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The Bigger Picture – A Global & Australian Economic Perspective

Global: ***The latest business surveys suggest that conditions in the big advanced economies have stabilised after the softening in growth that took place since late 2011. Monthly trade and industrial indicators still point to a broad-based slowing across the emerging economies that have been driving most global economic growth through the last few years. Central bank policy stimulus in the US, Euro-zone and Japan has helped to lift confidence in financial and commodity markets, reducing fears of Euro-zone collapse and continued slowing in the US. Our forecasts are for global growth to accelerate from this year's 3% to a still sub-trend 3¼% in 2013. Those forecasts incorporate an assumption that the US averts its "fiscal cliff" and China manages a soft landing.***

- The ECB's announcement of a new arrangement to purchase Euro-zone sovereign debt and the Fed's decisions to implement a third round of quantitative easing have boosted markets. Neither the Fed nor the ECB have set explicit limits on these new programmes – the Fed's QE3 will last until the outlook for the labour market "improves substantially" and the ECB's Governor has said that "there are no ex-ante limits" on its new plan to buy Euro-member sovereign bonds. Following this, the Bank of Japan lifted its existing scheme to buy Government bills and bonds by another 10 trillion yen to 80 trillion yen.
- The CPB's monthly estimate of global industrial output and trade show the pace of growth slowing through the first 6 months of the year. The quarterly pace of growth in world industrial output slipped from 1.8% in the March quarter to zero in June but the preliminary numbers for July show it picking up slightly. The slowdown is broad-based with industrial growth close to zero in the emerging market economies and the big advanced economies moving into an industrial downturn. The pace of growth in world trade also slowed in Q2, and while not as marked as the slowing in industrial production, the latest trade numbers still look weak.
- Industrial output in the advanced economies remains around 10% below its early 2008 level which would lead to the expectation that there is plenty of idle productive capacity that could be brought back into operation if demand were to increase. However there is a debate within certain countries, notably the UK, over the extent to which there is such spare capacity with business survey readings showing much less idle capacity than would be expected by looking at unemployment or pre-GFC output trends. This is not just a UK issue with the amount of unused output potential in the US, Canada and Germany also being lower than would be expected.
- The annualised rate of economic growth in the G7 slowed from around 2% in the latter half of 2011 to 1¾% in March 2012 and ¾% in June – implying that the main advanced economies were close to stalling by mid-2012. Conditions were worst in Western Europe where the UK and Euro-zone fell back into recessions as private demand proved too weak to offset actual and foreshadowed public sector austerity. The Japanese upturn, which should be boosted by post tsunami rebuilding, also proved disappointing and the Bank of Japan says that the pick-up in activity has "come to a pause". Against this uninspiring background, the latest business survey readings from the big advanced economies have been surprisingly good.
- The slowing in economic growth has been broad-based with the biggest emerging market economies sharing in the cyclical softening. The pace of economic growth in China, India and Brazil (accounting for around one quarter of the world economy) has slowed from 8¾% yoy in mid-2011 to less than 6% yoy in mid-2012.
- The very trade-dependant economies of East Asia have seen a sharp slowing in exports and industrial output growth. Indonesia, a closed economy heavily reliant on domestic demand, is the exception and activity in Thailand has been boosted by the recovery from last year's floods. The softening in Latin America extends beyond Brazil with a region-wide slowing in activity.
- While there are plenty of downside risks to the outlook, the latest business surveys hold out the hope that activity is stabilising in some of the major advanced economies. The Euro-zone looks set to remain in recession but growth in the US and UK should pick-up through the next year – provided that the US "fiscal cliff" can be averted. If it is not averted, the tightening in US fiscal policy would be substantial and has the potential to tip the US economy back into recession next year. Policy easing around the world underpins our forecast modest acceleration in forecast global growth from 3% this year to a still sub-trend 3¼% in 2013.

<u>Australia:</u> The Australian economy is passing through a soft patch. Our GDP forecasts are slightly weaker than a month ago, especially in the out years: 3.3% in 2012 (was 3.4%), 2.5% in 2013 (was 2.8%) and 3.2% in 2014 (was 3.6%). Key drivers of slower activity include; falling income growth from lower commodity prices, a high AUD and fiscal tightening (federal and state). Core CPI expected to stay within RBA target range; 2.4% in 2012 and 2.9% in 2013. We expect one more RBA rate cut in November, provided core inflation remains subdued (CPI of 0.7% or lower), with the possibility of another in early 2013. RBA expected to run accommodative policy in 2013 (3% or lower) to help offset changing nature of mining boom, but sensitive to asset prices and fiscal indiscipline.

- While the domestic economy is performing reasonably well in aggregate, the restructuring burden from the mining investment boom is taking a toll on activity and sentiment. The NAB Business Survey showed a pull back in business conditions in September, while forward indicators remain concerning. In the near term, domestic activity is expected to be weighed down by falling income growth from lower commodity prices, a still high AUD – which may be increasingly figuring in firms' re-structuring decisions – and fiscal tightening (both at the state and federal level).
- While commodity prices have recovered a little over recent weeks, after falling heavily in August, they generally remain below price levels earlier in the year (especially for iron ore and coal). What the lower commodity prices have done is to bring into doubt some marginal mines (especially coal) with a flow on downsizing in mining related services. Also, expansion plans at more marginal operations are likely to be shelved until there is greater clarity on commodity price expectations. Interestingly, total coal and iron ore production levels are expected to increase in Australian mines.
- Into the medium term, the mining sector will remain a significant part of Australia's growth story. We expect the mining investment boom to peak in late 2013 / mid 2014 with the effects of the softening in business investment activity to largely be offset by a strengthening in exports, though the demand for labour is likely to weaken.
- The general softness in the local economy is expected to persist through the remainder of this year. While the unemployment rate is current low, at 5.1%, labour market indicators generally point to continued soft conditions, and we anticipate the unemployment rate rising to 5.3% by year end. While lower borrowing costs may be expected to strengthen discretionary spending, it appears that government carbon price compensation payments in May and June this year caused a pull forward in demand, which is subsequently being unwound. However, it appears that relatively low interest rates, combined with the repair of household balance sheets that has occurred since the GFC, have stabilised house prices, which could now increase somewhat as the full impacts of RBA rate cuts filter through the economy.
- The general softness in the local economy combined with recent developments internationally allowed the RBA to take out some additional insurance at its October Board meeting, with the RBA lowering the cash rate by 25 bp to 3.25%. A weaker demand profile, continued retail discounting and the still strong AUD should see inflation remain within the RBA's 2-3% target band; underlying annual CPI inflation (inc. carbon tax) is expected to be 2.4% in 2012, rising to 2.9% in 2013. Provided inflation comes in close to expectations, we now expect to see an additional 25 bp rate cut in November. This should help to counterbalance lower commodity prices, fiscal tightening (at both the state and federal level) and the impacts on some industries from the persistently high AUD.
- Over coming months, as well as the inflation data, the RBA will be particularly sensitive to any rise in unemployment and further signs of falling activity and credit demand. It is possible that the need for another cut in early 2013 may emerge if activity and the labour market deteriorate further. While we had previously expected the RBA to begin tightening by late 2013, we now judge the RBA's concerns about the labour market implications of the changing phases of the resource boom will delay any upward adjustment in rates till mid 2014.

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