Australia in 2024: risks & issues

November 2023

- The Australian and global economies avoided the feared recession in 2023.
- The expectation is that recession can be avoided in 2024 as well.
- Much depends on successfully taming inflation and central banks avoiding a policy "mistake".
- Global risks are dominated by potential financial shocks, limited fiscal scope, China and geopolitics.
- The consumer is the main domestic risk.

There were plenty of negatives at work in the global (and Australian) economic story in 2023. Growth was sluggish. But the much-feared recession failed to appear. The year ahead is shaping up as something of a repeat performance. Forecasts are for modest growth – but no recession. And all the debate is about the downside risks.

Inflation is proving difficult to contain. And the market desire to call an end to the tightening cycle and price in rate cuts looks premature. The ability to use fiscal policy is constrained. Risks to the China economic story continue to build. And geopolitical threats continue to flare. Don't forget that there is a US Presidential Election scheduled for November 2024.

Rear view

The common forecasting theme at the start of 2023 could be summarised as gathering storm clouds. The common drivers of this storm were the lingering effects of the Russia-Ukraine war, the global cost-of-living crisis and the slowdown in the Chinese economy.

- The IMF warned that "risks to the outlook remain unusually large". The Fund went as far as to say that "more than a third of the global economy will contract in 2023".

- The OECD noted that "uncertainty about the outlook is high, and the risks have become more skewed to the downside and more acute".
- Then RBA Governor Lowe began warning that "we are travelling along a narrow path". And that the chances of getting knocked off that path were high.

The reality proved somewhat different. The global economy probably grew by 3% in 2023. Sluggish. But not a recession. Genuine recessions were limited to a few European and Latin American nations.

From an Australian perspective, growth in our major trading partners is set to print around 3½%pa – a bit below the long-run average (Chart 1).

Australian GDP growth for 2023 will probably print around 1.6%pa. Like the global economy, a disappointing result. But not a recession.

Better than expected global outcomes reflected:

- the final unwind of pandemic-era pressures on supply chains and shipping costs;
- pauses after the rapid period of monetary policy tightening that began in late 2021;
- a recovery in global transport and tourism activity that more than offset weakness in manufacturing;
- the rapid resolution of potential negatives such as financial crises in the US (Silicon Valley Bank, Signature Bank) and Switzerland (Credit Suisse – a global systemically important bank).

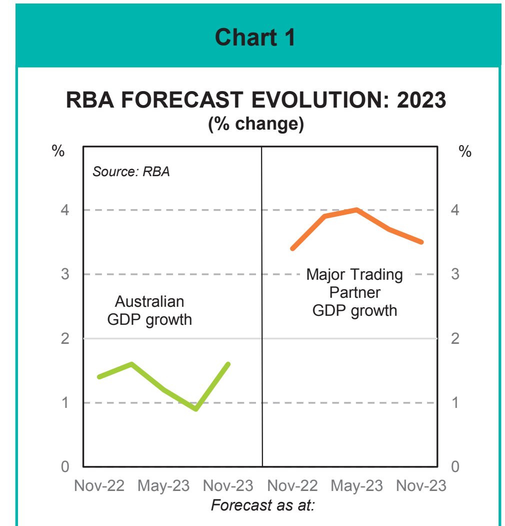
The real surprise was the remarkable resilience of labour markets around the world. More than 60% of the advanced economies had unemployment rates in 2023 that were *below* pre-pandemic 2019 levels (Chart 3). Strong labour markets supported the consumer.

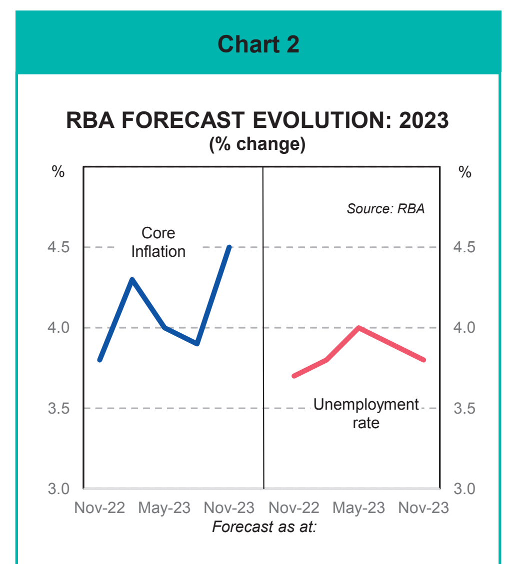
The Australian unemployment rate held close to 50-year lows in 2023 and policy makers had to lower their jobless forecasts as the year went on (Chart 2).

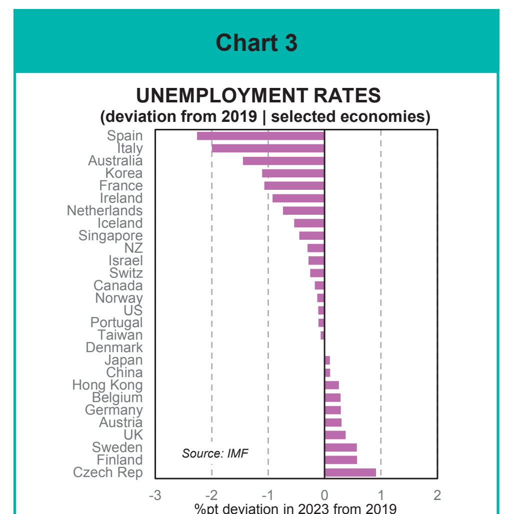
Inflation rates look to have peaked in most countries/regions during 2023 (Chart 4).

Before getting too carried away with this otherwise sunny interpretation of 2023, the year ends with most parts of the global economy sitting well below where they should have been.

Comparing 2023 growth outcomes with what pre-pandemic projections suggested reveals the scale of output loss.







World GDP, for example, is more than 3ppts below where it should have been (Chart 5). China's output loss exceeds 4ppts. Only the US economy is more or less where it should be.

The global backdrop

Turning to the year ahead, some forecasters are quietly whispering "soft landing". And that is what the forecasts suggest.

The recent IMF forecasts put global growth in 2024 at 2.9%, similar to that recorded in 2023 (Table 1). Growth expectations for advanced economies (1.4% in 2024) and emerging market & developing economies (4.0% in 2024) are also similar to 2023 outcomes.

Table 1: Key Global Forecasts (%pa)

	2022 (a)	2023 (f)	2024 (f)
GDP			
World	3.5	3.0	2.9
United States	2.1	2.1	2.5
Adv economies	2.6	1.5	1.4
EMDE	4.1	4.0	4.0
China	3.0	5.0	4.2
Inflation			
Adv Economy CPI	7.3	4.6	3.0
Labour Market			
Adv Economy unemployment	4.5	4.4	4.6

Source: ABS / RBA

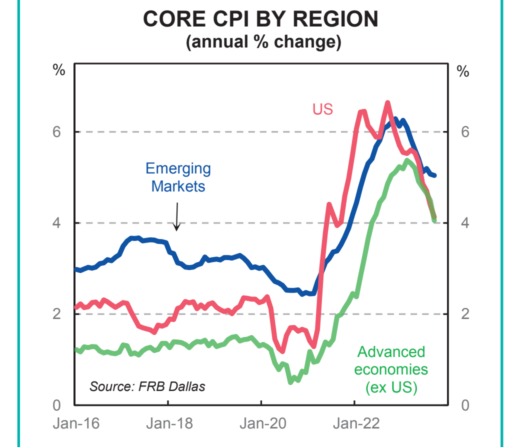
But a wide range of outcomes are evident within those regional groupings:

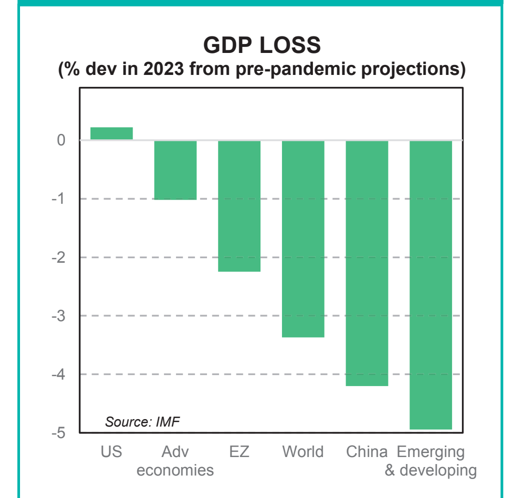
- in the advanced economies, weak outcomes are expected in important countries like Germany, Italy and the UK; and
- in the EMDE economies, some key economies like China, Brazil, Mexico and Russia are expected to slow.

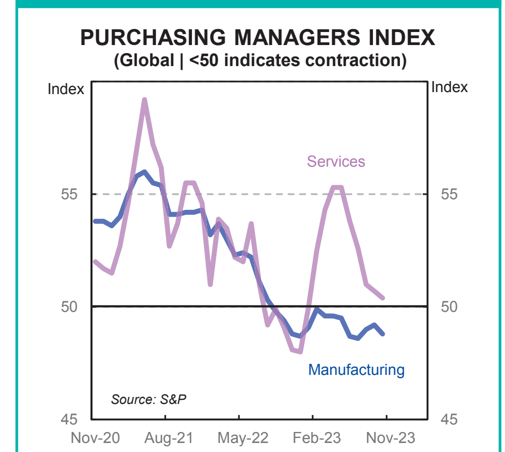
This "soft landing" also involves a further slowing in inflation rates and the maintenance of the low unemployment rate environment.

But as noted earlier in the commentary on 2023, don't get too carried away with this benign set of *projections* for 2024.

We used up a fair amount of our "luck" in 2023. The economic dice may not roll our way again in 2024. And the list of downside economic risks keeps growing.







The bounceback from the pandemic drag, for example, is now complete. The World Health Organization no longer considers COVID-19 a global health emergency. Global supply chain pressures have dissipated. Global shipping costs are back to normal levels. The boost to growth from these unwinds in 2023 will not be repeated in 2024.

Similarly, the global appetite for travel and tourism after the pandemic shutdown looks to have run its course.

International tourist arrivals are nearing pre pandemic levels in many regions. The maturing of the tourism boom means the contribution to global growth will wane.

A tourism-led services recovery in 2023 offset a downturn in the interest-rate-sensitive manufacturing sector. But the end of that offset means manufacturing weakness is more likely to come to the fore in 2024. Purchasing managers indexes show global manufacturing in recession and global services slowing quickly (Chart 6).

The rapid resolution of potential financial shocks helped the global economy in 2023. But regulators remain worried about risks in areas such as commercial real estate.

The pandemic created new risks to the offices segment as working-from-home took off. The pandemic also accelerated the trend to online shopping and risks in the retail space. Together with higher borrowing costs, there are pressures on commercial real estate valuations.

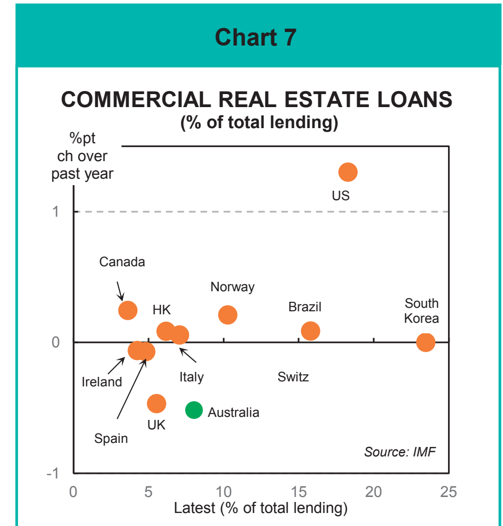
In contrast, the increase in demand for logistics space is supporting the industrial segment.

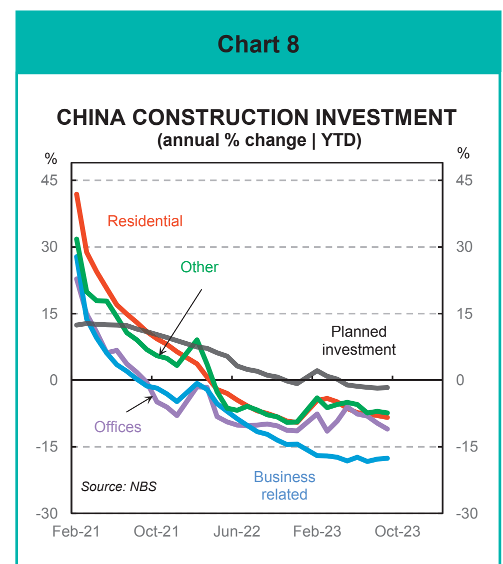
The US looks most exposed given commercial real estate loans outstanding and their growth (Chart 7). Note that Australian banks commercial real estate loans are only a small share of assets. And outstandings have declined over the past year.

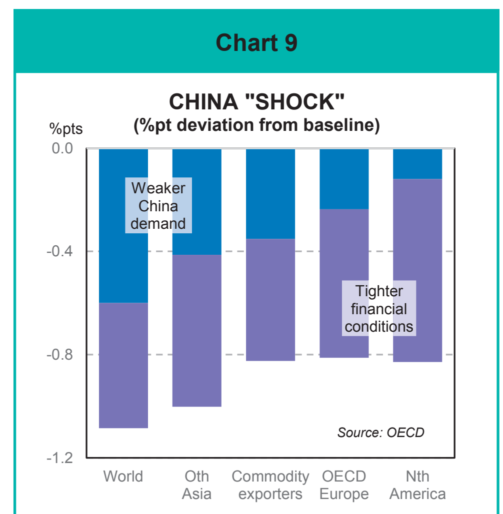
China is another potential source of global financial instability. Their problems are more to do with residential real estate and property development rather than the commercial side.

A downturn in residential construction activity is weighing on Chinese economic growth (Chart 8).

In something of a vicious circle, the severe funding constraints facing property developers is slowing the completion of pre-sold homes. Home buyer confidence is under pressure, prolonging the falls in real estate prices. In turn, declining real estate activity is hurting local government finances.
The problems in real estate are weighing on business confidence and capex. Exports are under pressure as foreign demand weakens.







The scope for supportive fiscal policy may be limited. But China is experiencing deflation rather than the inflation prevalent in the rest of the world. So there is room for monetary policy to help. There have been some modest moves. But policy makers seem reluctant to take the aggressive steps that have characterised previous cycles.

The OECD has modelled the impact of a negative shock to Chinese GDP growth on the global economy.

The shock involves a one-year decline of 3% in domestic demand (relative to baseline).

This shock would directly *lower* global GDP growth by 0.6ppts. And world trade by 1¼ppts (Chart 9). The rest of Asia and commodity exporters would be hit the hardest.

Any tightening of global financial conditions as risk gets repriced would magnify the impact. The OECD scenario involves a 10% decline in global equity prices and higher investment risk premia. Global GDP growth could be lowered by a further 0.5% in the first year of the shock (Chart 9). The combined shocks (1.1% off global growth) would also be deflationary, reducing global inflation by around 0.4ppts.

A final pandemic-era influence on the global economy is the savings stockpile built up during the period of government largesse in 2020 and 2021. This excess savings helped support consumer spending in 2022 and 2023.

These excess savings ranged from 4-7% of GDP in some of the major economies at the peak in 2021 (Chart 10).

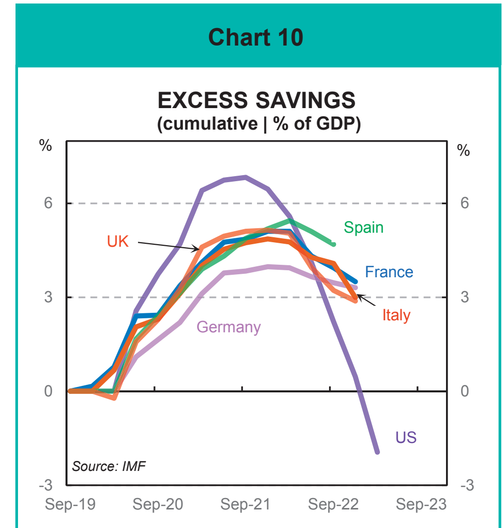
Excess savings persist. And these savings remain a source of funding for consumer spending in 2024. But the rapid rundown of the savings stockpile in the US suggests that the support could be short-lived.

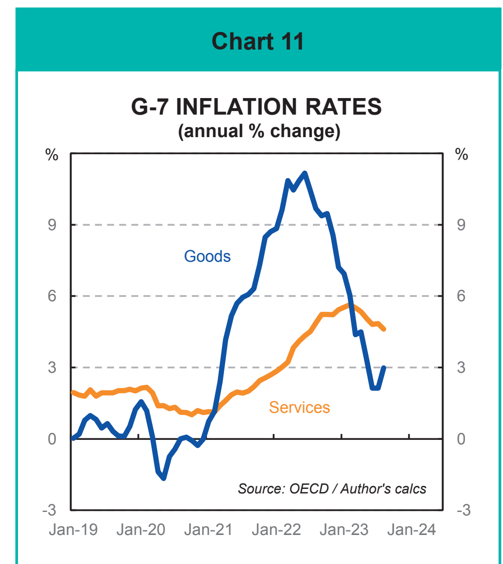
Inflation rates may have peaked in 2023. And are set to move lower in 2024. But some key parts of the inflation story are proving “sticky”. And progress toward central bank targets is slow.

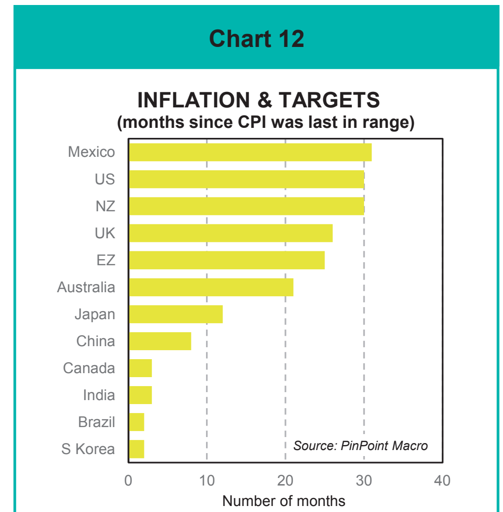
Most of the inflation slowdown is concentrated in the *goods* component of the CPI. *Services* inflation, in contrast, is proving more difficult to tame (Chart 11).

Services prices are impacted by some lift in labour costs, the lagged flow-through of earlier rises in energy costs and rising dwelling rents.

The practical impact is that inflation rates remain above central bank targets in many countries. And this period of above target inflation is now proving somewhat lengthy. Inflation has run above target in the US for more than 30 months (Chart 12). Australia has clocked up 21 months above target.







Central banks are a little restive at the slow path back to target. They worry about the impact on their credibility. And they worry about the impact on inflation expectations.

RBA Governor Bullock probably summed it up best when she noted recently that the Board has “a low tolerance for allowing inflation to return to target more slowly than currently expected”.

Nevertheless, financial markets and economic commentators persist in looking for reasons to call an interest-rate peak. And to put rate cuts into their forecast profiles. Futures markets, for example, expect policy interest rates to be 1-2% lower in two years time (Chart 13).

Yet Fed Chairman Powell warned in November 2023 that “the question of rate cuts just doesn’t come up.....the question we’re asking is should we hike more.”

The ”higher-for-longer” thinking proposed by central bank commentary means the possibility of a policy mistake has lifted. And a reason why the economic risks are to the downside.

Better economic outcomes in 2023 were also reflected in fiscal policy outcomes as well. Budget deficits were smaller than expected in some countries. And rare surpluses appeared in some countries such as Australia. Nevertheless, public debt levels remain elevated. The scope for fiscal policy to play a supportive role remains limited. Current forecasts imply a modest fiscal contraction in 2024 (Chart 14).

Aside from the traditional short term monetary and fiscal levers, policy makers need to worry about the medium term as well. Policy makers everywhere face issues related to climate change, aging populations, protectionist sentiment, populism and rising infrastructure needs.

A common forecasting theme for most of the past decade is the steady erosion of *potential* GDP growth estimates. Potential per capita growth rates for the advanced economies, for example, were cut from 2.2%pa in 2000-2004 to 1.2% now (Chart15).

The biggest contributor to the slowdown in potential growth rates is slower growth in total factor productivity (TFP). This slowdown is often attributed to the loss of reform momentum since the turn of the century. It explains the repetitive refrain from policy makers, politicians and economists about the need to reignite productivity growth.

Finally, there is always the X Factor. A common X Factor in recent years is geopolitics. Geopolitical events often have an impact on financial market pricing. And from there into the real economy.

Chart 13

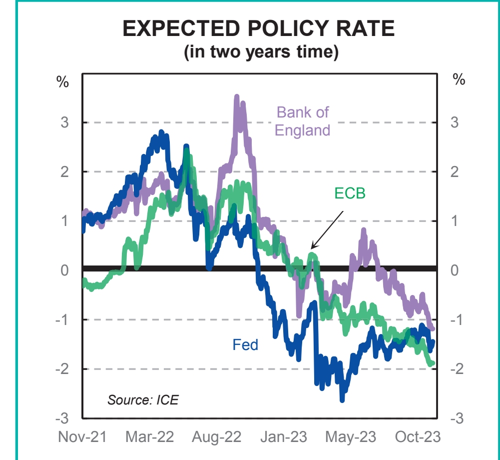


Chart 14

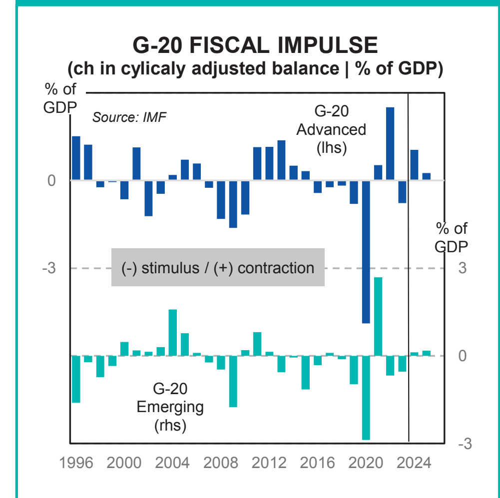
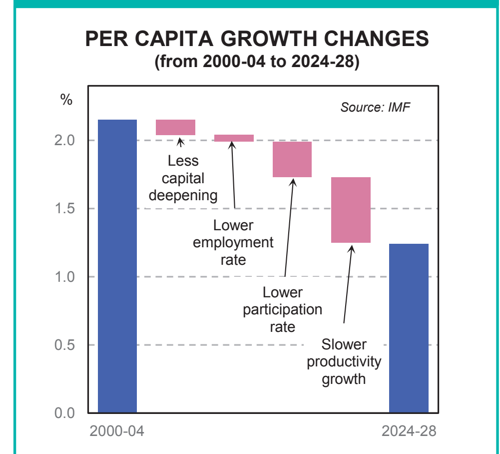


Chart 15



These events can also influence activity in other ways. The impact on the Russia-Ukraine war on energy prices, food prices and global supply chains is a case in point.

Beyond the horrendous humanitarian costs, the current Israel-Hamas conflict has disturbed financial markets and economies.

The onset of conflict was associated with higher oil and gold prices, higher bond yields, lower share prices and increased market volatility (Charts 17-18).

The Australian economy

Transmission channels from the rest of the world into Australia generally operate quickly and fully. So any snapshot of the Australian economy will have a lot of similarities to the rest of the world:

- GDP growth slowed in 2023 but remains a fair way from recession.
- The consensus for 2024 is sluggish growth but no recession.
- The labour market remains resilient – the current 3.6% unemployment rate is at levels last seen in the 1970s.
- Inflation rates have slowed but services inflation is proving persistent.
- As a result, the RBA's tightening bias remains in place and any easing cycle is in the far distance.
- Australian financial markets have danced to the global tune.

None of these outcomes are unusual. But there are some parts of the global transmission story that look a little threatening from an Australian perspective.

One of those concerns is the Aussie dollar. The AUD is one of the most traded currencies in the world. Those sitting above the AUD in turnover terms are "safe-haven" currencies like the USD, JPY and EUR. So the first currency you want to sell in uncertain times is the AUD. And probably by more than the currency fundamentals would justify.

The practical outcome is that the AUD is an effective shock absorber for the Australian economy. A lower currency limits the damage to economic activity and incomes from a negative global shock. A rising currency limits the inflation damage from a positive global shock.

But this time is different. The AUD/USD has fallen as expected. But the more important trade-weighted measure of the currency (the TWI) is barely changed from where it was in 2019 (Chart 19).

Chart 16

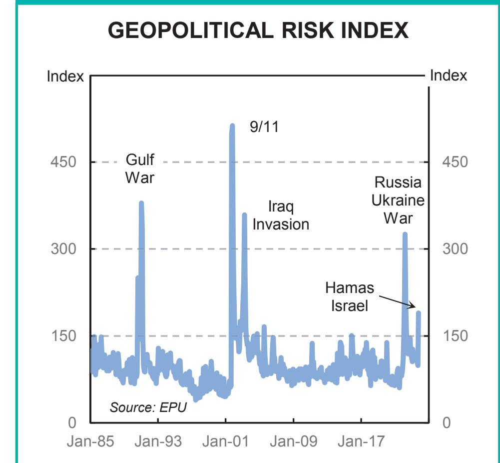


Chart 17

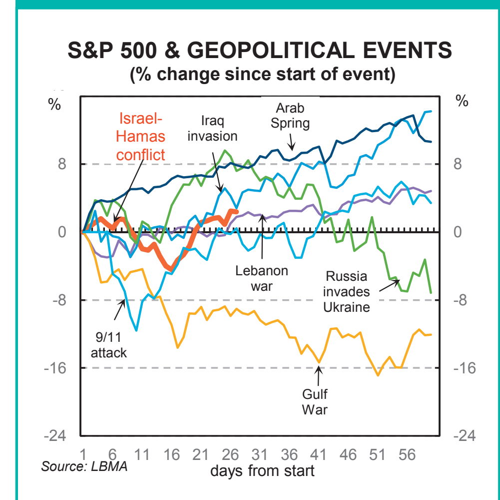
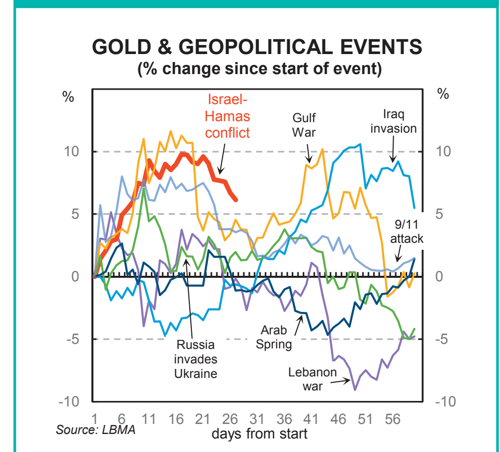


Chart 18



The overarching currency theme at present is a strong USD story. So most currencies have weakened against the USD. The TWI is little changed as a result. The usual currency protection for Australia is not there.

Another concern is the combination of a sluggish global backdrop with a weak Chinese economy dominated by downside risks. This is not a great backdrop for commodity prices. Falling commodity prices are a negative for Australian incomes.

There is a strong correlation between commodity prices and *nominal* GDP growth (Chart 20).

The flow chain underlying this correlation is that lower commodity prices mean lower Australian export prices and a falling terms-of-trade. And swings in the terms-of-trade drive the swings in nominal GDP growth.

Nominal GDP represents total Australian income. And it is also the tax base. Weaker income would be a negative for government revenues and business profits.

A falling terms-of-trade may weaken some of the other factors that have helped protect the Australian economy. Australia's fiscal position, for example, may look stretched from an historical perspective. But it looks good compared with many other countries. There was even a surprise budget *surplus* in 2022/23 (Chart 21). But revenue losses from a falling terms-of-trade mean *deficits* will return. And public debt will rise again. The ability to deploy fiscal policy to deal with negative economic shocks will remain constrained.

A falling terms-of-trade also means a reduction in Australia's trade surplus. Very large trade surpluses drove the move to overall current account surpluses since 2019 (Chart 22). A surplus means Australia switched from a net *borrower* from the rest of the world to a net *lender*. Our exposure to global funding markets was lower as a result. This reduction is a useful protection in volatile and uncertain times. But that protection may be a little thinner in 2024.

Aside from the downside risks from an external "shock", the other key risk relates to the possibility of a domestic policy "mistake".

The RBA began responding aggressively to the lift in inflation rates in 2022 with a series of 50bpt jumps in the cash rate. The process continued during 2023, albeit with a shift to the more normal policy adjustments of 25bpts. The bottom line is that the current tightening cycle is the biggest of the modern era. The cash rate was lifted by 425bpts over a period of 19 months (Chart 23).

Chart 19

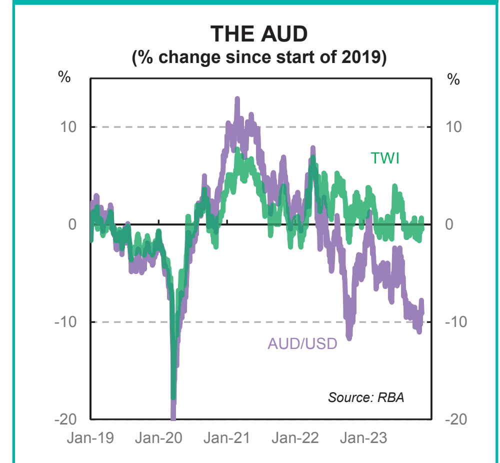


Chart 20

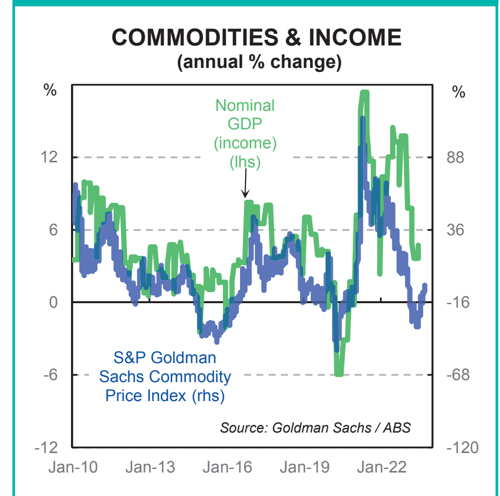
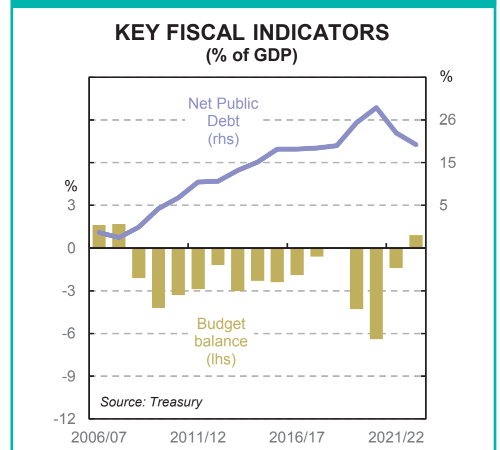


Chart 21



The size of the rise does reflect the starting point - policy rates were cut to record lows during the pandemic. But it also reflects the difficulty that the RBA has faced in containing inflation.

The underlying inflation rate, which strips out some of the extreme price moves that distort the price picture, peaked at 6.8% at the end of 2022 (Chart 24). By Q3 2023 that rate had stepped down to 5.2% - still well north of the RBA's 2-3% inflation target.

The step down in inflation rates reflects a significant slowing in goods inflation. The slow progress in moving back to the RBA's target reflects sticky *services* inflation (Chart 24).

Goods price inflation should slow further during 2024. Global cost pressures are easing as supply chain issues are resolved and freight and raw materials costs ease back. Slow growth in domestic demand will also feed into the goods inflation equation.

The extent of progress on the services front is the main uncertainty in the inflation outlook.

Services inflation is broadly based. Rents, dwelling purchase costs, childcare, health, utilities, education, financial services, overseas holidays and State & local government charges are all contributing.

Services inflation stickiness reflects labour cost trends from a fundamental perspective (Chart 25). Wages and unit labour costs have lifted.

Much of the services inflation story is related to housing. Housing has the biggest weight in the CPI (even more than food). The Housing sub-group is strongly correlated with house prices (Chart 26).

So from that perspective the RBA is probably watching the turn up in the house price cycle with some trepidation (Chart 27). Upturns generally run for longer and further than downturns.

The key here is to recognise that the housing "market" is like no other. Enter your local ColesWorth and everything you see is for sale. Not so for housing.

There are around 11 million dwellings in Australia. In any year, dwelling sales are equivalent to 6-8% of the stock (Chart 28). New construction typically adds 1½-2% to the stock each year. Demolitions will partly offset this new build.

So at any point in time maybe 10% of the housing stock is in play. The rest is off-market or "locked-up". You don't need much of a shift in supply or demand to have a big impact on price. The demand side of the equation is strong.

Chart 22

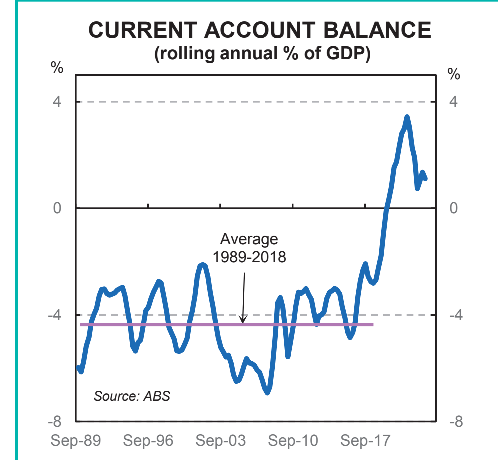


Chart 23

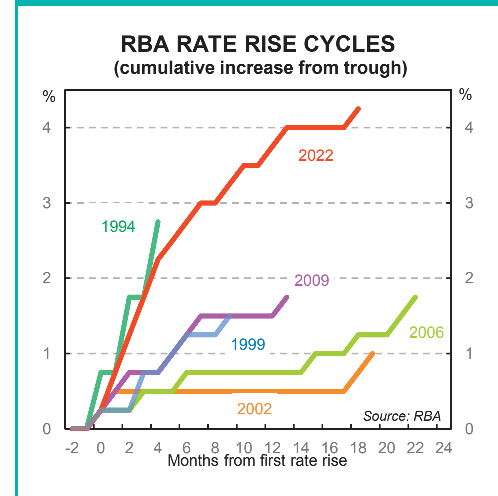
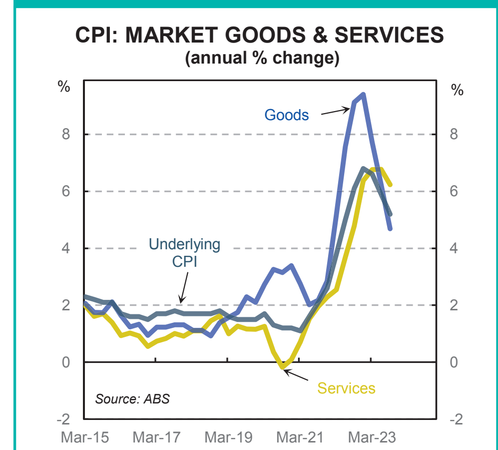


Chart 24



Population growth is exceptionally high as migrants and foreign students return to Australia. Falling construction activity as profits are squeezed and insolvencies rise is limiting the ability of supply to respond.

The rental market typically provides something of a safety valve when demand and supply are out of whack. But the very low residential vacancy rates evident across most capital cities is limiting the ability to absorb housing pressures.

These considerations suggest dwelling prices and rents will continue to feed into the overall inflation story. They may slow the progress in reducing inflation back towards the RBA's 2-3% inflation target. And they will feed into the RBA's interest rate decision.

Dwelling prices close to the end of 2023 were about 8% above the early 2023 trough. The consensus among the major banks is that dwelling prices will rise by a further 4% in 2024 (Table 2).

Table 2: Dwelling Price Forecasts (%pa)

	2022 (a)	2023 (f)	2024 (f)
Sydney	-11.4	10	5
Melbourne	-7.1	4	4
Brisbane	-1.9	7	5
Adelaide	9.3	6	4
Perth	4.1	8	5
Hobart	-6.9	-5	2
Darwin	2.5	-1	0
Canberra	-3.1	-1	4
Australia	**-4.9**	**7**	**4**

Source: CBA / NAB / WBC / ANZ / CoreLogic

New RBA Governor Bullock has been at pains to stress her commitment to returning inflation back to target. And her words were backed up by action at the November Board meeting. The cash rate was lifted by 25bpts to 4.35%, the highest since 2011. To put that it some perspective, about the same time as we were getting excited about the iPhone 5!

The more subtle signalling from Governor Bullock, as noted earlier, is the need to get inflation back to target within the expected forecast timeframe (by end 2025).

The RBA's inflation target is actually benchmarked against *headline* inflation. So getting there by end 2025 (and then only just) implies 19 quarters where inflation has run above target! Small wonder there is a low tolerance for anything that might lengthen that time frame.

Chart 25

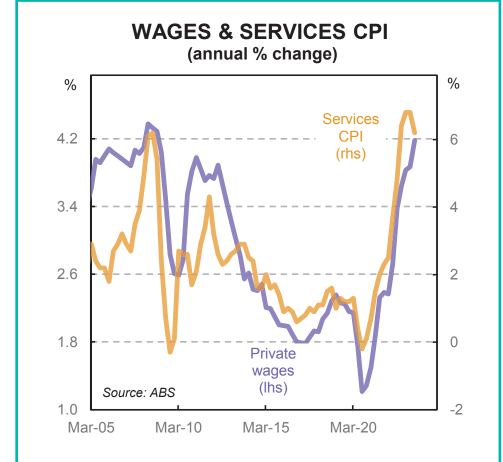


Chart 26

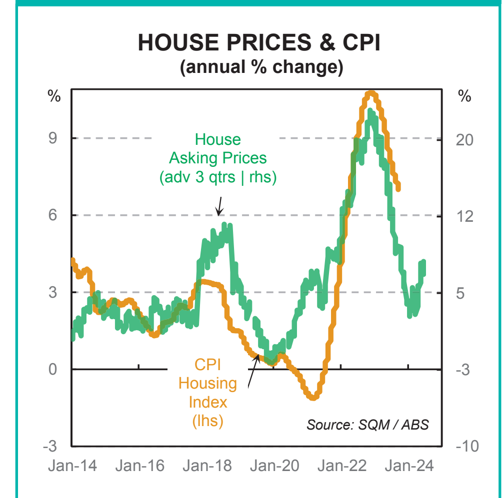
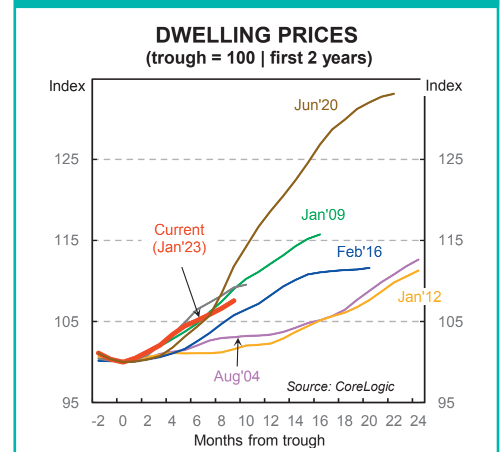


Chart 27



RBA forecasts are published every three months. They typically show inflation returning, sustainably, to target within the forecast period (Chart 29 – green lines). The last time they could do this was early 2022. The RBA was playing catch up from then on: revising forecasts higher. And those forecasts remained above the target band.

The RBA is clear that it will persist with a tightening bias. The risk lies with one last rate rise. Any chance of rate cuts looks to be in the far distance.

The Overnight Index Swap market (OIS), which provides an indication of where markets expect the RBA's cash rate to go, is pricing a plateau of 4½% by mid 2024 (Chart 30).

Nevertheless, Australian markets are still inclined to price in some chance of a rate cut as we move into the second half of 2024.

A cut would probably require signs that consumers are buckling under the strain of higher debt service costs and rising unemployment. Or a faster return of inflation to the RBA's target band than currently expected.

Beyond the inflation and monetary policy story, expectations for economic activity look relatively neutral.

RBA projections, for example, typically set the baseline for the private sector consensus (Table 3). These projections have the Australian economy running at a sub-trend 2.0% through 2024. Unexciting. But better than the likely outcome for 2023.

Table 3: Australia: Key Forecasts (%pa)

	End 2022 *(a)*	End 2023 *(f)*	End 2024 *(f)*
GDP	**2.7**	**1.6**	**2.0**
H/hold spending	5.2	1.1	2.1
Dwelling capex	-4.0	-1.2	2.0
Business capex	4.0	7.3	0.3
Public spending	2.6	2.4	1.3
Employment	5.2	2.5	1.5
Unemployment	3.5	3.8	4.2
CPI	7.8	4.5	3.5
Wages	3.4	4.0	3.7
Terms of trade	7.2	-5.5	-4.5

Source: ABS / RBA

The main points are:

- The modest pick up in GDP growth reflects households lifting their spending and an end to the downturn in residential construction.

Chart 28

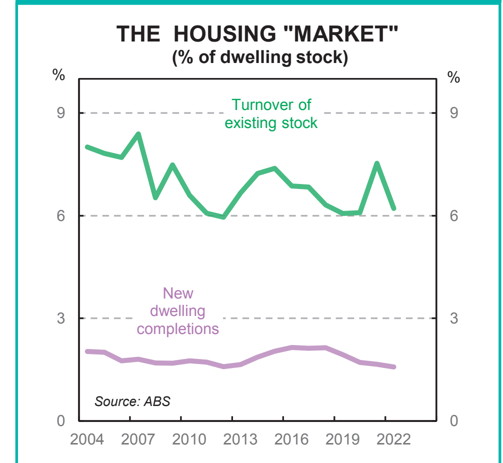


Chart 29

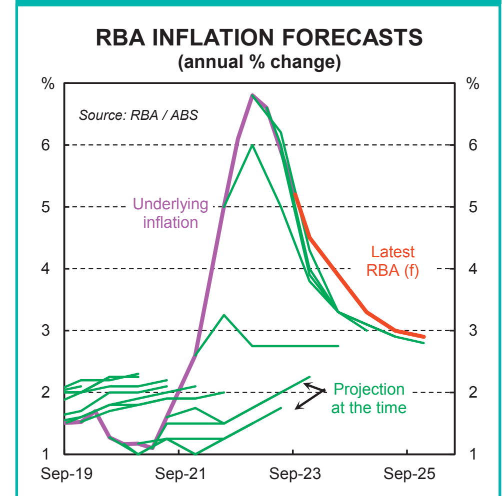
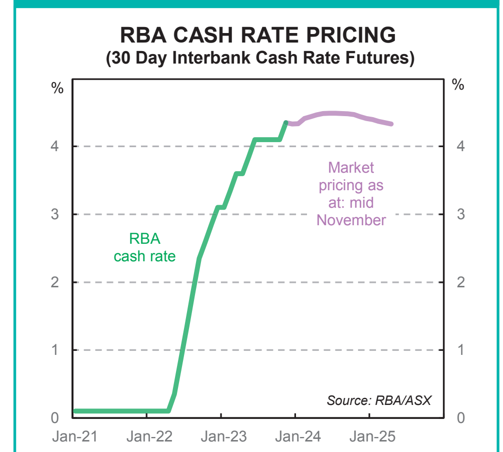


Chart 30



- After a number of years of solid rises, businesses hold their nerve and maintain capex at peak levels.
- The public sector provides some modest support as the unwind of pandemic-related measures is completed.
- Import growth runs ahead of exports so net external trade is a small drag on overall GDP growth.
- While GDP growth is still soft, it remains sufficient to limit any substantial damage to the labour market.
- A small lift in unemployment is enough, however, to slow wages growth.

The main downside risks to the domestic economy emanate from Australian households.

A residential construction downturn started in late 2021. But the drag on the overall economy has been quite limited. The reduction in economic growth from falling construction amounts to 0.3% of GDP – the smallest of the post-2000 downturns (Chart 31).

The downturn is unusual in the sense that it reflects materials and labour shortages that generated a cost squeeze and rising construction insolvencies. Leading indicators, like building approvals, are yet to turn up. But the strength of population growth (Chart 32) and some government initiatives suggest *rising* construction activity is a plausible outcome for 2024.

The risk of a consumer "recession" remains.

The general consumer recession themes are well understood. Australian households are dealing with:

- a cost-of-living shock which is how higher inflation rates translate through in the real world;
- a real wage squeeze as prices run ahead of wages;
- falling rural incomes following adverse weather conditions;
- a financial shock as mortgage rates rise and debt service costs lift; and
- a housing crisis as supply shortages and rising demand push up dwelling rents.

What is less appreciated is that households are also dealing with a tax drag. Tax payments are growing rapidly and reducing disposable income (Chart 33).

Rising tax payments reflect labour market strength and some modest lift in wages growth. But taxes per person are rising quickly.

Households have not been sitting on their hands through this period. Home loan refinancing activity is running at record levels.

Chart 31

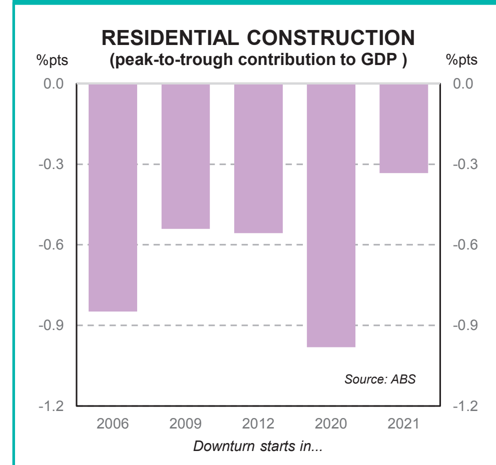


Chart 32

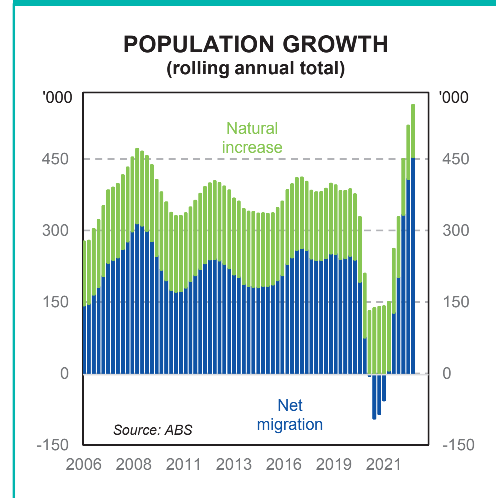
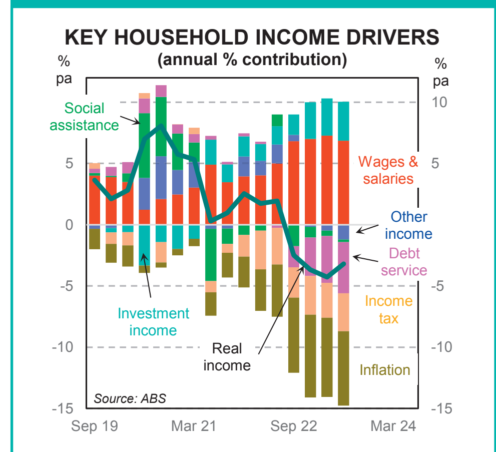


Chart 33



This refinancing means that the average interest rate paid by those with mortgages has risen by *less* than the RBA's cash rate.

Similarly, the different consumer inflation measures provide some insights.

The CPI is a fixed weight index. It assumes that we buy the same basket of goods each week. In contrast the Consumption Deflator is an implicit price index. It measures prices of what we actually buy each week.
The Consumption Deflator is growing more slowly than the CPI. This gap indicates that households are responding to high inflation by shifting spending towards cheaper items (Chart 34).

Looking ahead, there are some positives emerging in the consumer outlook that should support a modest lift in spending. These include:

- A return to real wage growth. Wages are expected to run ahead of prices in 2024 for the first time since 2020.
- The stockpile of savings built up during the pandemic (Chart 35). That stock sat at $301bn (20% of disposable income) as at mid 2023, a large potential support to consumer activity.
- Rising dwelling prices are now boosting household wealth.
- The impact of slow growth on the labour market should prove less damaging than expected, supporting consumer sentiment.
- The Stage 3 tax cuts are scheduled for mid 2024, reducing fiscal drag. As an aside, those arguing for the abolition or redirection of those tax cuts need to acknowledge the pressure from rising tax payments on household budgets.

That leaves interest rates and debt servicing costs as the main threat to the consumer.

Earlier work for iPartners *inFocus* noted that the last consumer recession was in 2008. That consumer recession was associated with a lift in the Debt Service Ratio (DSR) to 10% of disposable income (Chart 36).

A rising cash rate will push up the DSR. The rollover of fixed home loans onto higher rates also means a higher DSR. Some back-of-the-envelope calculations suggest the RBA would need to lift the cash rate to around 6% to get back to those 2008 stress levels. The expected cash rate peak is 4.6%.

So the RBA should stop short of the danger zone. But that "narrow path" that policy makers are trying to navigate will only get narrower in the year ahead.

Chart 34

CONSUMER INFLATION MEASURES
(start=100)

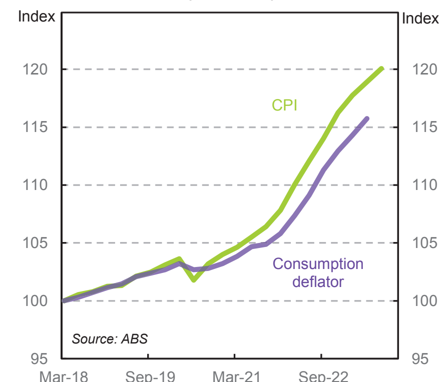


Chart 35

"EXCESS SAVINGS" DRIVERS
(contributions & stock)

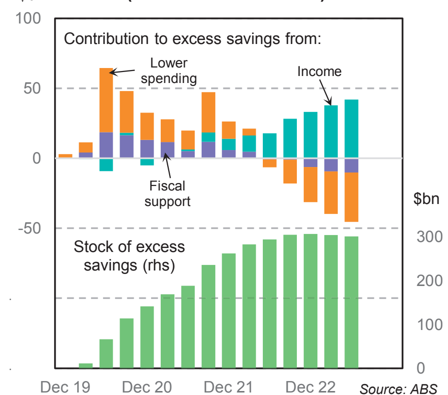
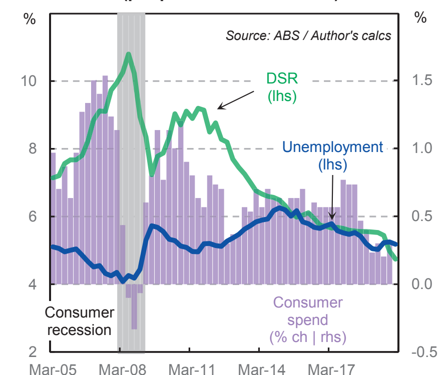


Chart 36

STRESS & THE CONSUMER
(pre pandemic: 2005-2019)



Some thoughts on financial markets

Shorter-term interest rates should closely follow the RBA trajectory. The risk is higher policy rates in the first half of 2024 before some retracement towards the end of the year.

Longer-term rates typically reflect US trends and policy rate differentials. This mix of drivers should see longer-term rates declining in the second half of 2024.

The key Aussie dollar fundamentals are moving in different directions. The AUD may be range bound in 2024 as the positives from a widening interest rate differential are offset by a falling terms-of-trade and narrowing current account surplus.

Lower commodity prices and the potential for some squeeze on profits as nominal GDP growth slows imply a negative lead for Australian equity markets in 2024.

Watch out for the X Factor. And don't forget that a US Presidential Election is scheduled for 5 November 2024.

Meanwhile, I'm off to update my iPhone!

Table 4: Illustrative Financial Forecasts

	End '23	Mid'24	End'24
US Fed funds	5.5	5.5	4.5
RBA cash rate	4.35	4.60	4.35
Australia			
3-yr bonds	4.5	4.7	4.5
10-yr bonds	5.0	5.2	5.0
Curve slope	48bpts	46bpts	48bpts
Aus-US 10-yr spread	-58bpts	-45bpts	-10bpts
AUD/USD	0.64	0.65	0.64

Source: RBA / Author's calcs

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