

Australian Economic Update – July 2011

Introduction

The global economic recovery remains on track, although downside risks emanating from fiscal consolidation in Europe and weaker than expected economic growth in the US have gained prominence. Buoyant economic growth in Asia has lifted the demand for Australian resources exports and driven the Australian terms of trade to record highs. Despite the resources boom, economic growth in Australia is likely to be concentrated in sectors related to the resources boom and in sections of the services sector. Manufacturing and other trade-exposed sectors are expected to struggle in 2011, weighed down in particular by the strong Australian dollar.

International economic conditions

Global economic recovery remains on track

The global economy slowed during the June quarter, amid a moderation of growth in the United States (US) economy, disruptions to Japanese supply-chains following the earthquake and tsunami, and a slowdown in the Chinese economy. Reflecting these factors, the International Monetary Fund (IMF) marginally downgraded its 2011 growth forecast for the global economy. Nevertheless, the world economy is still expected to expand at or near its long term average growth rate.

The global economic recovery will be supported by buoyant economic growth in Asia, while the US and European economies will remain soft for some time, reflecting strains on fiscal and financial sector balance sheets, both being legacies of the global financial crisis. Strong economic growth in Asia is lifting the demand for Australian resources exports, driving the Australian terms of trade to record highs and boosting private investments in the resources sector.

Downside risks to recovery has increased

The downside risks to the global economic outlook have, however, increased over the last few months. While economic growth is improving in Germany and France, economic conditions remain very weak in a number of countries where public and private debt problems are prominent. The prime example is Greece, which is fighting a sovereign debt default. Credit default swap spreads have risen to new highs in Greece amid doubts about whether the Greek Government has the political resolve to implement fiscal and economic reforms that are necessary to secure longer term fiscal sustainability. This, in turn, has renewed the market's focus on the potential for transmission of shocks from peripheral Eurozone economies to the banking systems in major Eurozone economies. Over the year ahead, planned fiscal consolidation efforts in Greece, Portugal and Spain will weigh on growth in the Eurozone.

In the US, a range of indicators suggested that growth had moderated. The recovery in consumption had lost momentum. The housing sector remained weak and the pick-up in employment had been unexpectedly slow. In addition, the US households and businesses have to grapple with uncertainty arising from near-term fiscal adjustment by the US Government against the backdrop of a fragile economy.

Overheating pressures in some key emerging economies have intensified as evident from rapidly rising inflationary pressures, and in some cases high asset prices. While some economies have tightened monetary policies at a faster pace, others have fallen somewhat behind the curve. The longer policy rates stay low, the higher the chances of a hard landing in the future, an outcome that could derail the global economic recovery.

Australian economic conditions

The multi-speed Australian economy has become more apparent with the release of recent economic data. Boosted by strong economic growth in Asian economies, Australia's terms of trade remains near record highs, driving significant investments and business expansions in the resources sector. The ensuing strength of the Australian dollar and prospects of higher interest rates that could follow from rising inflationary pressures due to the shortage of skilled labour and the resources boom have dimmed the outlook for the manufacturing, tourism and retail sectors.

Australian consumers have remained cautious. Retail turnover in Australia contracted by a seasonally adjusted 0.6% in May 2011, following the 1.2% expansion recorded in April. Compared to the same time last year, retail turnover rose 2.2%, lower than the 3.2% growth recorded in April. In trend terms, the annual growth rate of retail turnover has averaged 2.7% over the last twelve months, sharply lower than the 5.1% recorded in the preceding twelve months period.

The outlook for investment continued to be strong, driven primarily by the resources sector. Consistent with this, capital imports had trended higher over recent months. In contrast, investment in the non-resources sector remained soft, with signs yet to emerge of a pick-up in non-residential construction.

Ai Group's monthly performance indices provide evidence that economic growth in Australia remains patchy. Charts 1, 2 and 3 show the movements of Ai Group's monthly performance indices (the PMI, PSI and PCI) to June 2011.

Chart 1: Australian PMI

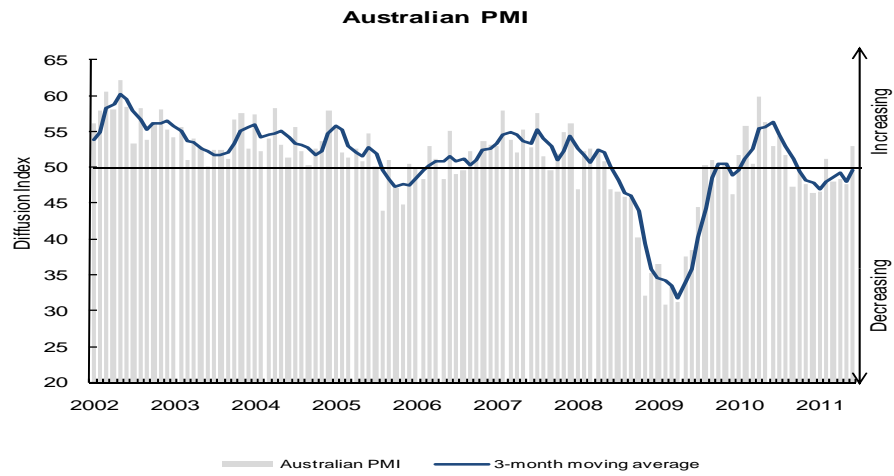


Chart 2: Australian PSI

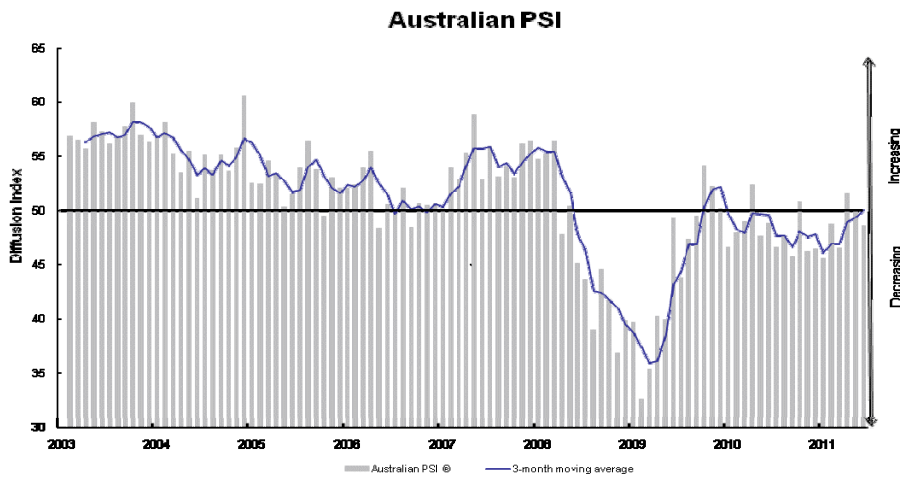
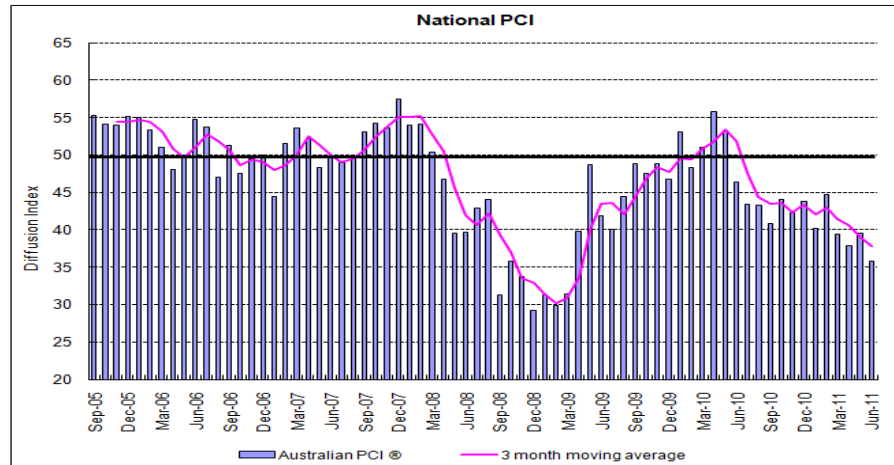


Chart 3: Australian PCI



The services and construction sectors all contracted in June, while the manufacturing sector moved into positive territory for the first time since February, albeit by only a modest extent. Businesses generally remained cautious of the business outlook, citing the strong Australian dollar, increased competition from import substitutes, soft domestic demand, higher interest rates and funding constraints as factors inhibiting activity.

For the manufacturing sector and trade exposed sub-sectors in the services industry, such as tourism and education, the difficulties of the high dollar are a key factor. The strengthening of the Australian dollar, along with the tightening of the labour market and rising interest rate pressures, is the transmission mechanism by which sections of the economy are slowing to make way for the expansion of the minerals sector and industries and sectors connected to it (including, engineering construction and some service and manufacturing businesses).

Another element in the weakness of the performance indices is the caution on the part of households and businesses. The national saving ratio is currently high relative to the past could of decades, demand for new housing units is low and business borrowing is expanding relatively slowly.

Reflecting the lop-sided economic growth in the Australian economy, it is perhaps unsurprising that economic growth over the year to June 2011 has been concentrated in the mining and services related sectors of the economy (Table 1).

Table 1: Employment growth in the year to June 2011

Mining	19.4
Arts & Recreation Services	12.1
Financial & Insurance Services	9.9
Administrative & Support Services	7.5
Electricity, Gas, Water & Waste Services	6.2
Education & Training	5.3
Health Care & Social Assistance	4.6
Rental, Hiring & Real Estate Services	4.0
Retail Trade	2.8
Accommodation & Food Services	2.8
Construction	2.5
National average	2.0
Public Administration & Safety	1.9
Professional, Scientific & Technical Services	0.9
Manufacturing	-0.5
Information Media & Telecommunications	-1.8
Other Services	-2.1
Transport, Postal & Warehousing	-2.9
Wholesale Trade	-3.5
Agriculture, Forestry & Fishing	-11.7

Source: ABS

Conclusion

The global economic recovery is likely to remain on track despite a slowing in growth momentum over the last months. That said downside risks emanating from fiscal consolidation in some European economies and weaker than anticipated economic growth in the US have gathered prominence. Emerging Asian economies are nevertheless expected to remain robust, albeit some risks posed by the tightening of monetary stance as the Governments attempt to contain inflationary pressures and, in some cases, rapidly rising asset prices.

The Australian economy is benefiting from strong economic growth in Asia, with its terms of trade remaining near record highs, helping to support investments in the resources sector. The strong Australian dollar and higher interest rates are, however, dampening growth in other sectors of the economy, such as manufacturing, retail and construction. The Ai Group's monthly performance indices for these sectors provide further evidence on the development of a multi-speed Australian economy.