Bank of Melbourne

Wednesday, 2 March 2022

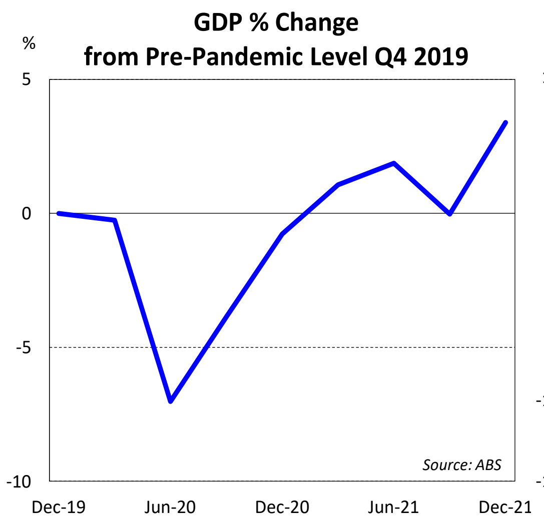
National Accounts

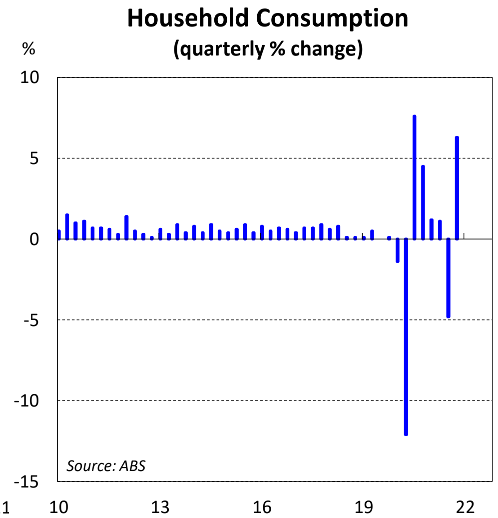
Economy Springs Back into Action

- **The Aussie economy sprung back into action in the final quarter of 2021. It's clear the economy has also ramped up its resilience. In the December quarter GDP sprung back 3.4%, after a Delta-induced contraction in the previous quarter. The size of the bounce has not been seen since the September quarter of 2020 and that followed a much deeper fall.**
- **The recovery at the end of 2021 meant the economic expansion for the year printed at 4.2%, a very solid pace. The economy at the end of 2021 is 3.4% larger than prior to the pandemic.**
- **Consumers armed with ballooning savings and pent-up demand emerged from lockdowns in Australia's most populous states and unleashed spending with a vengeance. Consumer spending drove the recovery. The household savings ratio fell to 13.6%, as household consumption surged 6.3%, piercing the pre-pandemic level for the first time.**
- **Consumers spent big on goods and services and in discretionary areas – especially clothing & footwear (up 42%), transport services, including airline travel (up 49%) and hotels, cafes & restaurants (up 24%). But services spending is not yet back to pre-pandemic levels.**
- **Whilst consumers helped lift the economy from the Delta doldrums, businesses didn't roll up their sleeves and share in the heavy lifting. Business spending shrunk, as did new dwelling construction. Net exports was a drag on GDP and the government sector sat on the sidelines.**
- **The NSW economy led the charge. State final demand in NSW spiked 6.7% - the fastest quarterly rise on record. Activity in Victoria and the ACT also rebounded strongly on reopening from lockdowns; indeed, state final demand in these regions rose to a record high.**
- **Most industries reported a solid gain in activity over the December quarter, led by those hit hardest by the Delta lockdowns. Accommodation & food services posted a 26.1% spike in activity in the quarter, as millions eagerly substituted home-cooked meals for dining out.**
- **There remains upward pressure on input costs and relatedly, domestic prices. The domestic final demand implicit price deflator jumped 1.1% in the December quarter - the fastest quarterly pace in over 13 years - to be up 3.0% in annual terms. These prices pressures are likely to be exacerbated by the developing conflict in Ukraine.**
- **Today's national accounts also confirmed labour-cost pressures are building.**
- **For 2022, we expect another leg up in economic output of around 5.5%, although this year isn't without its challenges. The Omicron wave is likely to have sidelined economic activity in the early part of this year. The floods in Queensland will hurt economic activity in large parts of Queensland, before the rebuilding effort adds to activity. And then there are the highly uncertain and fluid developments in Ukraine.**

Key Themes and Outlook

The Aussie economy bounced back in the final quarter of 2021, before the Omicron wave swept through the economy. What is clear is that the Australian economy is getting better at dealing with challenges. In the December quarter, GDP sprung back 3.4%, after contracting 1.9% in the September quarter due to the Delta lockdowns. The size of the bounce back in the December quarter has not been seen since the September quarter of 2020 – back then the economy was rebounding from a much deeper contraction in the previous quarter of 6.8%! Data already at hand shows the Omicron wave is likely to have had a more modest impact on economic activity than both Delta and Alpha. In the December quarter, Omicron emerged, but the economy mostly brushed it aside until early 2022.





The recovery at the end of 2021 meant the economic expansion for the year printed at 4.2%, a very solid pace, and following a 0.8% contraction for 2020. Indeed, the economy at the end of 2021 is 3.4% larger than prior to the pandemic.

The emergence from lockdown in the most populous and largest economic states of NSW and Victoria, unleashed consumer spending with a vengeance and helped the economy bounce back in the December quarter. Consumer spending surged 6.3% in the quarter – the biggest spike in 5 quarters and taking consumption above pre-pandemic levels for the first time.

Consumers ran down savings to spend up big in the quarter, especially on clothing & footwear (up ~42%), transport services, including airline travel (up ~49%) and hotels, cafes & restaurants (up ~24%).

Whilst consumers helped lift the economy from the Delta doldrums in the September quarter, businesses did not share in the heavy lifting. Business spending shrunk, as did new dwelling construction. Net exports also dragged on growth whilst the government sector was on the sidelines (making a nil contribution to growth in the quarter).

We expect another leg up in economic output in 2022 of around 5.5%, although growing downside risks in the global economy suggest growth could be lower.

The Australian economy's resilience has a lot to do with low interest rates and strong stimulus from the central bank and governments. These settings have helped the economy navigate the pandemic-related challenges.

The recovery from the pandemic has also contributed to inflation pressures, as have supply-chain disruptions. Today's set of data revealed the domestic final demand implicit price deflator rose

1.1%, the fastest rate since the September quarter of 2008. The compensation of employees also continued to show labour cost pressures mounting.

This year the economy is not without its challenges. The Omicron wave is likely to have sidelined economic activity in the early part of this year. The floods in Queensland will hurt economic activity in large parts of Queensland, before the rebuilding effort adds to activity. And then there are the highly uncertain and fluid developments in Ukraine.

Geopolitical developments are a fresh source of uncertainty. Commodity prices, especially energy prices, are being pushed even higher, as disruptions to energy from the conflict are likely. Russia is the world's largest exporter of natural gas and the world's third largest exporter of crude oil and crude products. Inflationary pressures from the conflict are coinciding with rising inflation from global-supply chain disruptions and recovering demand from the pandemic.

However, the conflict also has the potential to hurt global growth depending on how it evolves. A combination of elevated inflationary pressures and a slower trajectory for world growth raises the risk of stagflation – a situation last experienced in the 1970s.

The Australian economy might benefit in the short-term from rising commodity prices, but it would be hurt in an environment of slower global growth.

Furthermore, the task ahead for the Reserve Bank is made more challenging – if that was even possible! Current conditions warrant the RBA raising the cash rate, but the RBA also needs to take a forward-looking approach and consider what geopolitics mean for the global and domestic economy. And how long and deep the pass-through of elevated commodity prices from the turn in geopolitical events will be.

GDP Expenditure Measure:

The headline GDP measure is an average of 3 measures – expenditure, income and production.

Selected Expenditure Items on GDP, Chain Volume Measures

	Quarterly % Change
Household Consumption	6.3
Public Consumption	0.1
Dwelling Investment	-2.2
Business Investment	-0.3
Public Investment	-3.2
	Contribution to GDP, ppt
Inventories	0.9
Net Exports	-0.1

GDP expenditure bounced back strongly in the December quarter. Driving this bounce was consumer spending. **Household consumption** jumped 6.3% in the quarter, the fastest quarterly rise since the September quarter of 2020 when Australians emerged from the national lockdown. Critically, household spending exceeded pre-pandemic levels for the first time.

Spending on both goods and services was strong, each rising 6.3%, respectively, in the quarter. However, services spending is 3.9% below pre-pandemic levels, reflecting some lingering restrictions and limitations such as around travel. Unlike services, goods consumption is 8.8% above pre-pandemic levels.

Consumers spent biggest on discretionary areas – transport services including airline travel spiked 48.5%, clothing & footwear jumped 41.6% and hotels, cafes & restaurants rose 24.3%. Consumers pulled back spending the most on cigarettes & tobacco (well done Australia!) and the purchase of vehicles. These areas fell 3.0% and 2.5%, respectively, in the quarter. The purchase of vehicles has been hampered by inventory issues from global-supply-chain disruptions.

Whilst consumers helped lift the economy from the Delta doldrums in the September quarter, businesses failed to roll up their sleeves and help with the job of getting the recovery back on track. **Business spending** shrunk. Net exports also dragged on growth whilst the government sector was on the sidelines (making a nil contribution to growth in the quarter).

Business spending shrunk by 0.3% in the private sector, led by declines in engineering construction (-1.6% in the quarter) and machinery & equipment (-1.5% in the quarter). However, business surveys and business-spending plans suggest investment is set to resume its upswing this year.

New dwelling investment fell 2.2% in the December quarter, marking the first fall in six quarters. Both new dwelling construction and renovation activity contracted in the quarter, by 0.5% and 4.4%, respectively.

Ownership transfer costs fell for the first time in six quarters by 3.7%, but after very strong growth of nearly 71% over the previous 1½ years, due to rising housing turnover and dwelling price growth. This category represents the expenses associated with transactions related to new and existing properties, for example, legal fees.

The **government sector** pulled back growth in the quarter by 0.1%. It follows strong growth during the September quarter when parts of Australia were in lockdown due to the Delta outbreak. Public consumption lifted 0.1% in the December quarter after growing at the fastest quarterly rate in 26 years (of 3.8%) in the previous quarter. But public investment fell 3.2%.

Domestic demand roared back 2.9% in the quarter to be up 4.6% on a year ago.

Net exports detracted modestly (-0.1 percentage points) from growth in the quarter, as exports fell 1.5% in the quarter – a bigger fall than the 0.9% decline recorded for imports.

Finally, **inventories** added to growth by 0.9 percentage points in the quarter. This was focussed on an inventory rebuild in the non-farm economy of the private sector (+1.0 percentage points).

GDP Income Measure:

The income measure of GDP rose by 3.4% in the December quarter, when excluding the impact of prices. In nominal terms, GDP rose 3.4% over the quarter to be 10.2% higher over the year.

The rise in the quarter was driven by a large increase in **taxes less subsidies** of 29.2%. This reflected a decline in subsidies, as various COVID-19 support payments were unwound, as well as an increase in taxes alongside a post-lock down rebound in activity.

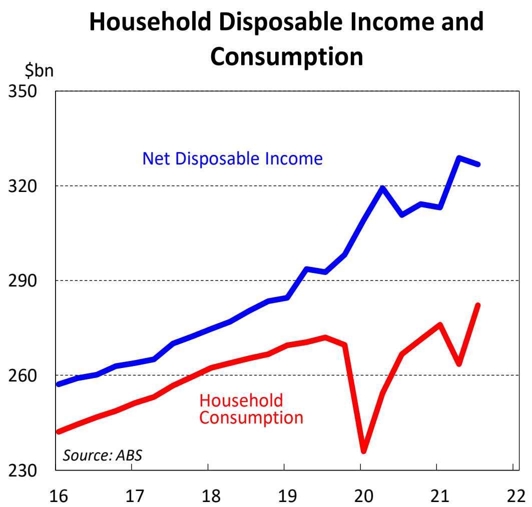
The **gross operating surplus** (i.e. profits) of private non-financial companies rose by 0.4% over the quarter. The increase was led by rises across manufacturing and professional, scientific & technical services. These increases were partly offset by a fall in mining profits, alongside the significant decline in the iron ore price. There was also a fall in profits in retail and wholesale trade, as well as accommodation and food services, underpinned by higher input costs, perhaps partly related to supply disruptions.

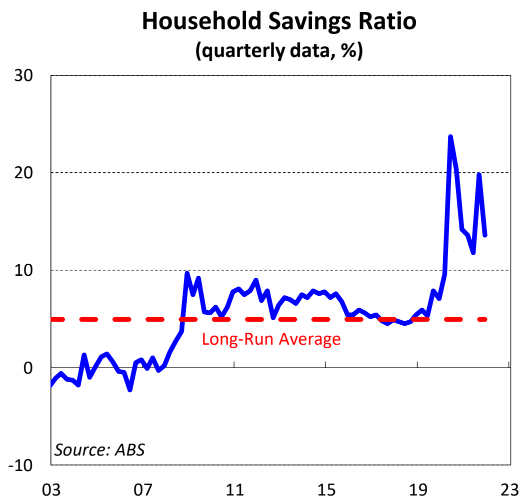
Compensation of employees (i.e. wages, salaries and other benefits) rose by 2.0% over the quarter, up from 0.5% in the September quarter. **Wages and salaries** were 0.3% higher. The increase was led by the private sector (2.2%), while there was also an increase in compensation in the public sector (1.5%). Over the year, compensation of employees rose by 5.3%, up from 4.6% in the September quarter. Labour costs are continuing to build.

Gross **household disposable income** declined by 0.5% in the quarter, reflecting the pullback in government support payments to households and businesses impacted by COVID-19.

The **household saving ratio** fell to 13.6% in the December quarter, as consumers ran down savings and shopped, underpinning consumer spending in the quarter. The fall was from 19.8% in the previous quarter. However, the saving ratio remains well above its pre-COVID average (around 5%). As we learn to live with COVID-19, and assuming there are no further lengthy lockdowns, we expect the saving ratio will continue to normalise over the coming quarters.

Huge amounts of household savings have been accumulated during the pandemic, largely because consumers have been unable to spend money on services (like travel and events) during lockdowns. These savings will support consumer spending over the period ahead, which we expect will be a key driver of economic growth this year. The extent to which households draw down on these savings is a key uncertainty for the outlook, which has been pointed out by the RBA. The more households draw down on these savings to spend, the faster growth will be in the near term. However, some households may opt to hold onto these savings to strengthen their balance sheet, including by paying down debt, which would provide less support to GDP growth in the short term.





The **terms of trade** (the ratio of export prices to import prices) fell 5.1% from a record high over quarter. The decline reflects a fall in the price of Australia's commodity exports. Notably, the price of iron ore futures fell from an average around US$137 a tonne over the September quarter, to around US$106 a tonne over the December quarter. Chinese curbs on steel production to cut carbon emissions ahead of the Winter Olympics reduced iron ore demand and prices over the quarter. Blackouts in China also impacted production. However, over the year the terms of trade were still 10.3% higher. A higher terms of trade supports national income through higher profits for mining companies, increased dividends for investors, and greater tax receipts for the Federal and state governments.

There remains considerable upward pressure on input costs and relatedly, **domestic prices**. This is highlighted by the domestic final demand implicit price deflator, which jumped by 1.1% over the December quarter - the fastest quarterly pace in over 13 years - to be up 3.0% in annual terms. Global supply-chain disruptions and materials shortages have underpinned growing price pressures, which are likely to be exacerbated by the developing conflict in Ukraine.

State Final Demand:

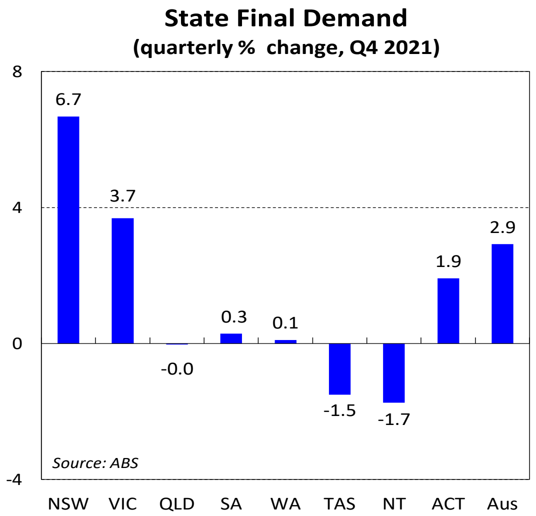
The easing of lockdown restrictions in NSW, Victoria and the ACT over the December quarter underpinned a strong rebound in demand. The recovery was strongest in the states most heavily impacted by the Delta lockdowns.

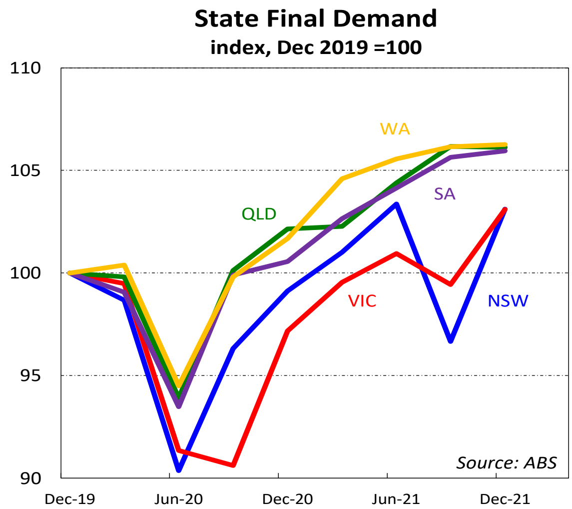
NSW reported a 6.7% surge in activity – the strongest quarterly rise in state final demand on record, going back to 1985. Consumers armed with ballooning savings and considerable pent-up demand emerged from lockdown midway through October - after strict restrictions were imposed for much of the September quarter – driving a sharp rise in activity. The post-lockdown boost was enough to elevate activity 3.1% beyond its pre-pandemic level, as of December 2019. However, the record quarterly jump fell just shy of offsetting the 6.5% decline in activity over the September quarter; leaving state final demand 0.2% below its pre-Delta (as of June 2021) and record high level.

Activity in Victoria and the ACT also rebounded strongly on reopening from lockdowns. Although the surge was softer than in NSW, reflecting a bounce-back from a relatively milder slowdown in the September quarter. State final demand jumped to fresh record highs in both Victoria and the ACT, rising 3.7% and 1.9%, respectively over the quarter. The result takes annual growth to 6.1% in Victoria and 2.3% in the ACT, well above their respective long-run averages of 2.5% and 2.2%. Both regions are now back on their pre-delta trajectories.

Results were considerably softer in other parts of the country where COVID-19 disruption over the second half of 2021 was more muted. Demand in Queensland (-0.0), SA (0.3%) and WA (0.1%) was broadly flat in the December quarter. Although, the mild rise in SA pushed activity to a record high level. Activity in all three states is comfortably above both pre-pandemic and pre-Delta levels.

Tasmania and the NT posted sizeable falls in activity over the final quarter of 2021, shedding 1.5% and 1.7%, respectively. These regions were largely insulated from COVID-19 disruption over 2021. However, this unwound over the December quarter, as case numbers jumped and restrictions were imposed. Encouragingly, economic activity is still running at a brisk pace in annual terms in Tasmania and Victoria at 5.8% and 4.7%, respectively, and is solidly above pre-pandemic levels.





Industry Breakdown:

Most industries reported a solid gain in activity over the December quarter, led by those hit hardest by the Delta lockdowns.

Accommodation & food services posted a 26.1% spike in activity in the quarter, as millions eagerly substituted home-cooked meals for dining out. Spending on retail and other services jumped at a record quarterly pace, surging 7.4% and 15.4%, respectively. The sharp rise helped take retail activity to a record high level.

Activity in the arts (8.2%) and healthcare (5.8%) sectors also accelerated at a strong pace over the December quarter, benefitting from strong demand alongside the end of lockdowns. Meanwhile, agricultural production jumped 9.0% on the back of a bumper grain harvest, which also boosted wholesale trade (3.5%) and transport, postal & warehousing (3.0%). Activity launched to a record high level across nine of the nineteen industry groups, while only two industries pulled-back over the quarter.

Mining and electricity, gas, water & waste services bucked the trend, each shedding 1.0% from output over the December quarter. Adverse whether events drove the pull-back in mining production. Softer demand for utilities explained the fall in electricity, gas, water & waste services.

In annual terms, the mining and electricity, gas, water & waste services sectors were 0.1% lower, while all other sectors recorded solid growth over the year to the December quarter.

Industry Gross Value Added, Chain Volume Measures

Ranked by Quarterly % Change, December Quarter 2021

By Industry	Quarterly % Change	Annual % Change
Accommodation & Food Services	26.1	1.8
Other Services	15.4	7.4
Agriculture, Forestry & Fishing	9.0	19.4
Arts & Recreation services	8.2	6.7
Retail Trade	7.4	3.5
Healthcare	5.8	7.1
Professional, Scientific & Technical Services	5.3	5.5
Administrative & Supportive Services	5.1	11.6
Wholesale Trade	3.5	1.8
Information, Media & Telecommunications	3.4	4.8
Transport, Postal & Warehousing	3.0	7.4
Rental, Hiring & Real Estate Services	2.9	9.8
Construction	1.9	7.4
Manufacturing	1.8	4.5
Public Administration & Safety	1.6	2.0
Financial & Insurance services	1.1	3.6
Education & Training	0.4	1.4
Electricity, Gas, Water & Waste Services	-1.0	-0.1
Mining	-1.0	-0.1

Source: ABS

Encouragingly, twelve of nineteen industry groups are running above pre-pandemic levels, while output in sixteen industries are above the levels prevailing before the Delta outbreak.

An Omicron induced softening in demand over January may weigh on several industries in the March quarter. However, we expect most industries will see growth over the start of 2022.

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