

# ECONOMIC UPDATE

PETER MUNCKTON – CHIEF ECONOMIST

WEEK ENDING 14<sup>TH</sup> JANUARY 2022



## Key points

- The Omicron wave has reduced both demand and supply in the economy;
- In the short-term this means modestly lower GDP growth. Over the longer term it is creating inflationary pressures;
- The Q4 CPI data will be an indicator as to how much global price rises are replicated in the domestic economy;
- COVID is the biggest risk to the economy. The next is rapid interest rate rises overseas to combat inflation.

## Summary

Lower demand and lower supply means that the economy is not growing as fast as it could. How much COVID impacts the economy for the remainder of this year is unknown. Governments' have shown they will tighten restrictions if they believe their health systems are coming under pressure. Consumer confidence about the health outlook will continue to play a large role on how the economy evolves.

Barring the arrival of a far more deadly variant, the main economic issue this year will be the mix of strong demand and problems with supply. Some of the supply problems is a direct result of the current Omicron wave. These supply problems should ease over the next month. COVID has also created longer-lasting supply problems as world production has struggled to catch-up to meet very high demand. Prior to the appearance of Omicron there were signs that these supply problems were starting to be reduced. But bottlenecks were still extremely elevated by historical standards, only worsened by the latest Omicron wave.

A bigger issue is the ongoing shortage of workers. Closed international (and state borders) is one factor, but so is the extremely high demand for employees. Monetary and fiscal policy is aimed at getting the unemployment rate lower. Worker shortages will remain an issue for this year.

Financial markets have become increasingly worried about inflation and the need for higher interest rates. Practically if inflation is towards the top end of the 2-3% target band and wages growth is rising to close to 3% that may be enough for the RBA to begin raising the cash rate. Financial market pricing is consistent with a first rate hike taking place by July. The overwhelming majority of economists expect a rate move by the end of the first half of 2023 (including me). A rising level of global rates means that if the RBA keeps the cash rate unchanged then in some respects it is easing monetary policy.

Currently financial markets expect the peak in the cash rate to be 2-2.25%. Some in financial markets think the peak in the cash rate might be just 1-1.5% reflecting the high level of household debt. But that cash rate level might be too low if the RBA is successful in raising inflation and wages growth. Borrowers' should be prepared for the possibility that the cash rate may peak above 2.5% in this cycle. Once the RBA decides to begin to increase the cash rate it is likely to raise rates to 1% quite quickly. The pace of rate rises is likely to slow above 1% given the uncertainty as to what the peak in the cash rate will be.

What might stop interest rates rising in Australia? Certainly the discovery of a more deadly variant would be close to the top of any list. Another is that interest rates in the US (and other countries) end up rising a lot quicker than anticipated to counter high inflation.

## There has been a big rise in cases

For a third year COVID will be the major factor driving economics. Cases are on the up in most states in Australia. And also in most countries. The optimists point to the recent decline in cases in London, New York and South Africa as a reason to expect that numbers will start to decline in Australia in coming weeks. Given the steep rise in cases at some stage that must be true although the level of existing COVID infection in the UK, US and South Africa countries is substantially higher than in Australia.

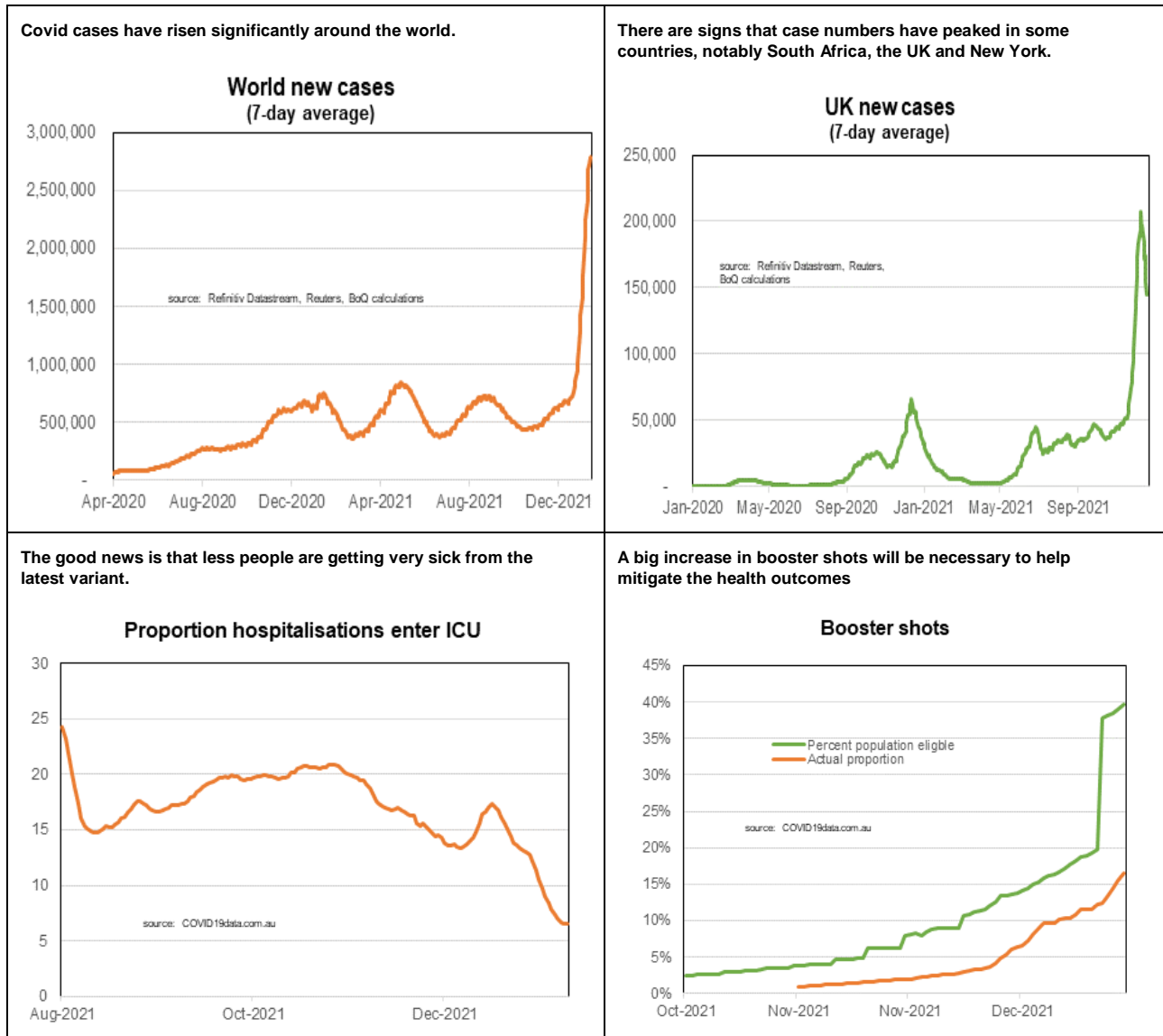
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The recent wave highlights the constraints for the economy to be able to return sustainably to 'normal' as COVID moves to become endemic. One is the capacity of the health system to deal with rising waves of the virus. Another is household reaction to news of rising case numbers.



## Economic growth has slowed

In the short term COVID has taken another chunk out of economic growth. There has been a substantial rise in the amount of time people are spending at home. Major bank data indicates a big fall in spending, particularly in Sydney and Melbourne. The increasing number of workers in quarantine is severely crimping the ability of the economy to supply goods and services. Inventories are being run down rapidly.

Barring another widespread lockdown (extremely unlikely) strong first quarter GDP growth (1.5-2%) is essentially locked in. The economy started the year with substantial momentum. And the general economy has become increasingly good at adjusting to the impact of COVID (although some sectors such as hospitality and Air Transport still find the going very tough).

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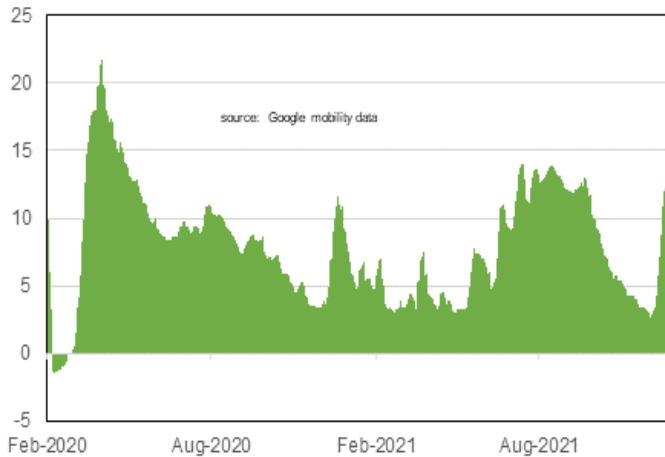
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The size of the economy remains below its pre-COVID peak.

**Time spent at home across Australia**  
(0 = Pre-COVID normal, 7-day average)



GDP per capita has just snuck back above its end-2019 level.

**Time spent at home by state**  
(0 = pre-COVID normal, 7-day average)



Nonetheless, lower demand and lower supply means that the economy is currently not growing as fast as it could. How much COVID impacts the economy for the remainder of this year is unknown. We don't know how many people have already been infected, whether there will be more variants and how serious and contagious those variants could be. Governments' have shown they will tighten restrictions if they believe their health systems are coming under too much pressure. Regardless of what the Government does consumer confidence about the health outlook will continue to play a large role on how the economy evolves.

## Economic outlook

Barring the arrival of a far more deadly variant, the main economic issue this year will be strong demand and problems with supply. Demand is being supported by robust employment growth, rising wages and profit growth, a high level of saving (by both households and firms) and extremely low interest rates. Fiscal policy is unlikely to tighten dramatically in an election year.

Some of the supply problems (such as the lack of fruit and veg currently in stores) is a direct result of the current Omicron wave. These supply problems should largely ease over the next month as cases decline, government regulations evolve and more people get booster shots.

COVID has also created longer-lasting supply problems as world production has struggled to catch-up to meet very high demand (such as computerised chips for cars). Prior to the appearance of Omicron there were signs that these supply problems were starting to be reduced. Shipping freight rates had declined, as had some overseas manufacturer's supplier delivery times. But bottlenecks were still extremely elevated by historical standards, only worsened by the latest Omicron wave. China's desire to have a zero COVID policy means there is potential for ongoing supplier delivery problems for some products.

There is a possibility that these longer-lasting supply problems could settle down in the second half of this year (depending upon the path of the virus). A bigger issue is the ongoing shortage of workers. Closed international (and state borders) is one factor, but so is the extremely high demand for workers. A return to 'normal' immigration levels will help but this will likely take time given the potential for further outbreaks throughout this year. Monetary and fiscal policy is aimed at getting the unemployment rate even lower (and wages growth higher). This suggests that worker shortages will remain a key issue for firms for this 2022.

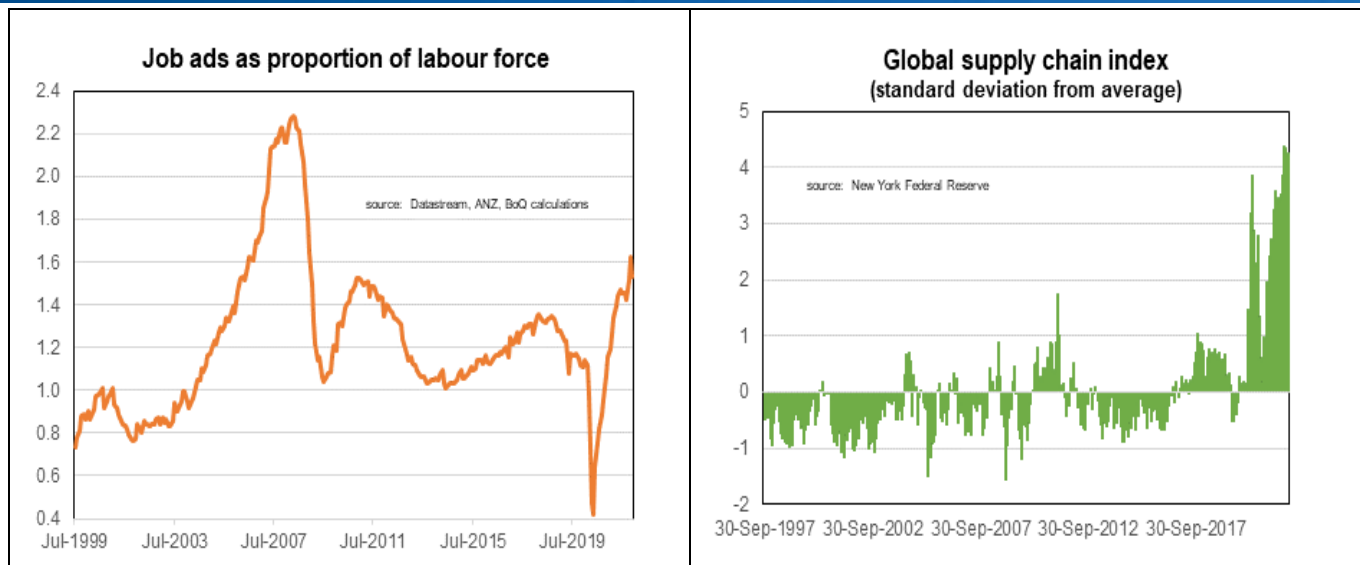
Demand for workers is very strong.

Supply-chain problems have probably peaked. But they are also some way from being resolved.

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## Inflation and wages the key for interest rates

Financial markets have become increasingly worried that the mismatch between strong demand and a lack of supply will lead to higher inflation and therefore the need for higher interest rates. Inflation has picked up globally, and is currently around 7% in the US (the highest rate in almost 40 years) and over 5% in Europe (the highest rate for at least 25 years). The RBA believes there are good reasons why inflation in Australia is running lower than in the US and Europe (inflation is also lower in most Asian countries). The upcoming Q4 CPI figures will be an indicator whether this pattern can be maintained.

Over the past couple of quarters the RBA's preferred measures of 'underlying' inflation have been running at around 0.6%. This is also around consumers' views of the current pace of inflation. And about the middle of the RBA's 2-3% inflation target. Normally that pace of inflation with a background of strong demand and ongoing problems with supply would see the cash rate well above 0.1%.

One reason the cash rate has not yet changed is that the RBA has made it explicit that it wants inflation to head towards the top end of its target band. This is to offset the outcomes of the past decade when inflation averaged under 2%. This sustained low rate of inflation has played a role in low wages growth, a concern given the high level of household debt.

I think the RBA will get uncomfortable if underlying inflation gets to the top of its target band (and certainly above 3%). The RBA may not wait until 3% is measured on an annual basis (ie, what has happened over the past 4 quarters). Two or three quarters of underlying inflation of 0.7-0.8% might be enough to convince them that inflation has got a bit high.

It will then come down to their view on whether the rise of inflation is 'sustainable'. The RBA believes that will require higher wages growth, and has nominated 3% as a key level. That rate was chosen on the assumption that productivity growth is around 0.5-1% (the pace it has been over the past decade) and so consistent with a 2.5% inflation rate. But productivity growth is very difficult to measure, often bumped around by the stage of the economic cycle.

Practically if inflation is towards the top end of the 2-3% target band and wages growth is rising to be close to 3% that may well be enough for the RBA to look to begin raising the cash rate. Certainly the historical economic factors that drive wages suggest that growth should continue to pickup. But it may still take time to get close to 3%. Current wage growth expectations remain low amongst workers, probably reflecting their experience of the past decade.

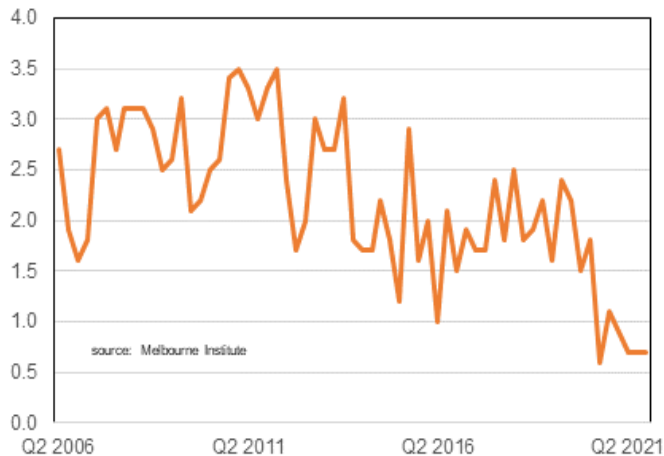
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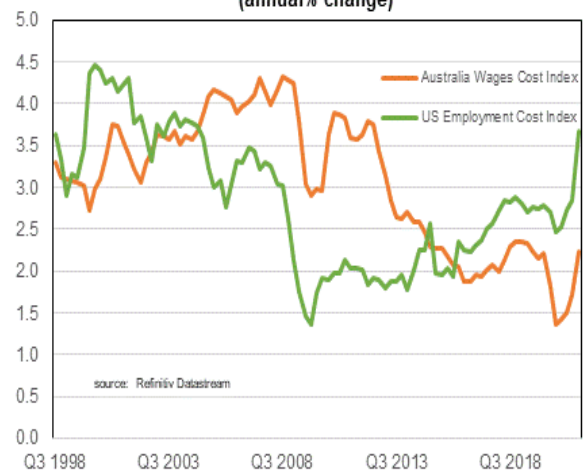
Expectations for wages growth remains low.

**Expected wage change**  
(expected % change next 12 months)



Over the past decade wages growth has been trending up in the US but down in Australia.

**Australia and US wages growth**  
(annual % change)



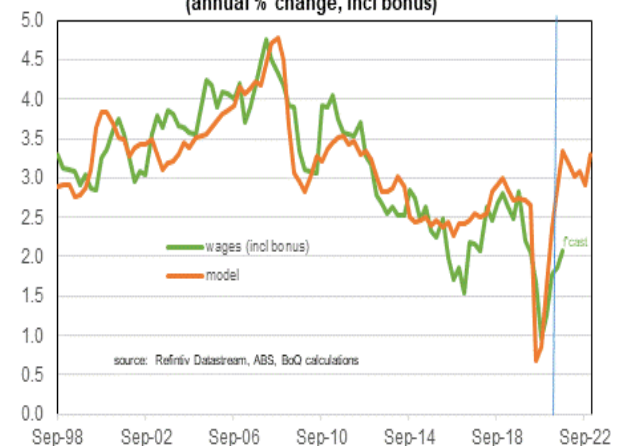
Inflation expectations has risen over the past year but remains below its pre-GFC levels.

**Consumer inflation expectations**



The variables that typically drives wages growth suggest that the current pace should be a bit over 3%.

**Wages growth model**  
(annual % change, incl bonus)



## What this means for the cash rate

The combination of strong demand and supply constraints does suggest the cash rate will be heading higher. The questions then are when will be the first rate hike, how high will the cash rate go in this cycle and how long will it take to get there?

Financial market pricing is consistent with a first rate hike taking place by July. According to a survey by Reuters, a couple of financial market economists think the first rate hike may take place in the third quarter and about one-third expect a rate increase in Q4. The overwhelming majority of economists expect a rate move by the end of the first half of 2023 (including me).

Financial markets are expecting cash rate hikes across most developed countries this year. At the time of writing, financial markets had priced in almost one percentage point of increases in the US, with tighter monetary policy also expected in the UK, Canada and New Zealand. The rising level of global rates means that if the RBA keeps the cash rate unchanged then in some respects it is easing monetary policy. If global interest rates do rise in line with current market expectations it will add to the argument to increase the cash rate in Australia later this year.



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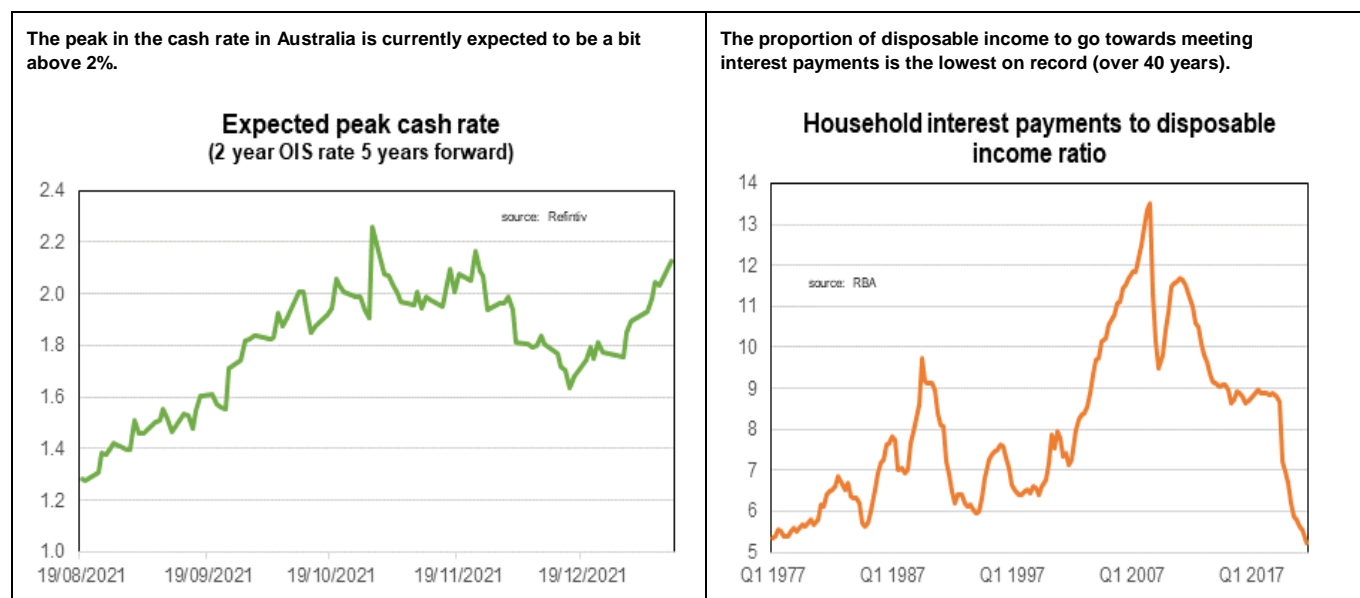
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When the RBA starts hiking rates does matter. What matters even more is how high interest rates go in this cycle. Currently financial markets expect the peak in the cash rate to be 2-2.25% (compared with 1.5-1.75% in the US and a bit over 1% in the UK). Some in financial markets expect that the peak in the cash rate might be just 1-1.5% in Australia reflecting the high level of household debt. But that cash rate level might be too low if the RBA is successful in raising inflation and wages growth. A cash rate of just over 2% is likely to be below the inflation rate. Borrowers' should be prepared for the possibility that the cash rate may peak above 2.5% in this cycle. How high the cash rate ends up going will partly depend upon how long-lasting the currently supply problems last.

Once the RBA decides to begin to increase the cash rate it is likely to raise rates to 1% quite quickly. A 1% cash rate is still very low given 2.5%-plus inflation and 3% wages growth. The pace of rate rises is likely to slow above 1% given the uncertainty as to what the peak in the cash rate will be in this cycle.

What might stop interest rates rising in Australia? Certainly the discovery of a more deadly variant would be close to the top of any list. Another is that interest rates in the US (and other countries) end up rising a lot quicker than anticipated to counter consistently higher inflation. That could lead to a fallout in financial markets and/or a substantial slowing in the global economy.



A cash rate close to 0% when inflation is around 2.5% is an emergency setting. An increase of interest rates when (if) it comes should therefore be seen as a good thing (it certainly will be by savers). In my view the economy ended up in a better position at the end of 2021 than it started the year. And despite the likelihood of further health concerns and supply constraints, the economy will likely end 2022 in an even better place.

We live in interesting times.

Regards

**Peter Munckton**  
**Chief Economist**  
**Bank of Queensland**

BOQ | Level 22 Chifley Towers Sydney NSW 2000

Twitter: @petermunckton

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Email: [peter.munckton@boq.com.au](mailto:peter.munckton@boq.com.au)

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