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Australian Economic Comment

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Five questions for 2023

Australia

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- Happy new year! Well let's hope so. 2022 turned out to be very different to expectations at the outset of the year, humbling many forecasters, from market economists to officialdom. In Australia, as in much of the developed world, growth was solid in 2022, but a sharp spike in inflation to multi-decade highs and a sharply rising RBA policy rate were the key surprises. Below we set out our some of our views for 2023, and key risks around these, through the lens of five key questions.

Has inflation peaked and how quickly will it fall to the RBA's 2-3% target band?

Inflation has most likely already peaked. On a quarterly (q-o-q) basis the peak was Q1 2022 - although on a year-ended (y-o-y) basis it is likely to have peaked in Q4 2022. We expect CPI inflation to have been 7.7%e over the year to Q4 2022 and to fall to 3.5%e y-o-y by Q4 2023. A key impact to watch for will be the drag in H1 2023 from much lower oil prices relative to H1 2022, which should directly knock around 1.2ppts off annual CPI. Falling global good prices and shipping costs should help too. Unlike in other countries, although wages growth has picked up, because it had such a low starting point, it is still not at worryingly high rates as yet. As a result, services price inflation looks less concerning and may be less persistent. However, rents and electricity prices are upside risks.

What will the RBA do?

Maybe not that much, certainly compared with last year. If inflation has peaked, the pressure on the RBA to hike further should start to reduce somewhat. However, with inflation still well above target, worries that higher than targeted inflation could embed in inflation expectations will be in focus. For us, the key is looking for signs clear signs that the labour market is loosening, rather than tightening. Our central case is that they could pause from February, but it is a close call, and there is a clear risk of another hike or two. This week's labour market figures for December (due on 19 January) will be particularly important for firming up this view, and quarterly CPI inflation (25 January) will also play a role. We see RBA cuts in 2023 or 2024 as unlikely, but the risk of cuts is clearly higher in 2024 than in 2023.

Will Australia have a recession?

In our view the RBA is more worried about avoiding a recession this year than inflation remaining above its target for a while. They are likely to be more dovish than other central banks as a result. They may also end up with more persistent above target inflation than elsewhere. But, after six years of below target inflation, from 2015 to 2021, a couple of years above target may be seen as tolerable. A key risk that could force a recession is that the rapid and significant hikes already delivered have a more negative lagged effect on growth than our central case, particularly on the consumer or the housing market. Another key risk is that the global downturn translates into weaker than expected growth locally, although China's re-opening should limit the impact of this risk on Australia. We see GDP growth slowing from 3.6%e in 2022 to 1.6%e in 2023 and similar in 2024.

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What should we expect from the government's May budget?

The new government's first budget was delivered in October 2022 and had the feel of a mini-budget which set out the key fiscal challenges the new government faced, rather than a plan for reform. It was also appropriately cautious, given that the economy was clearly overheating, inflation was rising sharply and the RBA was lifting its cash rate rapidly and substantially. The government banked the bulk of its revenue upside surprise at the time. The 2023 May budget should be used to map out a medium-term reform agenda to seek to boost productivity and support Australia's key growth drivers. Recent positive surprises to the tax take should mean the budget returns close to balance. Climate and energy policy are likely to be a key focus. Tax reform and competition policy ought to be in focus, but are always difficult areas to make progress. Reform of spending on aged care, health and the national disability insurance scheme are likely to be on the agenda.

What will China's re-opening mean for Australia?

In the first instance, China's economy is facing marked headwinds, weighing on near term growth. However, the China growth story is expected to quickly turn positive, with HSBC's China team expecting a strong pick-up in GDP from Q2 2023 onwards. This should be good for Australia and one of the factors that helps to prevent Australia from having a recession in 2023. A return of Chinese tourists and students should support services exports. Stabilisation in China's housing sector and a ramp up in infrastructure should drive demand for commodities. China's focus on the green transition should help Australia's green metals exporters and help drive investment in the hydrogen space. A recent thawing of the previously chilly Australia-China trade relationship is positive for growth.

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