

Australian Economic Update – September 2010

Executive Summary

The economic recovery in Australia has gained momentum, underpinned by significant increases in commodity prices, stronger corporate profitability, strengthening labour market conditions and higher wage growth.

The strength of the economic recovery in Australia rests firmly on sustained improvements in private domestic demand as the impact of fiscal stimulus fades.

Going forward, retail spending is likely to pick-up momentum. The brightening of employment prospects and the pick-up in wage growth in recent months has helped to ease consumer caution.

The outlook for private investment has brightened. The expected private capital expenditure data for the June quarter indicates that there could be a significant increase in the value of total investment in 2010-11.

The highly uncertain global economic outlook nevertheless poses significant risks. Ai Group's manufacturing, services and construction performance indexes, show weakness in activity in July and August, as businesses become more cautious and weigh the impacts of a slowing Chinese economy and a fragile economic recovery in the United States.

There is a risk Chinese households and businesses might overreact to the tightening of government policies and cause economic activity to decline substantially, especially given the weak and uncertain demand from American and European businesses.

Nevertheless, many analysts remain cautiously optimistic regarding the strength of domestic demand in China in the longer term. This bodes well for commodity prices and Australia's resources sector.

A two-speed economy, where resource-rich states grow much more strongly than the non-resource states appears to be re-emerging. This could lead to further supply-side constraints, such as acute skilled labour shortages emerging that could lead to rapidly increasing inflationary pressures, higher interest rates, a strong Australian dollar, all of which have the potential to inhibit sustained economic growth in Australia.

Australian Economic Data

Economic recovery gains traction

Recently released economic data suggests that the economic recovery in Australia has gained momentum, underpinned by significant increases in commodity prices, stronger corporate profitability, strengthening labour market conditions and higher wage growth.

The June quarter national accounts data showed that the Australian economy grew at its fastest pace in three years, as rising commodity prices bolstered the country's exports while domestic demand, primarily led by household consumption, continued its recovery.

Australia's real GDP increased by a seasonally adjusted 1.2% in the June quarter, up from a revised 0.7% in the March quarter. Growth through the year to the June quarter reached 3.3%, up from 2.6% in the March quarter.

Reflecting the significant increases in commodity prices, exports of goods and services increased 5.6% in the quarter and contributed 1.1 percentage points to economic growth, making it the most significant driver of the economy. Australia's terms of trade rose 12.5% in the March quarter to be up 24.5% over the year.

The strong demand for Australia's natural resources exports has helped lift company profits, supported business and consumer confidence and driven household spending. Household consumption posted solid growth, rising 1.6%, which is more than triple the growth rate recorded in the March quarter.

Investment expenditure, on the other hand, was relatively subdued in the quarter. Gross fixed capital formation increased 0.6%. Total private gross fixed capital formation increased 0.8%, reflecting the 5.0% rise in total dwellings investment. Public gross fixed capital formation was flat.

Consistent with the strengthening of domestic demand, the imports of goods and services increased 3.0% in the June quarter, almost double the 1.6% recorded in the March quarter. With export growth outpacing import growth, net exports became a net positive contributor to economic growth (0.4 percentage points) in the quarter.

Recovery rests on sustained improvements in private domestic demand

The strength of the economic recovery in Australia rests firmly on sustained improvements in private domestic demand as the impact of fiscal stimulus fades. The near term outlook for household consumption and private investment remain broadly positive at this juncture.

Household consumption gains momentum

Since the onset of the global financial crisis, households have tended to be more cautious in spending, adopting a more debt-averse attitude toward finances. This is reflected in the considerable rise in private savings and subdued retail spending since the start of the year.

However, going forward, retail spending and, hence, household consumption more broadly, is likely to pick-up momentum. The brightening of employment prospects and the pick-up in wage growth in recent months has helped to ease consumer caution. The Westpac-Melbourne Institute Consumer Sentiment Index rebounded strongly in July and August, despite consumer caution still featuring in the Westpac analysis, reversing all of the decline seen following the May interest rate hike and returning to a level on a par with that seen a year ago prior to the Reserve Bank of Australia's interest rate tightening. Reflecting this, retail trade grew strongly in July. The seasonally adjusted value of total turnover increased 0.7% in July 2010, following revised increases of 0.4% in May and June. Annual growth in retail turnover rose to 4% in July from 2% in June. It is noteworthy that the growth in retail spending in July was fairly broad-based, with food and clothing related expenditure being particularly strong.

Outlook for private investment brightens

Much like retail spending, private investment has been rather soft since the start of the year. The June quarter private capital expenditure data suggest that recent uncertainty around the global economy, including China, higher domestic interest rates, uncertainty on the Government's mining tax, and the strong Australian dollar have had an impact on short-term investment outcomes, particularly in the services sector.

The volume of private new capital expenditure fell by a seasonally adjusted 4.0% in the June quarter, following a (revised down) fall of 1.0% in the March quarter. The June quarter result was significantly worse than the median market forecast of a rise of 2.3%. Further, the annual rate of change worsened, from a fall of 0.3% in the March quarter to a fall of 4.8% in the June quarter 2010.

However, the outlook for private investment has brightened. The expected private capital expenditure data for the June quarter indicate that, taking into account reasonable realisation ratios, business investment expectations in the longer-term appear to be consistent with a 28% increase in the value of total investment in 2010-11. The high levels of expectation for investment in 2010-11 in particular, reflect recent still solid levels of business confidence and a number of large-scale projects, including the Gorgon LNG project and the ongoing expansion of the Pilbara iron ore mines. The expected lift in investment in 2010-11 could help to underpin employment and wages growth, thus adding further support to household spending.

Downside risks emanate from uncertain global economic outlook

An assessment of domestic demand in Australia ought to be weighed against the downside risks posed by the highly uncertain global economic outlook. Ai Group's manufacturing, services and construction performance indexes, show weakness in activity in July and August, as businesses

become more cautious and weigh the impacts of a slowing Chinese economy and a fragile economic recovery in the United States.

The pace of growth in manufacturing activity slowed in August. The seasonally adjusted Ai Group-PricewaterhouseCoopers Australian PMI® fell by 2.7 points to 51.7 in August, reflecting significantly slower growth in production and new orders, while growth in stocks and deliveries eased slightly.

Similarly, the services sector was sluggish in August with the gradual withdrawal of fiscal stimulus and the uncertainty surrounding the national political landscape continuing to impact on demand. The latest seasonally adjusted Ai Group/Commonwealth Bank Australian PSI® rose slightly to 47.5 in August remaining below the critical 50 point level for the fourth consecutive month.

The national construction industry declined for a third consecutive month in August. Subdued demand was the main factor underlying the weakness in industry conditions with many companies continuing to struggle amid falls in new orders. The seasonally adjusted Ai Group/ Housing Industry Association PCI® fell slightly by 0.1 points to 43.2 in August.

Slowdown in Chinese economy likely, but risk of a sharp downturn remains

The policymakers in China have engineered a slowdown of the Chinese economy in an attempt to quell rapidly rising inflationary pressures and the possibility of stock and real estate prices spiraling beyond levels that could be reasonably justified by economic fundamentals. Current data suggest that the slowdown in the Chinese economy is likely to be moderate. For instance, China's manufacturing PMI for August rose to a three-month high of 51.9 in August, pointing to a moderate improvement in Chinese manufacturing sector operating conditions following a slight deterioration in the preceding month. Nonetheless, the index is still almost six points lower than the series-record high registered at the start of the year.

While it appears that the Chinese policymakers might have been successful in slowing down the Chinese economy, there is still a risk that households and businesses might overreact to policy changes and cause economic activity to decline substantially, especially given the weak and uncertain demand from American and European businesses.

US economic recovery remains fragile

Recently released data suggest that the economic recovery in the United States is fragile. Unemployment has remained high at close to 10% and employment growth is weak, as businesses remain cautious about expanding capacity given sluggish consumer demand. American household spending has been significantly constrained by bleak employment prospects and declining house prices. House prices in the United States are widely expected to drop further as the properties foreclosed by banks are expected to be put onto the market sometime this year and into 2011. Making matters worse, the policymakers have run out of conventional policy options. The government is hesitating to implement another round of fiscal stimulus given its precarious state of government finances. The Federal Reserve, on the other hand, has lowered interest rates to near

zero levels, and further quantitative easing measures might have limited impact on the domestic demand as long term bond rates are already at considerably low levels.

Sluggish growth in Europe expected

The European economy is expected to remain sluggish as well, as several European governments remain plagued by high debt and deficit levels. The pledge by several governments to lower deficits and cut debt would serve to constraint already weak domestic demand.

Conclusion

A strong Chinese economy bodes well for Australia

In spite of the uncertain economic outlook in the United States and Europe, many analysts remain cautiously optimistic on the strength of domestic demand in China. This bodes well for commodity prices and Australia's resources sector, given the strong demand from China for Australian natural resources to fuel its rapid industrialisation. If this forecast was to materialise, the renewed resource boom in Australia is likely to be sustained, thus providing a boost to overall corporate profitability and, in doing so, lifting employment growth and household spending in Australia even further.

Re-emergence of a two-speed economy in Australia

Looking further ahead, a renewed resource boom in Australia could again lead to the emergence of the two-speed economy, where resource-rich states grow much more strongly than the non-resource states. This could lead to further supply-side constraints, such as acute skilled labour shortages emerging that could lead to rapidly increasing inflationary pressures, higher interest rates, a strong Australian dollar, all of which have the potential to inhibit sustained economic growth in Australia. This would remain a policy challenge for policymakers. The Federal Government might have to consider investing more wisely the revenue gains from the resource boom in infrastructure and the Reserve Bank of Australia might have to more skilfully head-off inflation using the somewhat blunt monetary policy instrument of higher interest rates.