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Business Outlook

A fork in the road.

June 2024

Deloitte
Access Economics



Executive summary

A fork in the road.

Macroeconomic trends

The past several months have seen the Reserve Bank playing a game of chicken, staring down less-than-perfect inflation prints in order to cling on to labour market outcomes that are, for now at least, holding relatively firm. That game is likely to reach its crescendo sooner rather than later.

Indeed, the handful of weeks from late July until early September 2024 represents a fork in the road for the Australian economy and economic policymakers, with the data releases and policy decisions in that short space of time potentially setting the tone for the economy for the next 12 months. June quarter inflation data is due in late July, while June quarter economic growth will be released in earlier September. Those two data points bookend a critical August meeting of the Reserve Bank Board and the July labour force release.

Two clear alternatives are possible, and each would set very different trajectories for the Australian economy over the year ahead.

Down one road, a high June quarter trimmed mean inflation result– scheduled for release on the last day in July – could force the hand of the Reserve Bank to lift interest rates once more in early August, further crushing household and business confidence and wiping out the benefits of tax cuts and real wage gains in the second half of 2024.

Down the other road, the June quarter inflation result may be more benign, consistent with the slower pace of growth in the Australian economy. That result would see the Reserve Bank hold interest rates steady at its meeting in August, enabling households to lead a steady recovery in economic growth in 2024-25.

Deloitte Access Economics' forecasts contained in this edition of *Business Outlook* most closely resemble the second road and include the view that interest rates neither will nor should increase from current levels. That has been Deloitte Access Economics' consistent view for some time, for several reasons.

First, interest rates at their current level are restrictive. Second, inflation is retreating back towards the target, albeit less hurriedly than might have been hoped. Third, further interest rate increases are unlikely to temper price growth any more quickly than would otherwise be the case. And finally, the surge of post-pandemic inflation hit Australia later than it hit other economies, and has therefore cooled earlier elsewhere as well. That has enabled short-term interest rates to be cut in several economies while the prospect of lower policy rates in the United States (US) and New Zealand has also strengthened notably in recent weeks.

Given the Reserve Bank's penchant for data dependent decisions, a lot is riding on the June quarter inflation data.

Global economic conditions

Economic conditions across many major advanced economies have reached a critical stage. Inflation has cooled (or is cooling sufficiently quickly) enough for central banks in the Eurozone, Canada, Sweden and Switzerland to have already cut interest rates, while a dovish pivot by the Reserve Bank of New Zealand suggests rates could soon be heading lower there as well.

In the US, interest rates have now been on hold for more than a year. With the pace of jobs growth now slowing and further progress being made on inflation, the likelihood that the Federal Reserve will cut the policy rate at its September meeting is rising.

Elsewhere, the pace of economic growth in China slowed enough in the June quarter to suggest that the 2024 growth target of 5% is in doubt. That outcome had already been Deloitte Access Economics' baseline expectation for some time, and so the latest growth data has not materially altered the Chinese economic forecasts contained in *Business Outlook*. That data does, however, cast a particularly fascinating shadow over the 'third plenum' – a five yearly meeting of China's leadership to set broad economic and social policies – being held as this document was finalised.

Overall, global conditions remain finely balanced. If central banks manage to successfully manoeuvre advanced economies through the final stages of the post-pandemic inflation shock, and if China's third plenum results in some meaningful reform rather than just temporary sticky tape, then both the near-term and longer-term outlooks for the global economy will benefit. Those are rather large 'ifs'.

Australian economic conditions

The previous edition of *Business Outlook* set out the potential for Australia's economic prospects to strengthen in the second half of 2024. With the revamped Stage 3 tax cuts now in place, additional payments flowing to households in the form of energy bill relief and other support, rising real wages, and a looming lift in dwelling construction activity, stronger growth from late 2024 has been an emerging theme of the Australian economic outlook.

That theme is now under threat, however, as a result of recent inflation prints that have been slightly stronger than had been expected. That has put the Reserve Bank in a more uncomfortable position than it would have preferred, and has opened the door to another interest rate rise in August.

How significant would a further interest rate increase be at this point? On the one hand, most mortgage holders would be able to manage another 25 basis point hike, just as most have been able to manage the previous 425 basis points that the Reserve Bank has delivered since May 2022. On the other hand, another rate hike now might just be the proverbial straw on the camel's back. Consumer and business confidence remains at rock bottom, household budgets have been decimated by broad cost of living pressures, and insolvencies have surged.

In that environment, Australians and Australian businesses were looking forward to 1 July as the trigger for tax cuts and other relief. To have the Reserve Bank of Australia (RBA) Board snatch that relief away just as it arrived would be a mighty blow.

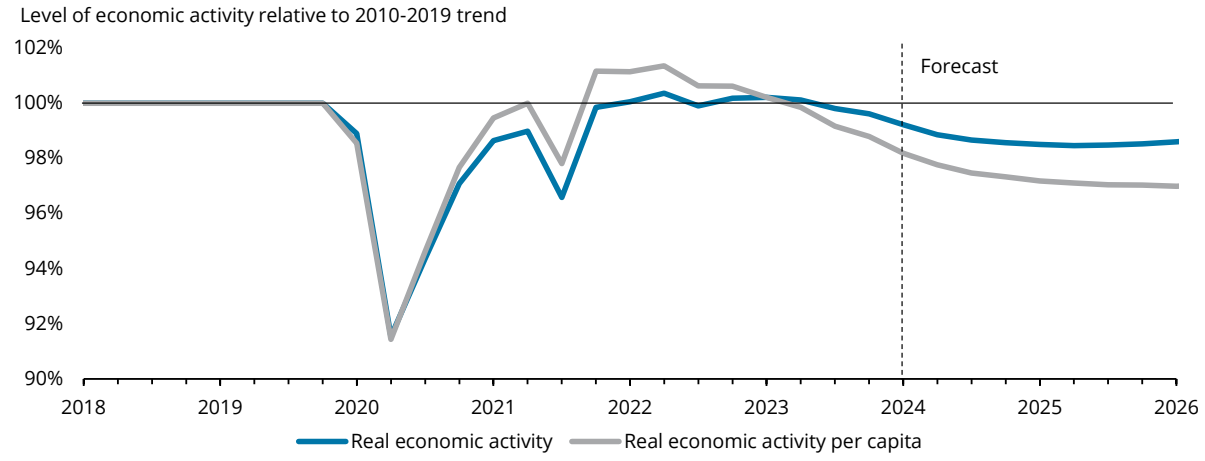
This may all be moot. Deloitte Access Economics does not expect the RBA to hike rates in August. That decision will, largely, depend on the June quarter inflation data. Should rates stay on hold, the narrative of a strengthening Australian economy through the second half of 2024 would remain intact.

As an aside, a key reason why support for consumers is available from 1 July is because of good budgeting. With growth slow and household budgets bare, it has become clearer how important fiscal policy will be to supporting the economy. The federal budget will shift from a surplus in 2023-24 to a deficit in 2024-25, likely to be worth some 1.5% of gross domestic product (GDP). If it wasn't for fiscal policy, the economy might be in recession in the coming year. The revamped Stage 3 tax cuts will play a critical role; adding around one percentage point to real household income growth in the coming year.

Several other forecasters do expect an August rate hike. In part, that is because of the Reserve Bank's rhetoric. If you say you have a 'low tolerance' for upside inflation surprises, that you are 'remaining vigilant', and that you 'will do what is necessary', then not acting in response to an upside inflation surprise would risk credibility.

More generally, there have been two schools of thought among Australian economists about the correct stance of monetary policy since this inflation surge began. One reason for that is that some economists have been focusing on the *level* of economic activity while others have been focusing on the *rate* of growth.

Chart i Economic activity in Australia relative to the pre-pandemic trend



Source: Deloitte Access Economics; Australian Bureau of Statistics.
Note: This chart shows real gross domestic product (GDP) and real GDP per capita for Australia, relative to the trend in these variables calculated from March 2010 to December 2019. A ratio above 100% indicates that actual economic activity is above the trend, while a ratio below 100% indicates that the level of economic activity is below trend. The forecasts shown in the chart are drawn from this edition of *Business Outlook*.

Neither are completely correct or incorrect but, importantly, the data is increasingly converging on the same conclusion: economic activity in Australia is weak, and further increases in interest rates are not justified.

Chart i on the previous page highlights this point. The chart shows that the level of real economic activity in Australia is now meaningfully below where the pre-pandemic trend would have taken it, with that outcome even worse on a per capita basis.

Why does that matter? In recent months, the number of people in the labour force has ticked above the pre-pandemic trend, while Australia's stock of productive capital is also at least as large as it otherwise would have been if not for COVID-19. That suggests that Australia's economy should be at least as large as it would have been in the absence of the pandemic. But it's not. Chart i shows that real economic activity is currently around 1% below the level implied by the pre-pandemic trend, with that gap expected to increase to closer to 2% over the next two years.

How does this conclusion square with Australia's still-low unemployment rate of around 4%? That can be explained by a growing body of evidence that suggests Australia's unemployment rate remains so low because of job growth in non-market sectors such as health and disability services. Those jobs are important, but strong employment growth in those sectors is not typically associated with a booming economy.

Interest rates tackle inflation that is caused by an overheating economy. Too much demand chasing too little supply pushes up prices. By supressing demand and slowing the pace of economic growth, higher interest rates can therefore help to bring inflation to heel.

But the Australian economy is not overheating. Indeed the level of economic activity is below the level that might have been expected in the absence of the pandemic, even though inputs of capital and labour are higher.

That means that the lingering inflation in the economy is predominantly being caused not by too much demand, but by other factors. For example, the housing shortage is pushing up rents, previously high inflation is causing 'administrative' price increases for items like school fees, and insurance premiums are rising because of earlier increases in the cost of claims. None of this sort of inflation will be tamed by higher interest rates.

Although there is no perfect, real world comparison to use to demonstrate this point, the New Zealand experience offers an interesting counterfactual. New Zealand's economic and industry structure, pandemic response, and inflation experience are all relatively similar to Australia's, as is shown in Chart ii, below. One key difference between the economies, however, has been the central bank's response to the post-COVID-19 inflation surge. As the chart shows, the Reserve Bank of New Zealand has been far more hawkish in raising rates compared to the RBA. The official cash rate in New Zealand currently stands at 5.5% compared to Australia's 4.35%.

New Zealand has spent the past 18 months dipping in and out of 'technical' recession, while the unemployment rate has risen from well below Australia's rate to now be above. And yet inflation has not been tamed any more quickly in New Zealand than it has in Australia. In fact, price growth has decelerated more rapidly in Australia. This comparison provides some illustration of the impotence of interest rate setting in the current environment. However there are also other factors which explain the differences between the two economies, including the proportion of variable rate mortgages (which is higher in Australia).

So, will the RBA lift interest rates in August? If the June quarter trimmed mean inflation rate comes in at more than 1.0%, there is a solid chance. Should the RBA lift interest rates? No. A lift in interest rates now will not reap the reward of bringing inflation to target any quicker, but would successfully pull the rug out from under a cautious economic recovery expected through the second half of 2024.

Chart ii Inflation, interest rates and unemployment in Australia and New Zealand



Source: Reserve Bank of Australia; Reserve Bank of New Zealand

Industries

Australia's soft economic growth is reflected in activity levels across a range of industries. Business conditions and confidence are weak (though confidence is showing signs of life), while insolvencies are at a 25-year high. Industries that are doing well are dominated by the non-market segments of the economy in areas like health and aged care, disability services, and parts of education.

The second half of 2024 looks more promising, with tax cuts and other support payments to households, moderating inflation, and the prospect of lower interest rates likely to buoy consumer demand. That will provide some much needed support to the retail and wholesale industries.

States and territories

The outlook across Australia's states and territories is varied. While the east coast continues to benefit from strong population growth, individuals and families are increasingly feeling the pain of cost-of-living pressures, weighing on economic growth. Larger mortgages in New South Wales and Victoria mean higher interest rates hit homebuyers harder in those states, though tax cuts and energy bill support for households are now providing some respite.

Meanwhile, Queensland and Western Australia are experiencing opposing conditions in commodity markets. While Queensland's coal exports are growing strongly (and expenditure on exploration for new coal deposits is up sharply), Western Australian commodity export volumes have been weighed down by weather-related disruptions, planned maintenance and lower volumes from the North West Shelf.

Risks to the outlook

The forecasts in *Business Outlook* are best understood as the 'most likely' outcome around which unexpected (or unprojected) events will produce different outcomes. Those risks could be to the downside or the upside.

There are a range of both cyclical and structural risks that the Australian economy faces, some of which are set out below:

- Geopolitical risks have been bubbling away for several years, but may be even more present in 2024. There appears to be no imminent end to the conflict in Ukraine, while conflict in the Middle East threatens to draw in other actors, and global supply chain issues linger with instability in the Red Sea. To date, volatility in oil prices has been surprisingly muted given the situation at hand. That may change given the continually rising temperature in the region. Any jump in energy prices risks a further spike in inflation in Australia.
- The US election is less than four months away and, if pollsters and betting markets are to be believed, the attempted assassination of former president and Republican nominee Donald Trump may have secured his election victory. Nothing is ever certain, but a sweeping Republican win in November 2024 appears to be increasingly likely. The previous Trump presidency was broadly positive for the US economy and stock market, prior to the onset of the pandemic. A pro-business, pro-growth and anti-imports agenda can be expected, including tariff hikes and tax cuts.
- China's economy has been central to Australia's own economic performance for at least the last couple of decades. While major advanced economies outperformed expectations by avoiding a recession in 2023, China disappointed most observers. That disappointment has continued through 2024, with annual growth for the second quarter of 4.7% coming in below forecasts. Structural issues related to demographics are also starting to bite – China's population declined again in 2023 following the first fall in 60 years in 2022. As *Business Outlook* goes to print, China's Central Committee is holding its 'third plenum' – a meeting held every five years to set broad economic and social policies. Major economic reform is required; whether it happens remains to be seen.

These risks are worth following closely throughout the remainder of 2024 and beyond.

Key forecasts tables

Table i Calendar year

	History 2023	Forecast 2024	2025	2026	2027	2028
Components of real GDP, growth						
Household consumption	2.1%	1.3%	1.4%	1.4%	1.7%	2.0%
Dwelling investment	-1.9%	-2.9%	6.4%	12.6%	8.9%	4.8%
Business investment	9.2%	2.3%	1.5%	2.0%	2.2%	2.8%
General government consumption	1.7%	3.4%	2.8%	2.7%	2.4%	2.4%
General government investment	5.6%	-1.4%	2.2%	2.7%	2.7%	2.8%
Exports of goods and services	6.6%	1.7%	1.4%	1.9%	2.9%	3.7%
Imports of goods and services	6.5%	5.9%	1.6%	2.3%	3.2%	3.9%
GDP aggregates and other selected measures, growth						
Real GDP	2.0%	1.0%	1.7%	2.3%	2.3%	2.4%
Nominal GDP	5.5%	2.9%	2.5%	3.8%	4.3%	4.5%
GDP implicit price deflator	3.5%	1.9%	0.8%	1.5%	1.9%	2.1%
Dwelling commencements	-9.5%	-3.2%	11.1%	16.0%	9.2%	3.7%
Household savings (ratio to disposable income)	1.5%	1.1%	1.9%	2.9%	3.5%	3.9%
Population and the labour market						
Population growth	2.5%	1.9%	1.4%	1.4%	1.4%	1.4%
Employment growth	3.4%	2.2%	1.0%	1.5%	1.5%	1.5%
Unemployment rate	3.7%	4.2%	4.6%	4.6%	4.6%	4.6%
Participation rate	66.6%	66.8%	66.6%	66.6%	66.5%	66.5%
Prices and wages, growth						
Headline CPI	5.6%	3.5%	2.7%	2.5%	2.5%	2.5%
Underlying CPI	5.4%	3.6%	2.7%	2.5%	2.5%	2.5%
Average weekly ordinary-time earnings	4.0%	4.3%	3.8%	3.7%	3.6%	3.6%
Wage Price Index	3.9%	3.8%	3.4%	3.2%	3.2%	3.2%
Financial markets						
90 day bill rate	4.0%	4.3%	3.6%	2.9%	2.8%	2.7%
10 year bond rate	3.9%	4.2%	3.8%	3.2%	3.1%	3.1%
Trade weighted index exchange rate	61.07	61.16	60.78	61.18	61.19	61.21
AUD/USD exchange rate	0.664	0.668	0.700	0.708	0.707	0.707
Balance of payments						
Trade balance (ratio to nominal GDP)	3.9%	1.7%	0.6%	0.1%	0.1%	0.2%
Current account balance (ratio to nominal GDP)	0.3%	-1.3%	-1.8%	-2.1%	-2.1%	-1.9%
Net foreign debt (ratio to nominal GDP)	45.1%	44.4%	43.2%	42.1%	41.0%	39.7%
Terms of trade index	96.1	91.3	87.5	86.0	86.0	86.7

Note: Base year for real data is 2021-22. Rates of growth in all tables (unless otherwise indicated) are 'year average percentage changes' – the percentage difference between the year indicated and the prior year.