Weekly Economic Outlook

Bank of Melbourne

Monday, 28 February 2022

Russia-Ukraine: Implications for Australia

The tragic developments in Ukraine are dominating the attention of the world and markets.

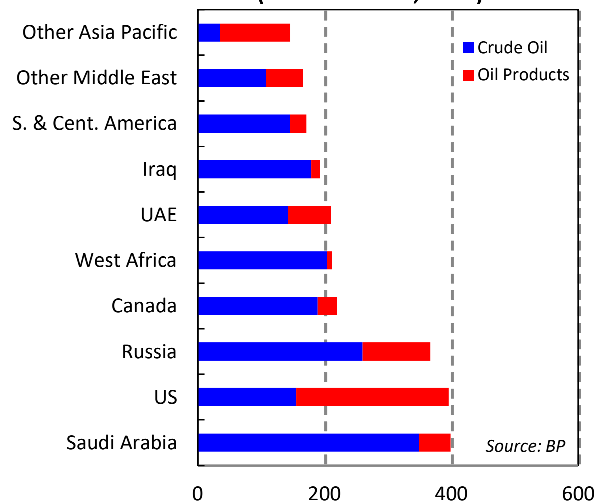
Russia formally invaded Ukraine on Thursday, with President Putin ordering a 'special military operation' in the country. Missile strikes have been carried out across the country. It is not clear how far Russia will go. Some have raised the concern that Russia's invasion could result in a broader conflict.

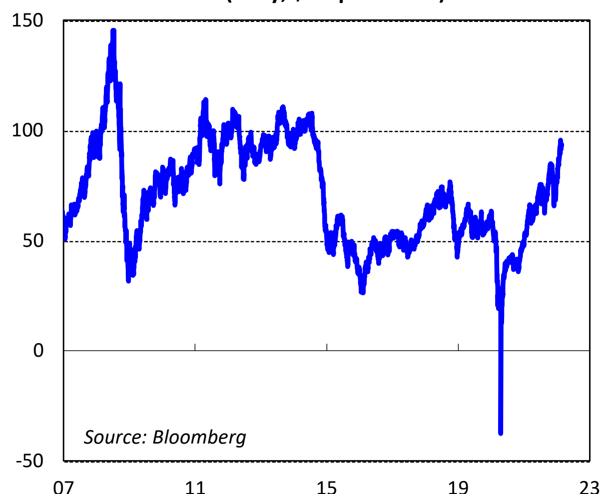
Western nations responded by implementing a range of new sanctions, including measures which restrict Russia's access to international payments. Russia's energy exports – a critical driver of the Russian economy – have notably been excluded from the sanctions list. The Biden administration has advised it will not sanction Russian crude oil because it would cause prices to spike. One senior White House adviser said sanctioning oil flows may mean President Putin could "sell only half of his product, but for double the price". In other words, "the United States and our allies would suffer".

Russia is the world's largest exporter of natural gas and the third largest exporter of crude oil and petroleum products (behind Saudi Arabia). Between Russia and Ukraine also lie a large share of global production of wheat, base metals and precious metals.

Russia's military actions in Ukraine and the sanctions on Russia by the West have raised economic and geopolitical uncertainty for markets. One of the immediate reactions has been for investors to pare back risk, which has resulted in lower global bond yields, wider credit spreads and higher oil prices. There has also been heightened volatility in financial markets. However, movements have been relatively modest since the invasion began.

Europe stands as the most exposed to the conflict. It is highly reliant on Russian gas, and possesses significant trade and investment links with Ukraine and Russia.





This conflict comes at a time when major central banks around the world, including our own Reserve Bank, are grappling with mounting inflationary pressures while their respective economies recover from the pandemic. This conflict adds to the challenges of an already difficult inflation backdrop. It raises the risk of higher inflation, especially via higher energy prices. It also poses downside risks to consumer sentiment and world economic growth; the extent of downside risk to world growth depends on how this conflict evolves. In particular, if it draws the world into a wider conflict, there would be more severe economic ramifications. It means stagflation risks have grown, which is the scenario of low growth and high inflation.

But what does it mean for the Australian economy specifically?

The developments have not changed our core view that Australia is set for solid economic growth this year, although it remains highly uncertain how the conflict will play out.

One of the main transmission mechanisms from the conflict to Australia is higher commodity prices, which in turn could add to inflationary pressures. Further disruptions to global supply chains could also add to inflationary pressures. Australians have already been hit by higher prices at the petrol pump – unleaded petrol price averaged 170 cents per litre nationally in the week ending 25 February.

Australia has limited ‘direct’ trade ties with Russia and Ukraine, altogether accounting for just 0.2% of both Australian merchandise exports and imports in 2021. There is also negligible trade in services. However, there is also a possibility that the developments could weigh on global economic growth, which in turn would flow through to weaker demand for Australian exports more broadly.

There could be some short-term upsides for some Australian wheat and natural gas exporters via higher prices. Russia is the world’s biggest wheat exporter and Ukraine is the fifth largest – collectively they account for more than 25% of the world’s exports of wheat. So, disruption to these supplies would likely drive an increase in the price of wheat. Similarly, a hit to gas supply will push up global prices and benefit Australian gas exporters. However, in aggregate these benefits could be outweighed by other disruptions to the global economy.

Another consideration is the implications for Australia’s already tense relationship with China. China has not condemned the Russian invasion and, in fact, has lifted restrictions on Russian wheat and barley in recent days. The move prompted criticism from Prime Minister Morrison that China is subverting Western sanctions on Russia. An escalation in Australia-China tensions risks resulting in further punitive measures from China on Australian exports.

Turning to the economic calendar, it is a busy week with a Reserve Bank meeting and a slew of economic data.

Reserve Bank

The Reserve Bank (RBA) meets on Tuesday. No change in policy settings is expected at this week’s meeting but speculation is heating up over when the RBA will lift the cash rate. The focus will be on any tweaks to the language in the statement which hint at when to expect lift off. We do not expect developments in Ukraine will deviate the RBA from its path for now, but Putin’s plans remain uncertain and unpredictable.

We expect that the first rate hike will come in August this year, with a 15 basis point move, although an earlier hike cannot be ruled out. We expect another 25 basis point hike later in 2022.

With the unemployment rate at 4.2%, and likely to head lower, the RBA can comfortably tick-off its goal of full employment, meaning the timing of the first hike will depend on consumer price inflation and wages. Last week’s annual wages print rose to 2.3% in the December quarter. It

reflects a pick up in growth and a tightening of the jobs market, but isn't shooting the lights out. We expect wages growth to pick up more materially as we move through 2022. Retention payments, bonus payments and job hopping are already rising, as are wage expectations. This supports our expectation of an August move.

GDP and partials

On Wednesday, GDP data for the December quarter will be published. We are expecting a solid 2.8% bounce, off the back of the Delta lockdowns which drove a 1.9% contraction in the September quarter. We expect the rebound will be led by consumer spending – consumers eagerly opened their wallets as restrictions eased. We received some partial indicators last week, which suggested that dwelling investment declined in the quarter, as home building activity pulled back, and new investment was broadly flat.

More partial indicators for the December quarter will be published early this week, ahead of the release of GDP. Today, company profits and business inventories were released. Inventories rose 1.1% – exceeding market expectations of a flat result – and partially unwinding the hit to inventories during the Delta lockdowns. This will see inventories add 1 percentage point to GDP growth for the December quarter. Company profits rose 2.0% in the quarter, in line with market expectations, alongside the broader recovery in the economy.

In addition, tomorrow the balance of payments data will be published, which includes data on the current account and net exports. We anticipate the current account surplus narrowed to $13.5 billion in the December quarter, from the $23.9 billion record high in the previous quarter. We expect net exports will shave 1.0 percentage point of GDP growth in the December quarter. While both export and import volumes appear to have declined in the quarter, exports look to have fallen more, as they were hit by supply disruptions.

Housing

We also receive a raft of housing market data this week.

CoreLogic data tomorrow should indicate that dwelling prices rose 0.3% in February, off the back of a 1.1% increase in January. Annual growth remained very strong in January, hitting 22.4% - its highest level since the 1980s. Growing affordability constraints, rising fixed rates and a lift in housing supply are taking the steam out of the market. In recent months, Brisbane and Adelaide have outperformed the other capitals, partly reflecting their relative affordability. Brisbane has also been benefitting from significant interstate population inflows. Dwelling prices in regional areas have continued to rise faster than in capital cities.

Whilst dwelling prices have continued to grow, the monthly rate of growth has slowed since early 2021. We expect a more material slowdown in dwelling prices once the RBA starts its rate-hike cycle.

We expect housing finance approvals rose 5.0% in January, with a 5.5% increase in lending to investors beating a 4.5% in lending to owner occupiers. However, seasonality and Omicron mean there is considerable uncertainty over these estimates. This follows a 4.4% increase in housing finance approvals in December, which took approvals to a new record high alongside an uptick in sales and dwelling prices as restrictions eased after the Delta lockdowns. More generally, low interest rates and the recovering economy continued to drive strong demand for housing finance.

We anticipate building approvals fell 4.0% in January, as a spike in unit approvals in December reverses. Approvals jumped 8.2% in December. In January, excluding units, building approvals may look more solid. The pipeline of construction activity remains robust following the significant run-up in approvals over late 2020 and through 2021. This will support employment and economic

growth over 2022 and beyond, as projects are completed.

Other data

Earlier this morning, retail trade data showed a surprise 1.8% increase in January, beating expectations, despite the 'shadow lockdown' underpinned by Omicron. In fact, only two retail categories recorded declines in the month – clothing, footwear & personal accessories and cafes, restaurants & takeaway. This follows a 4.5% decline in sales in December, off the back of a jump in November boosted by reopening and Black Friday sales. The January result bodes well for the economic recovery. We expect spending will hold up after case numbers peaked in late January, although the lift in February may be more muted given the strong result for January. Elevated household savings, low interest rates, the strong labour market and pent-up demand will support robust growth in consumer spending over 2022.

Private sector credit data for January was also released this morning, rising 0.6% in the month as expected. In annual terms, credit growth jumped to 7.6% – the highest annual growth in over 13 years. This follows a 0.8% increase in the month of December. Business credit growth rose 0.6% in the January, hitting 9.0% annual growth – also the strongest pace in more than 13 years. Housing credit grew 0.7% in January, with lending to owner-occupiers up 0.8% and lending to investors up 0.5%.

In the coming period, business credit will be supported by strong demand as the economy recovers, low interest rates, and generous investment incentives from the government. Surveys and our liaison suggest businesses are mildly optimistic, despite ongoing challenges around supply disruptions, rising inflationary pressures and the prospect of rate hikes later this year. We expect housing credit growth will begin to moderate later in the year as the RBA lifts the cash rate.

Finally, trade balance data for January will be released on Thursday. We anticipate the surplus widened to $10.4 billion in the month, from $8.4 billion in December. We expect stronger exports will drive the result, alongside higher prices and volumes for iron ore and coal, with exports up a forecast $3 billion. We also project imports to rise $1.0 billion in the month, alongside higher fuel costs and higher volumes.

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Forecasts

		2022				2023	
End Period:	**Close (25 Feb)**	**Q1 (f)**	**Q2 (f)**	**Q3 (f)**	**Q4 (f)**	**Q1 (f)**	**Q2 (f)**
Aust. Interest Rates:							
RBA Cash Rate, %	0.10	0.10	0.10	0.25	0.50	0.75	1.00
90 Day BBSW, %	0.08	0.10	0.10	0.35	0.60	0.95	1.20
3 Year Swap, %	1.89	1.75	1.75	1.80	1.90	2.00	2.10
10 Year Bond, %	2.23	2.20	2.40	2.40	2.50	2.50	2.40
US Interest Rates:							
Fed Funds Rate, %	0.125	0.375	0.875	1.125	1.375	1.625	1.875
US 10 Year Bond, %	1.95	2.00	2.30	2.40	2.50	2.50	2.40
USD Exchange Rates:							
AUD-USD	0.7177	0.70	0.70	0.71	0.73	0.75	0.76
USD-JPY	115.29	116	117	117	118	118	119
EUR-USD	1.1210	1.13	1.11	1.12	1.13	1.14	1.15
GBP-USD	1.3406	1.36	1.37	1.38	1.38	1.38	1.37
NZD-USD	0.6695	0.65	0.65	0.66	0.68	0.69	0.70
AUD Exchange Rates:							
AUD-USD	0.7177	0.70	0.70	0.71	0.73	0.75	0.76
AUD-EUR	0.6402	0.62	0.63	0.63	0.65	0.66	0.66
AUD-JPY	82.744	81.2	81.9	83.1	86.1	88.5	90.4
AUD-GBP	0.5354	0.51	0.51	0.51	0.53	0.54	0.55
AUD-NZD	1.0716	1.08	1.08	1.08	1.08	1.09	1.09

	2020	**2021 (f)**	**2022 (f)**	**2023 (f)**
GDP, %	-0.8	3.2	5.5	2.7
CPI (Headline), %	0.9	3.5	3.3	2.5
CPI (Trimmed mean), %	1.2	2.6	3.3	2.9
Unemployment Rate, %	6.8	4.7	3.8	3.9
Wages Growth, %	1.4	2.3	3.2	3.5

AUD cross exchange rates have been rounded.

Financial forecasts are quarter end.

GDP, CPI, employment and wage growth forecasts are year end.

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