AUSTRALIA ECONOMIC OUTLOOK Q3 2022

KPMG Australia
Economics & Tax Centre

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Contents

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KEY ISSUES

1. Inflation is still rising putting pressure on household budgets
2. Limited spare capacity in the labour market
3. RBA has a narrow path as it attempts to slow inflation without causing a recession

RISKS TO THE OUTLOOK

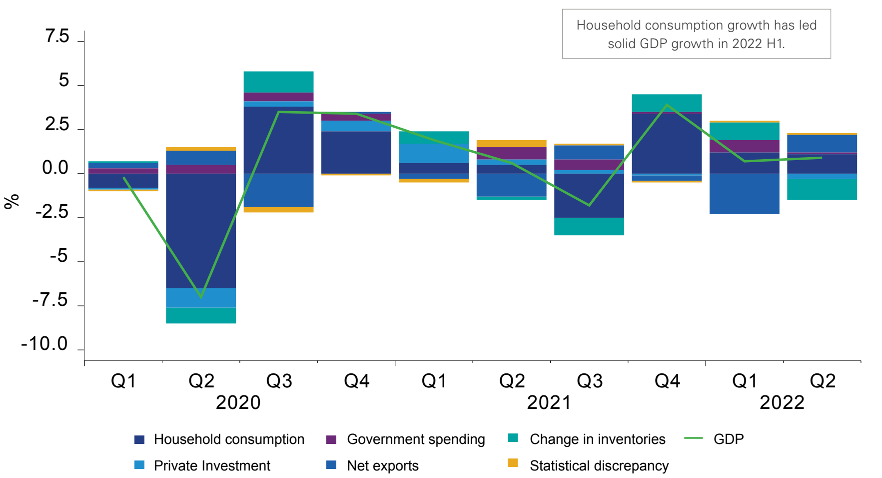
1. High interest rates slow economic growth more sharply than we anticipate
2. RBA overshoots and raises interest rates too far
3. Persistently higher inflation
4. Uncertain recovery in migration and services exports
5. Population permanently smaller and older post-COVID

Spending resilient despite mounting headwinds

A surge in consumption drove continued solid GDP growth in the first half of 2022. Strong employment growth and the release of pent-up demand from previous COVID lockdowns enabled households to overcome the drag from rising interest rates and the higher cost of living. Consumption rose by 2.2 percent q/q in both Q1 and Q2, well above trend growth. The increase in spending is being driven by a rebound in services, with households continuing to normalise their spending patterns.

The lockdowns and real estate downturn in China are weighing on construction activity and demand for iron ore. But the disruption to energy markets from the war in Ukraine has led to strong demand for Australian energy exports which has helped lift the trade balance to new highs. While some of that reflects stronger commodity prices, export volumes have risen too. Indeed, net trade (the difference between export and import volumes) made a 1 percentage point contribution to growth in Q2.

Quarterly GDP growth by component



Source: KPMG Economics, Australian bureau of Statistics, Macrobond

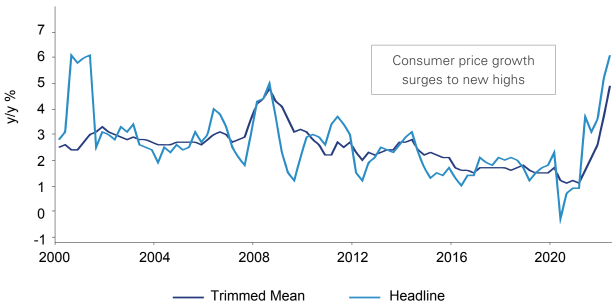
Notwithstanding the robust growth in disposable income, which grew 1 percent on the quarter in Q2, households have partly funded increases in consumption in recent quarters by reducing their saving rate. The household saving rate is now 8.7 percent, still a little above its pre-COVID level, but standing at its lowest rate in two years.

Investment is expected to rebound in the months ahead as disruptions to construction from flooding and supply chain constraints ease. However we still expect the pace of growth to moderate as the economic environment deteriorates. Overall, GDP growth momentum is expected to ease going through H2 2022, to a trough in mid-2023. But at this stage we still expect the economy to escape a recession, given its positive fundamentals.

Inflation set to peak in the second half of 2022

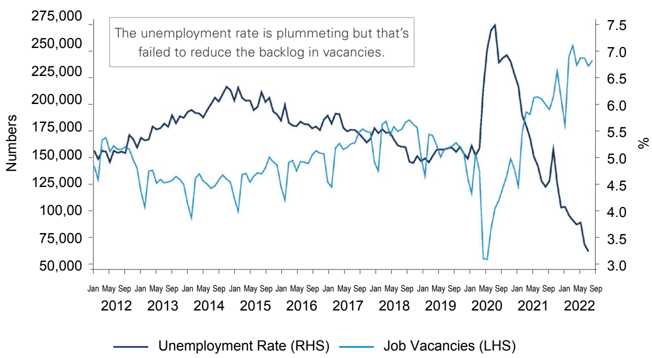
Oil prices have eased from the highs seen in March and April, but overall energy prices remain high compared to a year ago. The war in Ukraine has also put pressure on food prices globally and those pressures have been exacerbated in Australia by the recent floods. Escalating construction costs and rising housing rents are also a driver. Taken together the headline inflation rate reached 6.1 percent in Q2, and trimmed mean inflation rose to 4.9 percent, the highest rate for each series since 1991.

Australian Consumer Price Inflation



Source: KPMG Economics, Australian bureau of Statistics, Macrobond

Unemployment Rate and Job Vacancies



Source: KPMG Economics, Australian bureau of Statistics, Australia & New Zealand banking Group Limited

Labour market tightness stoking wages growth

The labour market remains tight, with robust employment growth taking the participation rate to record highs. There are now roughly as many job vacancies as unemployed people in Australia, and overall the data suggests the economy has reached full employment. Migration should ease severe skill shortages in some specific industries. But given the fact that migration will boost demand for labour as well as supply, the labour market is likely to remain very tight for some time to come.

The tight labour market is finally spurring wage growth, though the pace remains low compared to many advanced economies. Annual growth in the wage price index reached 2.6 percent in Q2. But the historically large 5.2 percent increase in the minimum wage in Q3, and reports of larger increases in the private sector suggest the pace will accelerate beyond 3 percent in the months ahead.

RBA raising rates rapidly to cool domestic inflation pressures

The rapid rise in inflation and tight labour market has forced the RBA to accelerate its hiking cycle. The cash rate is now at 2.60 percent and Governor Lowe has indicated that further rate hikes will be needed. By mid next year we think the cash rate will have reached a peak of 3.35 percent.

Momentum set to ease over H2 2022

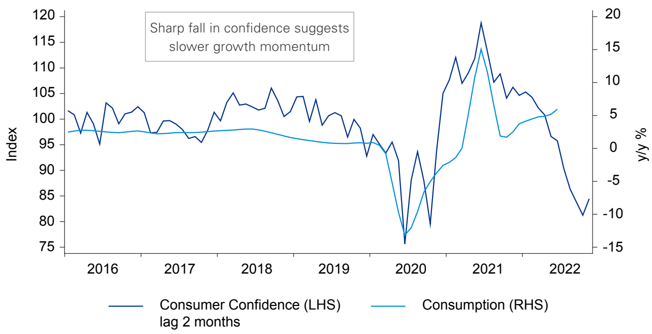
Economy rebounded in H1 2022

The Australian economy shook off headwinds and rebounded in the first half of the year, with solid quarterly GDP growth of 0.8 percent and 0.9 percent in Q1 and Q2 respectively. In both quarters exceptionally strong consumption growth drove demand with households lifting spending, particularly on services, and reducing their saving rate. Services consumption was above its pre-virus level in Q2 for the first time since the pandemic began. With the supply side of the services economy now back at pre-COVID levels we expect the recovery in the sector to continue as pent-up demand is met.

Domestic momentum now easing

Households however are now showing that they are not confident the good times will last. Consumer confidence remains close to its recent lows, and while there was a slight rebound in September, confidence remains at one of the lowest levels on record. The weakness in confidence likely reflects the surge in the cost of living along with rising interest rates.

Consumption and Consumer Confidence



Source: KPMG Economics, Melbourne Institute of Applied Economic & Social Research, Australian Bureau of Statistics

Rate hikes have already started weighing on the housing market. House prices have fallen over 5 percent from their peak in May. The sharpest falls have been felt in Sydney and Melbourne, but prices are now declining in almost every state and major city. Given our view that interest rates won't reach their peak until early next year, we expect the housing downturn to persist to mid-2023.

Falls in household wealth from the house price correction will inevitably weigh on consumption growth. That will be most obvious in sales of household goods and vehicles.

Near term outlook for investment remains strong, export picture is patchy

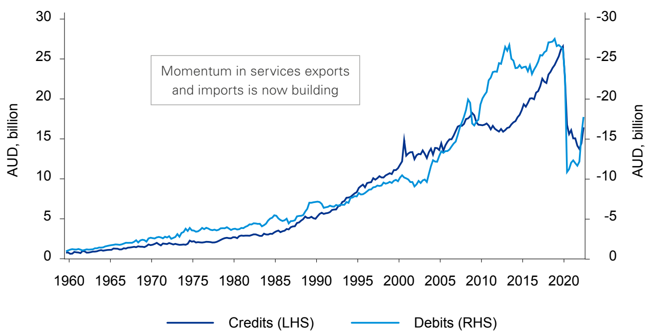
With disruptions from floods and supply chains easing, the construction sector is not expected to contract sharply in the near term; the pipeline of dwelling and non-dwelling construction activity currently underway, has surged in recent months.

What's more, firms' expectations of nominal capital expenditure (capex) in 2022-23 is consistent with a large 9.5 percent increase in private capex, although some of that increase will reflect firms' expectations for higher prices and catch-up from delayed investment in FY22. Even so, the strength in capex expectations suggests that real capital investment will increase in FY23.

While net exports have held up remarkably well in recent months, we think headwinds will weigh on the external sector in the months ahead. Continued travel restrictions in China means services exports are unlikely to fully recover in the near term. By contrast, services imports should continue their impressive rally in the months ahead.

Together with a slowdown in consumption growth and lower government spending as COVID-relief packages continue to wind down, quarterly GDP growth momentum is expected to ease through the second half of 2022.

Services Trade Volumes



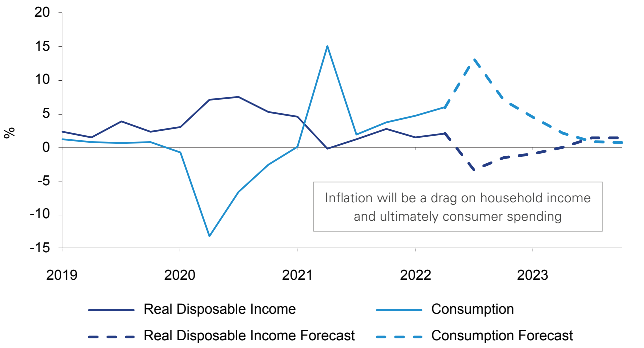
Source: KPMG Economics, Australian Bureau of Statistics

2023 expected to be cyclical trough

Supports for household spending are waning, drags on growth building

Moving into 2023, the recent tailwinds for households will ease. The household saving rate will be back at pre-virus levels, with the easy win from the recovery in services consumption largely complete. House prices are expected to see a peak-to-trough decline in the mid-teens, with an outsized decline in Sydney. Inflation is expected to continue to outpace wages growth, resulting in negative real household income growth. Taken together we expect these factors will hamper household consumption growth in 2023, with the pace expected to fall from nearly 8 percent this year to just 2 percent in 2023.

Real Diposable Income and Consumption



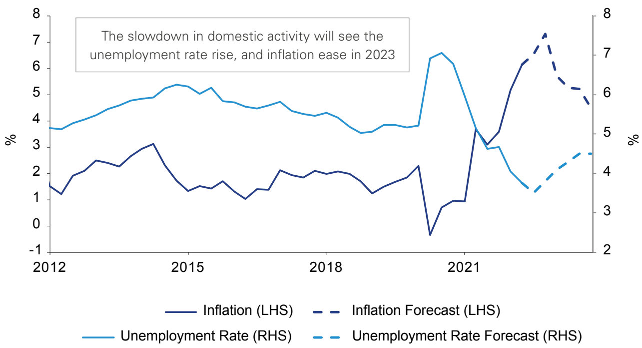
Source: KPMG Economics, NiGEM

Dwelling investment is also expected to decline in 2023. While the pipeline of unfinished work will support the construction industry this year, the downturn in dwelling approvals, and falling house prices suggest that activity will weaken next year.

What's more, growth in business investment is likely to slow as the economic slowdown discourages businesses from expanding. Government spending is projected to be relatively flat as the last of the pandemic support measures expire. Overall, we expect the pace of quarterly GDP growth to drop sharply in early 2023.

The slowdown in domestic demand momentum will inevitably weigh on the labour market. We expect the unemployment rate to rise to 4.5 percent in 2023, though this is still at levels close to full employment.

Inflation & Unemployment Rate



Source: KPMG Economics, NiGEM

RBA hiking cycle to end in early 2023

Conditions globally have deteriorated rapidly in recent weeks. There is still considerable scope for recovery in China if COVID restrictions are lifted, but there are few signs yet of a shift in stance. Elsewhere, the outlook for activity in the US and Europe looks bleak, with recessions now likely in many countries.

In Australia we expect rates to peak at 3.35 percent by mid-2023 – given the lags in monetary policy transmission, we expect the RBA to stop and pause at this point. While inflation is unlikely to have returned to the RBA's target band by then, we expect a sharp moderation in momentum will confirm the RBA's decision to halt tightening in H2 2023.

Jobs and Skills Summit makes a start

The Government's recent Job and Skills Summit was aimed at increasing the size and quality of the Australian workforce. The Summit generated a range of policies, many of which the government is now pursuing. The main areas of focus were female participation, improving access to education and training and increasing the supply of labour through higher migration. We expect the upcoming Budget on 25th October will make further headway in this space.

Persistently higher inflation a key downside risk

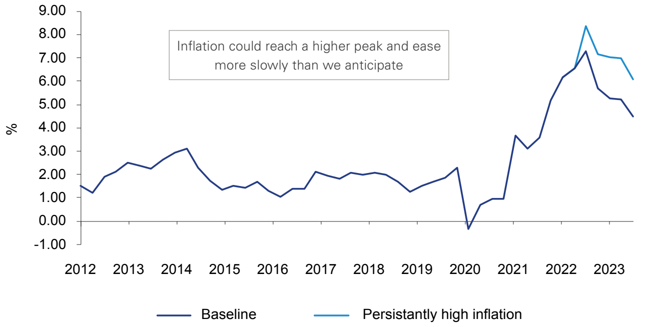
Inflation uncertainty

In our baseline forecast, inflation expectations remain anchored and as a result headline inflation falls markedly as food and fuel price momentum eases in the years ahead.

There are three underlying risks to that assumption:

– Global tensions may intensify further resulting in even tighter capacity constraints and higher imported inflation.

CPI Inflation



Source: KPMG Economics, NiGEM

– Households could continue to prove more resilient than expected, supporting robust demand and strong domestic inflationary pressures.

– Price and wage setting behavior may change, keeping inflation high even as demand and supply constraints ease.

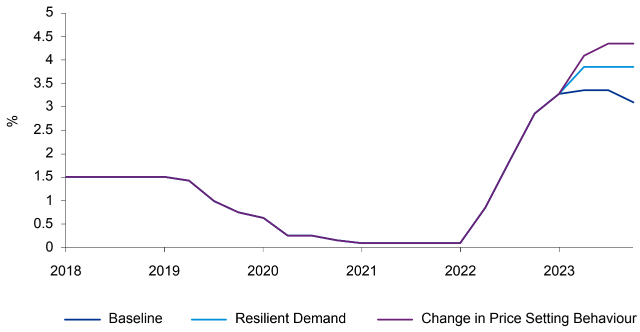
If demand eases but inflation is kept high by global supply constraints, the RBA would likely respond in a limited way, to ensure inflation expectations remain anchored. Even so, the prolonged period of higher inflation would weigh on real household income growth, reducing activity.

Demand could be more resilient

By contrast, demand could be more resilient than we expect. Households have recently increased their consumption by gradually reducing their saving rate. But the extended period of high savings resulted in large household deposits in offset accounts.

If households draw-down these savings, the savings rate could fall below pre-virus levels for an extended period, keeping demand strong and inflation high. In that scenario the RBA would be forced to hike rates further than we currently anticipate.

Cash Rate Scenarios



Source: KPMG Economics, NiGEM

The higher level of interest rates would see households gradually exhaust those pent-up savings and eventually slow household demand. But in the process the RBA would cause a deeper housing downturn and slower investment growth. And once savings had been exhausted consumption growth would decline sharply. This scenario would mean the RBA's path toward a soft landing is even more difficult to navigate; in this scenario, a recession in 2023 followed by significant rate cuts in 2024 would be the most likely outcome.

Change in price setting behaviour

In the final scenario in which wage and price setting behaviour has changed, monetary policy would need to be tightened considerably beyond 3 percent. Indeed, if the softer demand we are forecasting was not enough to reduce wage growth and inflation the RBA may need to force Australia into a prolonged recession to return the wage-price setting cycle to something consistent with 2-3 percent headline inflation.

In sum, these scenarios show that persistently high inflation, irrespective of its cause, is a key downside risk to our central case economic forecasts.

Long run growth limited 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.

	Labour supply growth	Investment	Average # years of education in labour force	WB institution quality	R&D spending
	Avg last decade	% of GDP; 2019	Years	Percentile ranking	% of GDP; Avg last decade
Australia	1.6%	22.7%	14.0	90.7	2%
OECD (avg)	0.7%	22.9%	13.4	78.1	1.8%

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 proved resilient through the pandemic, when compared to the OECD group. The Omicron strain 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. The potential for new variants continues to pose a downside risk to the economy.

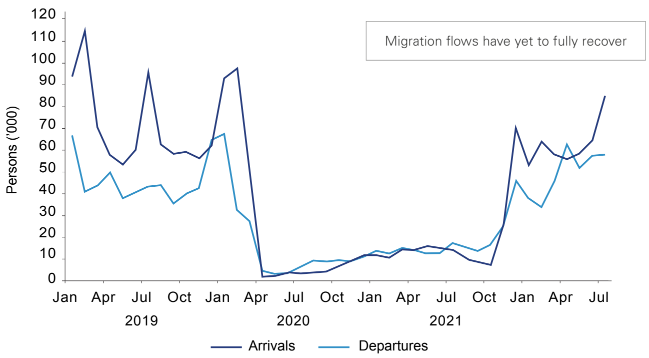
Forward view

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 permanent migration is gradually recovering as growth in permanent arrivals has outpaced departures. Even so, a permanently lower trajectory for migration presents a downside risk to long run growth.

On the flip side, the recent Jobs and Skills Summit increased the cap on permanent migration. If migration arrivals pick up and net migration grows meaningfully in the years ahead, a larger population is possible which would be an upside risk to our long run growth forecasts.

Long Term Migration



Source: KPMG Economics, Australian bureau of Statistics, Macrobond

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 policies out of the Jobs and Skills Summit, particularly those focused around increasing education and skilled migration, lead to a marked increase in productivity growth in the years ahead.

Forecasts

	FISCAL YEAR				CALENDAR YEAR			
	2020-21	2021-22	2022-23	2023-24	2020	2021	2022	2023
Consumption	1.0%	4.1%	6.5%	1.3%	-5.8%	4.9%	7.7%	2.0%
Business investment	-0.7%	5.8%	4.4%	2.6%	-4.3%	6.9%	3.1%	4.5%
Housing investment	8.3%	5.8%	-1.8%	0.9%	-2.8%	15.7%	-2.4%	-0.2%
Government	5.7%	6.6%	2.5%	1.0%	5.8%	5.8%	5.3%	1.3%
Exports	-8.4%	0.0%	3.1%	3.7%	-9.8%	-1.8%	1.4%	3.5%
Imports	-2.7%	7.7%	6.1%	3.0%	-13.0%	6.3%	11.4%	1.2%
GDP	**1.6%**	**3.9%**	**3.9%**	**1.5%**	**-2.1%**	**4.9%**	**4.2%**	**2.2%**
Headline CPI (%Y/Y)†	3.7%	6.1%	5.3%	3.2%	0.9%	3.6%	7.3%	4.5%
Wage Price Index (%Y/Y)†	1.7%	2.6%	3.2%	3.5%	1.4%	2.3%	3.1%	3.4%
Real wage growth	-2.0%	-3.5%	-2.1%	0.3%	0.5%	-1.3%	-4.2%	-1.1%
Current account balance (% of GDP)	3.3%	3.0%	1.0%	-0.3%	2.6%	3.5%	2.0%	0.5%
Government budget (% of GDP)	-9.2%	-4.3%	-1.9%	-1.4%	-12.8%	-5.1%	-2.5%	-1.6%
RBA Cash Rate†	0.1%	0.85%	3.35%	3.1%	0.15%	0.1%	3.1%	3.1%
10 year government bond†	1.6%	3.4%	4.0%	3.7%	0.9%	1.7%	4.0%	3.7%
USD per AUD †	0.77	0.71	0.69	0.71	0.73	0.73	0.69	0.70
Terms of Trade	10.4%	12.1%	-11.2%	-6.9%	-0.2%	17.6%	1.1%	-11.7%
Employment	0.6%	3.1%	2.5%	0.8%	-1.5%	3.1%	3.6%	0.9%
Unemployment rate	6.2%	4.3%	3.9%	4.5%	6.5%	5.1%	3.8%	4.4%
Dwelling price (%y/y)†	19.8%	9.5%	-13.1%	5.0%	4.3%	27.5%	-10.3%	-1.5%

† End of period

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