

## Ominous warnings from sharp declines in consumer and business confidence

(Op-ed article published in the *Sydney Morning Herald* and *Melbourne Age* on 16<sup>th</sup> April)

After a gradual recovery from the substantial fall in real incomes and the rapid increases in interest rates during the three years following the end of the Covid-19 pandemic, the Australian economy now appears to be in the early stages of another, potentially significant, downturn.

Although there is as yet little by way of 'hard' statistical evidence to confirm that, this week's news of plummeting consumer and business confidence provides an ominous signal.

The Westpac-Melbourne Institute index of consumer sentiment dropped by 11.4 points in April, the largest single-month decline since April 2020, immediately after the onset of the Covid-19 pandemic, to its lowest level since September 2023, just after the 12<sup>th</sup> of what would ultimately be 13 increases in the RBA's official cash rate, and only 4.5 points above that April 2020 level, which was in turn the lowest since the recession of the early 1990s.

Almost certainly, the big fall in consumer confidence this month is in response to the sharp increase in petrol and diesel prices, the increases in prices of other products which have flowed from the spike in fuel prices, and apprehension at the possibility of fuel shortages.

Perhaps surprisingly, consumer confidence fell by more among people who own their homes outright and among renters, than among people with mortgages – suggesting, possibly, that people are more worried about falling house prices than about higher interest rates. Also surprisingly, there was a much larger drop in confidence among people earning over \$100,000 a year than among lower-income earners (perhaps they're worried about the impact on the share market). Less surprisingly, consumer confidence fell much more among younger people than older ones.

And National Australia Bank's measure of business confidence also plummeted in March to its lowest level April 2020 – although, perhaps reflecting the fact that this survey was for March rather than April, the survey's measure of 'business conditions' dropped by much less, to be still above where it was a year ago. Business' capital expenditure intentions were little changed, while the measure of employment intentions actually rose to its highest level since mid-2024. It would be entirely unsurprising if these measures were to record significant falls in April.

While measures of consumer and business confidence are not, ordinarily, reliable proxies for 'harder' indicators like retail sales, employment or business investment, big movements in consumer and business confidence such as have been reported this week usually do presage significant turning points in the economy.

And that's consistent with economists' expectations that the spike in fuel prices since the outbreak of Gulf War III – and the fact that fuel prices have remained at

elevated levels despite the apparent, at least for now, suspension of military hostilities in the Gulf – will likely result in a significant downturn in economic activity, as well as an increase in inflation.

From the perspective of the advisors on and makers of economic policy, in the Reserve Bank and the Treasury, and at the highest levels of Government, the appropriate response to these developments is far less clear-cut than it was at the onset of the global financial crisis 18 years ago, the Covid pandemic six years ago, or in the aftermath of Russia's invasion of Ukraine just over four years ago.

Although the increases in fuel prices, air fares, and the prices of a growing range of other goods and services will add to both headline and 'underlying' inflation – prompting speculation as to the inevitability of a third successive increase in interest rates at next month's Reserve Bank Monetary Policy Board meeting – that is not necessarily a 'done deal'.

That's because – unlike the unexpected rebound in inflation in the second half of last year which prompted the two recent increases in official interest rates – the current surge in inflation isn't the result of 'excess demand', for which higher interest rates is the normal 'remedy'. Additionally, the impact of the current surge in fuel prices on household finances is, in aggregate, very similar to that of an increase in interest rates – albeit distributed differently across individual households. That is, higher fuel prices mean that households who have little choice, in the short term, as to how much fuel they use, have to spend more on petrol or diesel and thus have less to spend on other goods and services, which reduces aggregate demand for those other goods and services – in much the same way as higher interest rates mean that those with mortgages have to devote more of their incomes to paying interest and thus have less to spend on other goods and services.

So raising interest rates in response to the 'first round' impact of higher fuel prices on inflation would be 'doubling up' - and increasing the risk of a recession.

The Reserve Bank should only increase interest rates if it judges that there is a serious risk that people and businesses have begun to expect that inflation will remain permanently higher - because history tells them that if 'inflationary expectations' do become entrenched at higher levels, people and businesses will start to behave in ways that make it more likely that inflation *will* become permanently higher, as it did in the after the oil shocks of the 1970s.

But it is too soon to make that judgement as yet.

For its part the Federal Government – and probably state governments – will be tempted to offer additional "cost of living relief" to households, to help alleviate the impact of higher fuel and other prices on household budgets.

possible. That's because, if governments throw cash at households – and especially if they throw it in an 'untargeted' way, as they did with their electricity bill rebates between 2023 and 2025 – that will offset, in whole or in part, the effect that higher

fuel prices are having on household demand for other goods and services, which would in turn give the RBA less reason to think that aggregate demand for those other goods and services will ease (reducing the scope for 'second-round' increases in prices) without further increases in interest rates.

So, if the Federal and State governments want to help reduce the risk of further increases in interest rates – and hence the risk of recession – they should do as little as politically possible by way of providing 'cost of living relief' in their upcoming budgets.

And they should also resist the temptation to support additional wage increases – which in current circumstances would also likely result in further price increases, in turn increasing the risk of further increases in interest rates. That's a tough message for workers – but the point is that the benefits (to households) of additional wage increases are, in current circumstances, likely to be taken away from those households with big mortgages in the form of higher interest rates.

Instead, the focus of upcoming Budgets should be – as the Treasurer and others have indicated – strengthening Australia's resilience to shocks like the present one, reducing inter-generational inequity through tax reform and in other ways, and boosting productivity.