Markets Research

Macro-Thematic

national australia bank

Thematic – Assessing progress on the balance of supply and demand

Summary

The RBA has pursued a strategy of seeking to bring domestic supply and demand into better balance without opening up spare capacity in the labour market. Recent data is encouraging that this approach will ultimately succeed in returning inflation to target, with significant progress having already been made, but rebalancing is not yet complete. In this thematic, we review progress and find the composition of activity and still tight labour market are key to explaining the persistence in capacity pressures despite slower growth.

Key points

- GDP growth slowed over in 2023 and 2024, and the level of GDP has fallen around 1.0% below the level implied by a pre-COVID trend. However, this has been partly driven by the mining sector, where production grew rapidly prior to COVID but has flatlined since.
- Excluding mining, the pace of market GVA growth still looks to have slowed but the level of activity remains around 2.7% above trend. The level of non-market (public sector) activity is also elevated, around 3.6% above trend.
- Measures in the NAB Quarterly Business Survey reinforce that the balance of supply and demand has improved but remains tight. Capacity utilisation has eased but remains 1.9ppts above average, while the share of firms reporting a lack of demand is rising but remains below average. Labour availability remains a significant constraint for 33% of firms, down from a peak of 55% but still historically high, in line with still-high job vacancies.
- These findings align with the RBA's assessment in the most recent SoMP that the output gap is positive but closing. Inflation outcomes will be the ultimate arbiter, but the analysis here supports the assessment that while progress has been made, the task remains incomplete.

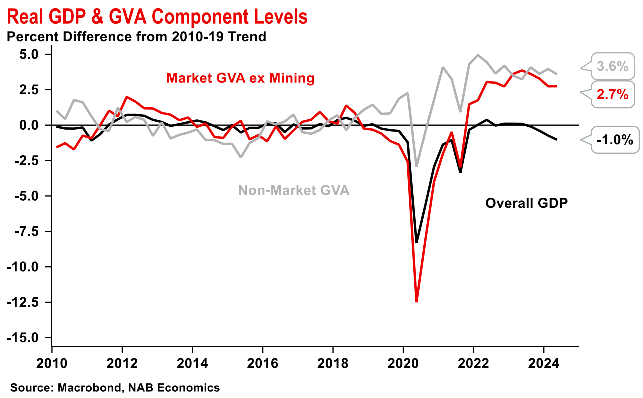
Details

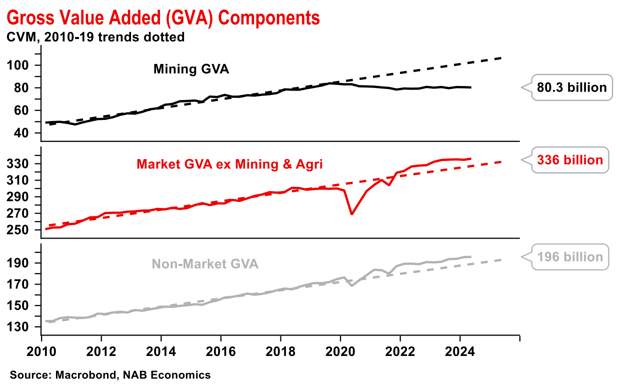
Slow growth has left the level of GDP below its pre-COVID trend, but this is largely due to the mining sector with the level of non-mining activity still elevated.

While economic commentary regularly focuses on the growth rate of GDP, the more important metric for understanding inflationary pressures is the balance of aggregate demand against the economy's supply capacity. While this is difficult to assess in real time, one simple approach is to compare the level of output to its medium-term trend.

For Australia, overall GDP growth has slowed to 1.0% y/y in Q2, the slowest pace in more than three decades outside of COVID. In level terms, this slowdown has seen GDP fall to around 1.0% below the level implied by its pre-COVID trend.

However, the trend in GDP is significantly distorted by the mining sector. Mining gross value added (GVA) grew rapidly during the pre-pandemic period as production capacity increased but has plateaued since then. Excluding mining, measures of GVA appear to be above their trend levels. Growth in market (private sector) GVA excluding mining has stalled but the level remains around 2.7% above trend, while non-market (public sector) GVA is still growing and the level remains around 3.6% above trend.





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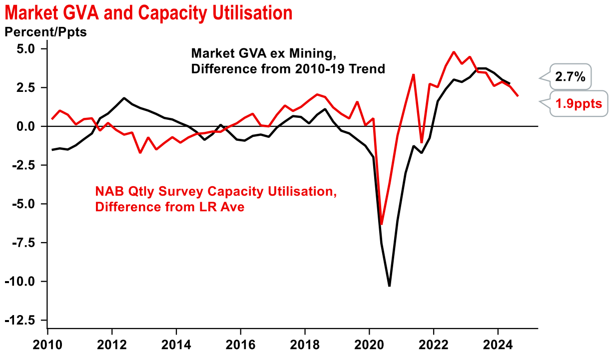
Most mining output is exported and elevated prices have masked the slowdown in volumes growth. Export volumes have subtracted a cumulative 0.8ppt from GDP growth since Q4 2019, whereas in the comparable period from Q4 2014 to 2019 they added a cumulative 6.7ppt. The result is that Domestic Final Demand growth has performed much more strongly than GDP as a whole, with ongoing growth in public demand and higher business investment offsetting the softness in household consumption.

Measures of private sector capacity utilisation from the NAB Quarterly Business Survey confirm the balance of supply and demand remains tight.

Overall capacity utilisation rose to record highs during the rebound from the COVID period, peaking at 85.9% in Q3 of 2022 or around 4.8ppts above the long-run average. Since then, capacity utilisation has tapered downwards but was still around 1.9ppts above average in Q3 2024. This mirrors the 'excess' level of demand seen in market GVA excluding mining, reinforcing that the level of private sector activity remains high relative to supply. (Note the NAB survey includes some mining sector firms).

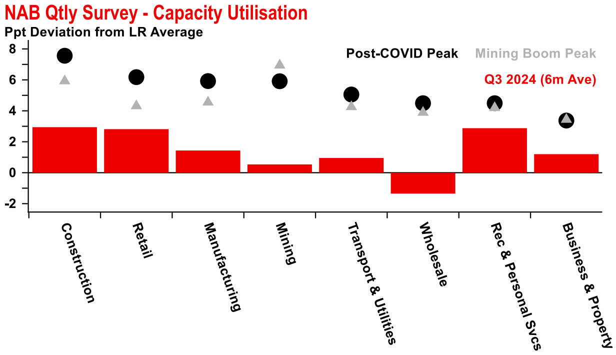
Market GVA and Capacity Utilisation



Source: Macrobond, NAB Economics

By industry, capacity utilisation peaked almost 8ppts above average construction, and more than 5ppts above in retail, manufacturing, mining and transport. All sectors are now showing improvement from their peak, but capacity utilisation remains elevated relative to average in construction (2.9ppts above average), recreation & personal services (2.9ppts above) and retail (2.4ppts above). That these are primarily consumer-facing sectors reinforces that the tight supply-demand balance has been broad based despite the pressure on household incomes.

NAB Qtly Survey - Capacity Utilisation



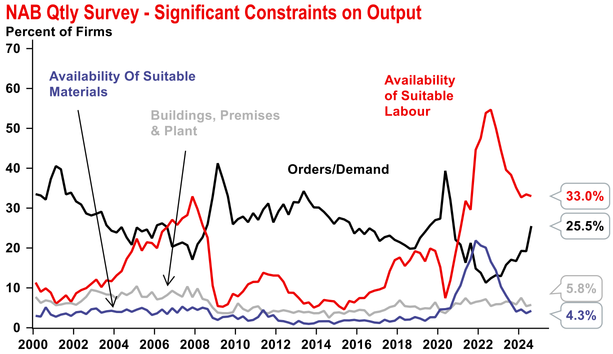
Source: Macrobond, NAB Economics

Survey measures also confirm demand has not been the main constraint on output for firms, with a tight labour market the most common constraint.

The NAB Quarterly Business Survey provides additional insight into the main constraints impacting firms' output, including whether a lack of orders from customers (i.e. weak demand) is impacting their operations.

Consistent with a tight balance if supply and demand during the post-COVID expansion, the share of firms reporting demand as a significant constraint fell to a record low of just 11% in Q2 2022. Since then, this measure has steadily risen with around 25% of firms reporting demand as a constraint in Q3 2024 but this is still below the long run average.

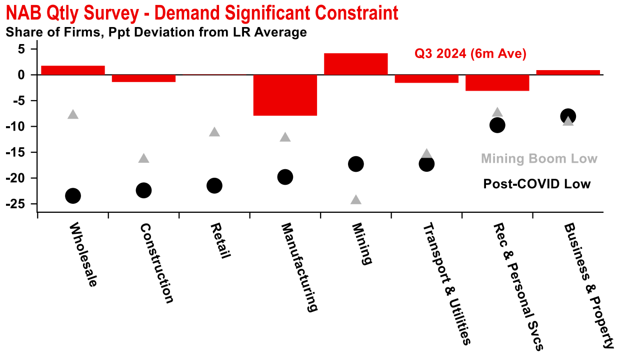
NAB Qtly Survey - Significant Constraints on Output



Source: Macrobond, NAB Economics

The normalisation of the demand constraint measure has been evident across industries, with most back to within 1-2pts of the pre-COVID average. The exceptions are manufacturing, where the share remains 7.9pts below average (over 6 months), and to a lesser extent recreation and personal services.

NAB Qtly Survey - Demand Significant Constraint

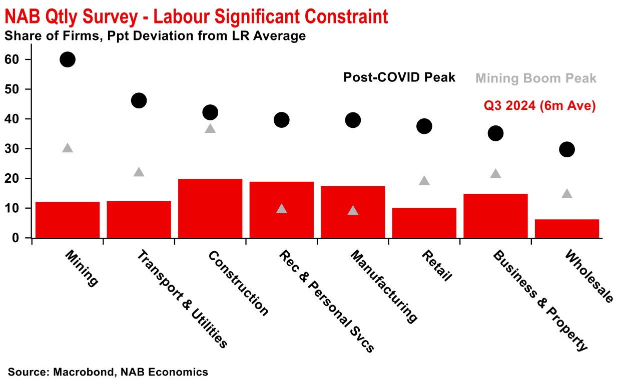


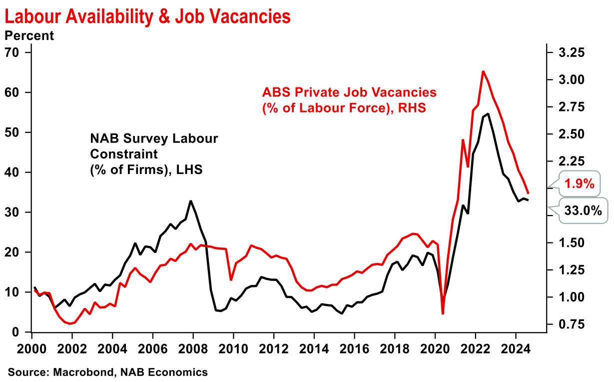
Source: Macrobond, NAB Economics

The broad-based increase in orders as a constraint suggests recent slower growth is beginning to translate through into an environment that is increasingly demand, rather than supply, constrained for many firms.

However, for now the survey suggests the labour market remains a lingering area of supply/demand imbalance. The share of firms reporting labour availability as a significant constraint has declined from its peak of around 55%, but at around 33% in Q3 2024 remains higher than at any point in the history or the survey prior to the pandemic.

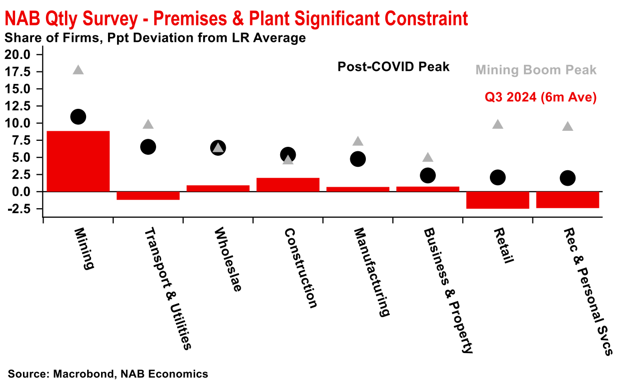
The easing in labour constraints has been broad based across sectors but all remain materially above average, and in some cases above the levels seen at the peak of the mining boom. This is consistent with signs of ongoing but incomplete easing in other measures of labour market spare capacity, including job vacancies and job ads. (As we have previously written, this likely reflects a mix of factors including the return of international students and visa workers filling some labour shortages, alongside persistently elevated labour demand including in health and care industries.)





The share of firms reporting materials availability as a constraint has more fully normalised, while the share reporting physical capital (buildings, premises and plant) as a constraint has been relatively stable through the recent cycle.

By industry, however, physical capital remains a significant constraint for an elevated share of firms in mining as well as, to a lesser degree, construction. The finding that mining firms are significantly constrained by physical capital reinforces that production capacity is the key limiting factor behind the lack of growth in mining GVA noted above.



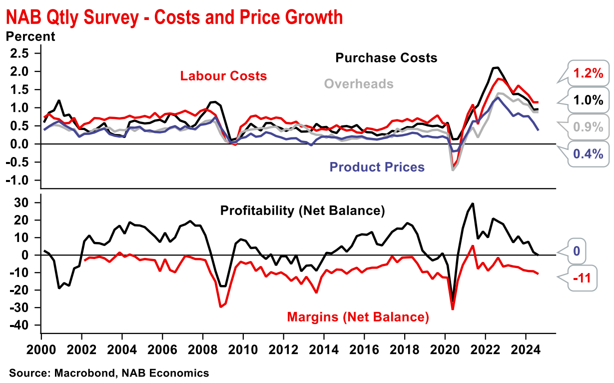
Overall, the data suggest there has been real progress bringing domestic supply and demand into better balance, enabling a gradual easing in inflation pressures, but there remains some way to go.

The RBA's August Statement on Monetary Policy (SoMP) stated that "a range of model-based estimates suggest the output gap is positive but continues to narrow." The suite of measures reviewed here broadly support this conclusion, reinforcing our assessment that recent slow growth outcomes reflect a necessary adjustment from an overheated economy.

Breaking down the composition of activity is particularly important for understanding the persistence of capacity pressures this cycle, with domestic final demand proving stronger than GDP as a whole. The evolution of non-mining activity relative to its pre-pandemic trend is consistent with capacity utilisation dynamics evident in the NAB Business Survey, which have eased but remain above their pre-COVID average.

The progress made on the balance of supply and demand to date has already resulted in some cooling in underlying inflation pressures. Notably, firms are increasingly operating in a demand, rather than supply, constrained environment, and pricing measures suggest it is increasingly difficult to pass cost pressures downstream.

NAB survey measures of input costs have cooled noticeably from their peaks but remain elevated even as final price pressures have continued to moderate, and indexes for profitability and margins have also declined. We expect these dynamics to translate into further gradual progress on inflation through H2 2024.



As a result, we expect the RBA's comfort in the outlook for a sustained return to the inflation target to build. NAB expects the RBA to cut rates in H1 2025, pencilling in February, and we continue to expect a gradual cutting cycle that is ultimately shallower than peer central banks.

Importantly, recent data is supportive of our view that the RBA will be able to manage this cycle without a sharper deterioration in the labour market. We expect the trough in growth is behind us, albeit we see a more gradual near-term pickup in activity growth than the RBA's own forecasts. NAB forecasts GDP growth around 2¼% for 2025, with the unemployment rate expected to stabilise around 4½%.

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