Overview

**KEY ISSUES**

1. Inflation is accelerating, putting pressure on the cost of living
2. Further tightening in the labour market
3. Limited spare capacity in the economy poses a challenge to newly elected government

**RISKS TO THE OUTLOOK**

4. Emergence of a new COVID variant
5. Faster pace of rate rises to combat inflation
6. Potential for an economic slowdown in medium term
7. Uncertain recovery in migration and services exports
8. Population permanently smaller and older post-COVID

**Economy weathering inflation storm**

Headline inflation in the March 2022 quarter was 5.1 percent over the year, faster than previously anticipated. Global supply shocks and strong domestic demand have combined to generate cost pressures that are now being passed on, with significant price rises seen in fuel, food, durables and new dwelling construction (raw materials).

Growth in household consumption and government spending remains robust. Recent floods and supply chain challenges have however, dampened business investment and residential construction activity. Overall, GDP still increased by 0.8 percent in the first quarter of 2022. Inflation is forecast to average 6.4 percent and GDP expand by 3.6 percent in 2022.

The Russian invasion of Ukraine has affected both Russian and Ukrainian exports of oil, gas, metals, food and intermediate inputs. This has led to a surge in food and fuel prices globally, and we expect the sanctions imposed on Russia to remain in place for some time, implying that the economic shocks will take time to unwind.
Second, lockdowns in China in pursuit of zero COVID-19 cases have constrained economic activity, particularly in the manufacturing sector. Global supply chains have been impacted by these ongoing restrictions, and while lockdowns have been loosened it will take time for production and supply chains to normalise (and so price pressures to ease). There is also an ongoing risk of future outbreaks and lockdowns.

Limited spare capacity in labour market

The latest data continues to confirm that there is very little spare capacity left in the labour market. The participation rate is at a high of 66.7 percent, while the unemployment and underemployment rates continue to trend down. Concurrently, the number of job vacancies has been trending up, with only 1.3 unemployed persons per job vacancy in the most recent data.

Monetary conditions tightening around the world

The combination of fiscal stimulus packages and pent-up demand as a result of COVID-19 has created significant demand pressures. Central banks around the world have begun tightening monetary conditions rapidly to manage further robust growth in demand in the presence of continued supply constraints.

Interest rates in the US, UK and Canada have already been raised several times since the start of the year. In Australia, the RBA have now taken a hawkish stance, with a cumulative 0.75 percent points in hikes in the last two meetings. Several more rate rises are anticipated, with the cash rate expected to reach 2 percent by end of 2022.

Climate change moving up the agenda after Federal election

Climate change was a key issue in the recent Federal election, with the incoming government committing to reduce carbon emissions by 43 percent relative to 2005 levels by 2030. While the incoming government anticipates that this will create 604,000 jobs and generate $52 billion in private investment, a more pressing immediate concern is balancing the need to reduce fiscal stimulus (given the current position of the economy) against spending commitments from the election, including aged care and enhancing the childcare subsidy. The new government will need to tread carefully to avoid further overheating the economy.
Headwinds to growth building

Economy shook off Omicron in Q1

As the pandemic transitions to early-stage endemic, Australia’s GDP growth of 0.8 percent over Q1 highlights the positive impact of stimulus on economic activity; the economy is now 4.5 percent larger than it was in Q4 2019. The strength of demand and need for workers has also been put on show by the job mobility rate, which has risen to levels not observed since 2012; 9.5 percent (1.3 million people) changed jobs during the year ending February 2022.

Normalising interest rates and rising inflation are now dampening momentum, with supply chain disruptions and slower growth in the global economy putting a further drag on growth:

- Growth in household consumption is expected to ease but remain positive, underpinned by high levels of employment, rising wages and the relatively high savings rate, which are expected to provide a buffer against the mounting headwinds.
- Business investment rose 1.5 percent on the quarter, with increases in machinery and equipment and intellectual property products offsetting flood-related declines in non-dwelling construction. The ABS capex survey suggests businesses plan to raise spending further, but supply chain disruptions and availability of labour may limit the ability to deliver projects.
- Record pipelines of work courtesy of the HomeBuilder program will continue to support dwelling investment in the near term. But with flows into the pipeline easing and mortgage rates rising, the seasonally adjusted estimate for dwellings approved has seen a y/y fall of 32.4 percent since April 2021.
- Rising costs - the Cordell Construction Cost Index (CCCI) increased 7.1 percent in Q1 – and supply chain delays are also dampening construction activity.

Exports challenged by global environment

- The impact of the slowdown in China’s economy is now being felt by Australian exporters. After negligible growth in export volumes in Q1 (due mostly to weather and pandemic disruptions), the outlook remains subdued; while imports into China were broadly flat y/y in April, this was a sharp fall from the 14.2 percent increase seen in March.
- While recovering, Australia’s services exports remain well below pre-COVID levels, highlighting the challenging international environment; slower global growth momentum, China’s border closure and high fuel costs will be significant headwinds through 2022.
- Some offset to the drags above may come through agriculture exports, with the winter grain harvest breaking all previous records.
2023 set to be tougher than 2022

More rate rises to come, but pace expected to moderate in 2023

Supply constraints and elevated demand pressures are expected to persist through 2022. Headline inflation is forecast to peak above 7 percent, with more interest rate rises anticipated in response. However, as the cost of borrowing and living start to take hold, momentum in consumption and investment will slow. Despite this, growth in business investment is expected to remain relatively robust, as it recovers from its historically low share of GDP.

The tightness in the labour market is now driving an acceleration in wages growth; the Fair Work Commission’s 5.2 percent increase in the minimum wage and a step change in negotiated wage agreements will add further upward pressure. Despite this, consumer price inflation has continued to outstrip wages. Coupled with rising mortgage rates, the net effect will be a reduction in real disposable household income.

This will dampen growth momentum in consumption from late 2022 onwards, which is expected to flow through to business investment and ultimately GDP. Against this backdrop, we expect the RBA to sharply slow their pace of tightening in 2023.

And there is a risk that the RBA tightens policy too fast and by too much, resulting in a sharp slowdown in domestic demand that triggers a pause or reversal of some rate hikes.

New government facing short and long term challenges

Similar to most other developed economies, Australia is close to full employment. With very little spare capacity remaining, any new economic initiatives could further exacerbate inflationary pressures. Additionally, any new initiatives will quickly hit budget constraints.

The new government is also faced with longer term challenges, particularly the issue of low productivity growth and budget sustainability. Lifting female participation, resetting energy policy, and tackling tax reform and education outcomes could all help lift growth in the long run.
International conditions will be challenging for some time

**Fallout from Ukraine-Russia conflict to continue into 2023**

Economic ramifications from the invasion have spread internationally – mainly through global commodity prices and supply chain linkages, adding to the post-COVID supply pressures. Prices of energy, metals, and some agricultural products, particularly wheat, corn and fertiliser, have risen to new highs.

**World Energy and Agricultural Product Prices**

The war has added to global supply chain disruptions and pushed commodity prices to record highs

Futures markets suggest oil and gas prices will rise quickly in 2022 before supply adjustments trigger modest price declines in 2023. Food prices are also anticipated to rise sharply in 2022, with only a moderate correction in 2023. Supply chain shortages are likely to persist into 2023 in some critical sectors, such as semiconductor chips, which will further cascade downstream.

**Zero-COVID stance in China not yet shifting**

The Chinese government has continued its commitment to zero-COVID in response to recent COVID-19 outbreaks. The lockdown in Shanghai and logistics delays in parts of China have adversely impacted China’s economic growth and global good supplies as mobility restrictions weighed on consumer spending, manufacturing activity and movements through Chinese ports. The near-term outlook for China has become more uncertain and challenging, posing upside risks to inflation and downside risks to global growth. The effectiveness of recent stimulus is contingent on future outbreaks and restrictions.

**Recession concerns rising in North America & Europe**

Leading recession indicators in North America and Europe are increasingly signaling a future downturn, as rising interest rates combine with soaring inflation and limited savings buffers for households. Business sentiment in the US has deteriorated with many leaders concerned over recession risks as equity prices decline sharply.

**China, Industrial Production and PMI**

China’s industrial production has fallen sharply, and its manufacturing PMI remains in contractionary territory

While Europe is particularly vulnerable to the Ukraine war owing to its trade and financial linkages. A recession in these regions would radiate globally, through reduced import demand and asset price corrections.

**Overall exports likely to lag imports over next 12 months**

The mining sector has not yet responded to higher commodity prices with increased investment, with businesses judging that the current shocks are ultimately temporary in nature – this will limit any upside to export volumes. Services exports from overseas tourists and students are gradually recovering, but the challenging global environment means it is likely to be some time before activity returns to pre-COVID levels. In contrast, goods imports have risen sharply and services are also rebounding, which will make net exports a drag on growth over the near term.
Long run constrained by fundamentals

Broad determinants

In the long run, non-mining economic activity is constrained by Australia’s supply side capacity. This is determined by three broad factors:

- Labour supply, which is determined by population trends and the participation rate
- Physical capital stock, which is determined by business investment
- Productivity, which is driven by a number of factors including workforce education and skills, technology, the institutional environment, links with other countries etc.

Underpinned by a solid institutional and policy framework, market dynamics, and flexible labour market incentives, GDP has generally risen over time. The pace of growth has slowed over the last two decades, with both population growth and productivity gains moderating over time. But Australia has still outperformed most other developed economies through this period.

COVID’s impact on potential output

The Australian economy has proved resilient through the pandemic, when compared to the OECD group. The Omicron strain has had limited impact on output and employment, both of which are back above pre-pandemic levels; beyond the impact of the border closure, there are few signs of COVID having a permanent impact on labour supply and productivity. Nevertheless, the potential for new, more disruptive variants continues to pose a downside risk to the economy.

Forward view

Despite the relatively positive performance, the slow recovery in migration is threatening to put the brakes on growth momentum.

The arrivals and departures data suggests that the partial recovery in permanent migration inflows during Q1 has been heavily offset by outflows.

While it is not unexpected that inward flows are taking time to recover, Australia is also lagging behind other countries such as the UK and Canada, where net migration patterns have recovered (and even moved beyond) pre-COVID levels. A permanently lower trajectory for migration presents a downside risk to long run growth.

Although the slowdown in productivity growth is partly a global phenomenon (and is being exacerbated by heightened geopolitical tensions, which are further disrupting supply chain efficiencies), this trend has been broadly acknowledged for some time by both politicians and policymakers. There is therefore some upside risk to our forecast if the new government successfully pursue a reform agenda.
## Forecasts

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<td>Exports</td>
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<td>Headline CPI (%Y/Y)†</td>
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<td>Average earnings (%Y/Y)†</td>
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† End period
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