.

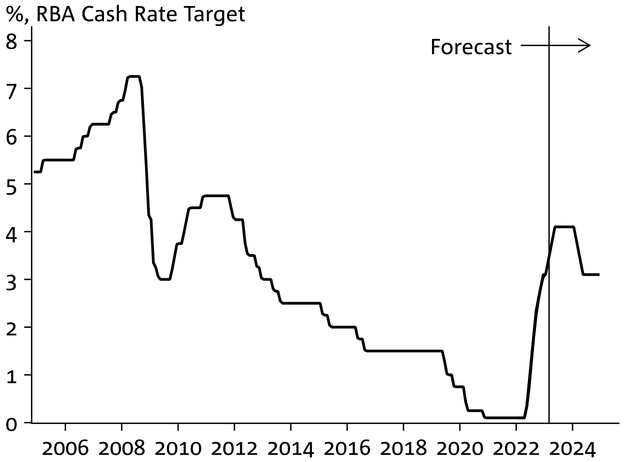
Many partial indicators of upstream price pressures have continued to ease or have almost fully recovered. Headline freight costs have recovered their pre covid levels, global measures of supply chain indices and supplier delivery times have improved. Commodity prices have broadly levelled out (but remain high).

The easing in global pressure should continue to flow through to domestic prices, though the speed and timing remains uncertain. That said, the monthly CPI indicator already points to an easing from the peak in Q4. More importantly, domestic wage pressure, while stronger than pre-pandemic does not look inconsistent with "at-target" inflation. Whether this remains the case amidst a still tight labour market and the risk of higher inflation expectations will be important going forward.

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

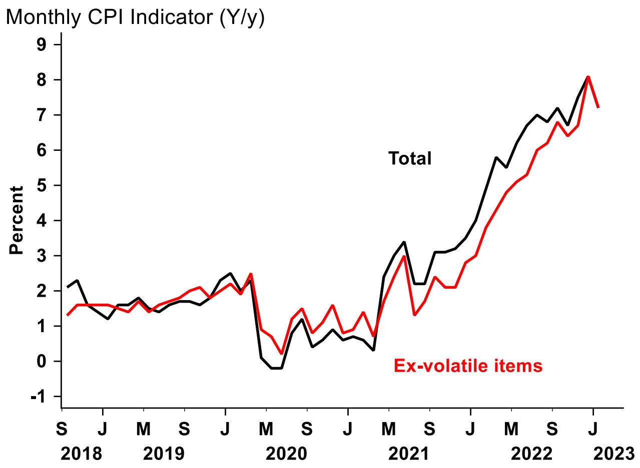
Our view on the exchange rate is broadly unchanged, expecting it to trade around US66c-68c in the near term before rising as US dollar weakens on the back of a softer economy in the back end of 2023.

Chart 15: Cash rate expected to rise to 4.1% by May and stay there through H2 2023.



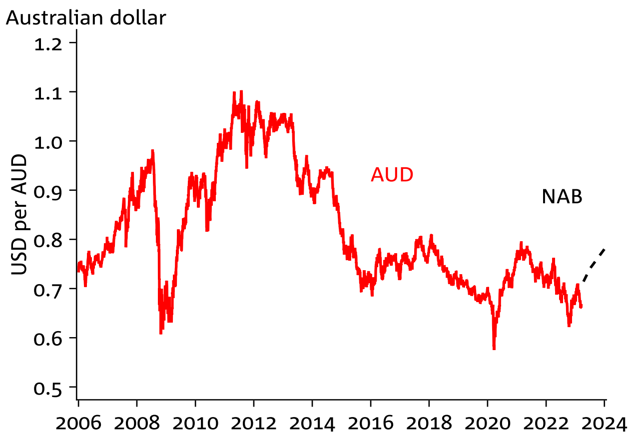
Source: Macrobond, NAB Economics

Chart 16: Inflation looks to have peaked in December



Source: ABS

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: Risks of Transmission from SVB and Credit Suisse

The collapse of Silicon Valley Bank (SVB) and Signature Bank, and issues around Credit Suisse, have generated significant volatility in financial markets. However, it remains unclear how these events will affect the real economy, both in the US and Australia. There are a number of potential transmission mechanisms, although for now the likely flow-through to the Australian economy appears limited.

The most direct impacts from the US two bank failures are on these banks' depositors (as well as creditors). Importantly, the Federal Deposit Insurance Corporation has responded quickly by guaranteeing all deposits at the two banks and thereby significantly limiting the damage. The size of Credit Suisse raises more significant concerns for the global banking system, but regulators have again acted swiftly to provide liquidity and shore up operations through the sale to UBS.

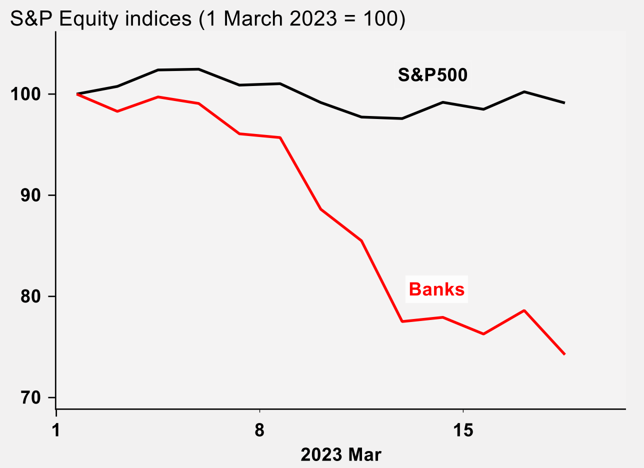
The events of recent weeks are also likely to lead to a tightening in financial conditions more broadly as lenders reduce their appetite for risk. This is likely to result in increased borrowing costs and reduced credit flows which will have implications for the global economy. While hard to quantify, it reinforces our view that the major advanced economy growth will see weak growth, if not a downturn.

Importantly, the central driver of the collapse of SVB was a loss of confidence in the Bank's operations, and the spectre of financial crisis evoked by these events is likely to have a more general impact on both business and consumer confidence in the US and around the world. With business confidence declining and consumer confidence already at very low levels in Australia due to elevated inflation and rising interest rates, the additional effect of the SVB collapse is difficult to predict.

Finally, there has been considerable debate about the effects of these events on the outlook for monetary policy. Given the role that rapidly rising interest rates played in SVB's liquidity crunch, and the tightening in financial conditions that the banking problems have triggered, central banks may assess that the room for further interest rate increases is more limited than previously thought. However, given that other tools are available to support the financial sector, including liquidity facilities and guarantee arrangements, central banks are unlikely to see a direct trade-off between tackling inflation and maintaining financial stability

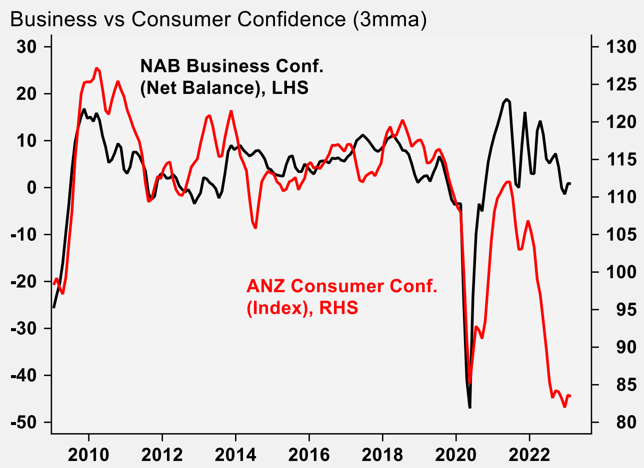
Any tightening in financial conditions would reduce the extent to which rates need to rise to curtail inflation. However, in the absence of further shocks it is likely that central banks will see the risks from inflation as remaining too great to leave rates at their present level. As such, we continue to expect the US federal funds rate to rise to 5-5.25% by May, and likewise continue to see the Australian cash rate rising to a peak of 4.1% in May.

Chart 18: US bank stocks have declined in response to the SVB and Signature Bank failures



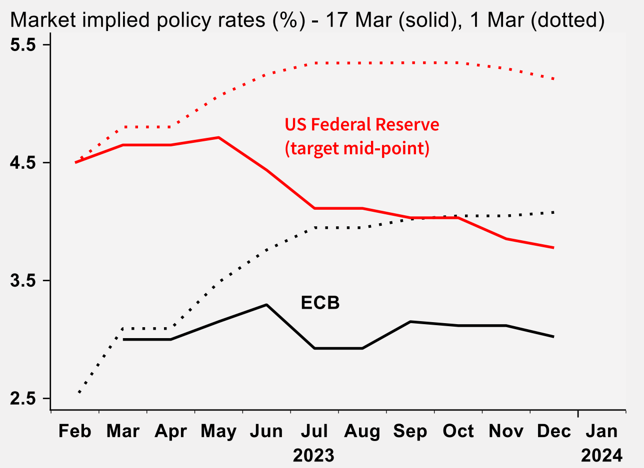
Source: Macrobond, NAB Economics

Chart 19: Business confidence was already declining and consumer confidence is very low in Australia



Source: Macrobond, NAB Economics

Chart 20: Market pricing of interest rates overseas have declined significantly



Source: Macrobond, NAB Economics

Key Domestic Forecasts:

	% Growth q/q				% Growth y/y			
	Q1-23 (f)	**Q2-23 (f)**	**Q3-23 (f)**	**Q4-23 (f)**	**2022**	**2023 (f)**	**2024 (f)**	**2025 (f)**
GDP and Components								
Private Consumption	0.3	0.2	-0.2	-0.3	5.4	-0.1	-0.3	2.2
Dwelling Investment	0.3	0.3	-0.1	-1.0	-3.7	-0.5	-5.1	4.7
Underlying Business Investment	-1.0	-1.0	-0.7	-0.5	3.5	-3.1	-2.2	2.5
Underlying Public Final Demand	0.7	0.5	0.5	0.5	2.5	2.2	2.0	2.0
Domestic Demand	**0.2**	**0.1**	**-0.1**	**-0.1**	**3.3**	**0.1**	**0.2**	**2.4**
Stocks (Cont. to GDP)	0.0	0.0	0.0	0.0	0.4	-0.4	0.0	0.2
Gross National Expenditure	**0.2**	**0.1**	**-0.1**	**-0.2**	**3.2**	**0.1**	**0.3**	**2.5**
Exports	0.6	0.7	0.7	0.6	7.7	2.7	2.2	2.3
Imports	0.3	0.1	-0.4	-0.5	12.1	-0.5	-0.6	3.8
Net Export (Cont. to GDP)	0.1	0.1	0.2	0.2	-0.5	0.7	0.6	-0.2
Real GDP	**0.3**	**0.3**	**0.1**	**0.1**	**2.7**	**0.7**	**0.9**	**2.2**
Nominal GDP	1.4	1.2	0.4	0.4	12.0	3.4	3.9	4.2
External Account								
Current Account Balance ($b)	39.6	41.1	50.1	44.1	29.4	44.1	47.6	46.6
Current Account Balance (% of GDP)	1.6	1.6	1.9	1.7	1.2	1.7	1.8	1.7
Terms of Trade	-0.4	-0.8	-2.8	-2.1	7.2	-6.0	1.0	-2.5
Labour Market								
Employment	0.3	0.3	0.3	0.2	4.8	1.1	0.7	1.8
Unemployment Rate (End of Period)	3.6	3.7	3.8	4.0	3.5	4.0	4.7	4.7
Ave. Earnings (Nat. Accts. Basis)	0.9	0.9	1.1	1.0	4.4	4.0	3.6	3.2
Wage Price Index (WPI)	0.9	0.9	1.1	1.0	3.3	4.0	3.6	3.2
Prices and Rates (end of period)	**Year-ended**							
Headline CPI	7.2	6.6	5.7	4.7	7.8	4.7	2.9	2.7
Trimmed-mean CPI	6.8	6.5	5.5	4.7	6.9	4.7	3.0	2.8
RBA Cash Rate	3.60	4.10	4.10	4.10	3.10	4.10	3.10	3.10
10 Year Govt. Bonds	3.75	3.85	3.85	3.65	4.04	3.65	3.50	3.55
$A/US cents	0.71	0.74	0.76	0.78	0.68	0.78	0.80	0.77

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

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Important notice