Australian Economic Update

by NAB Group Economics

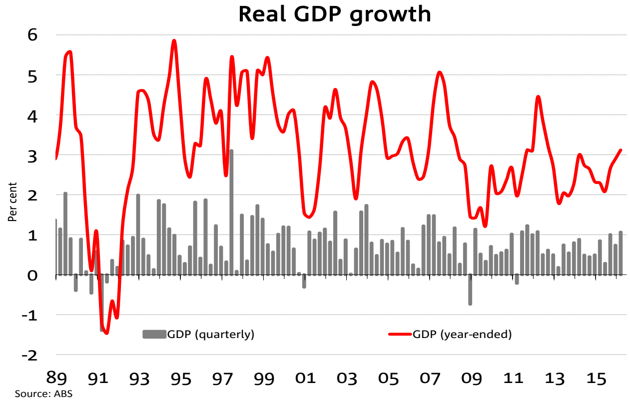
1 June 2016

National Australia Bank

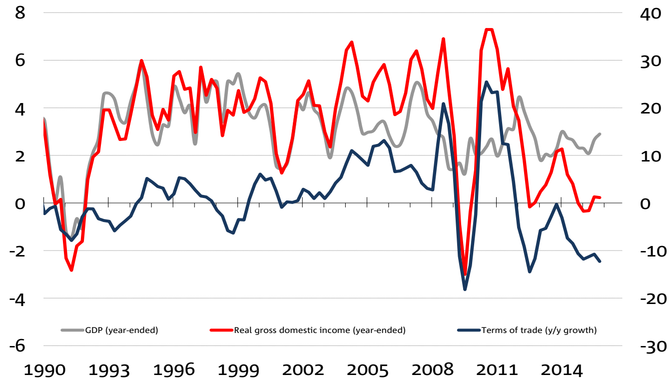
Export driven growth, but further signs of rebalancing

- **Today's National Accounts revealed stronger real GDP growth of 1.1% in Q1 2016 (up from 0.7% in Q4 2015), above the market expectation of 0.8% but in line with our forecast – with the composition of growth very similar to what we were expecting.** Year-ended growth also picked up to a solid 3.1% y/y.
- **Growth was heavily driven by net exports (contributing 1.1 ppts in the quarter), offsetting another sharp decline in business investment** – consistent with the shift to the production phase of the mining boom. Looking through these impacts, however, there are **signs that a non-mining recovery is still gaining traction**, especially in the services sectors. Household consumption made a strong contribution, rising 0.7% in Q1 despite a simultaneous rise in the household savings ratio (although the trend is down), supported by apparent strength in services consumption. Government spending and dwelling investment also made more modest contributions to growth.
- **Favourable seasonal conditions saw mining outperforming the other industries although the strength in services was also apparent and is expected to continue.** Industries including real estate services, ICT, public administration and finance & insurance again outperformed. The strength in agriculture was not consistent with production and exports data.
- **By state, non-mining states continued to outperform, while the slowdown in mining regions was less pronounced**. Subdued levels of private investment are also providing challenges for smaller states like SA and TAS, which showed minimal levels of growth.
- **Income measures picked up reasonably strongly in Q1, especially against the context of a further fall in the terms of trade.** Real gross domestic income and real net national disposable income were up 0.5% and 0.2% respectively, although the latter fell in per capita terms (-0.1%q/q). **In contrast, the gross operating surplus of non-financial corporates fell notably**, as the falling terms of trade and competitive pricing likely eroded profits. **Wages measures were subdued, but higher than in the previous quarter,** with average compensation of employees rising by 0.4% q/q (to be 1.2% higher over the year).
- **Consistent with the weak Q1 CPI outcome, there were broad based price declines over the quarter.** The GDP deflator was down 0.6%. The terms of trade continued to fall, down 1.9% in the March quarter to be 11.5% lower than a year ago, further weighing down on national income. The deflator and chain price index for household consumption both fell by 0.1%, consistent with the CPI decline.
- **The RBA is likely to look through the strong Q1 GDP result given it was largely due to a lift in exports that is not expected to be sustained in the medium term.** Additionally, the subdued Q1 CPI figure means **the RBA will also be focused on the national accounts measures related to prices**, including wages, unit labour costs, and the consumer price deflator – which were also subdued. At this stage, **NAB expects the RBA to remain on hold** for the remainder of 2016, though we do acknowledge a further rate cut remains a possibility if inflation continues to surprise to the low side. With activity indicators positive NAB does not expect any consideration of further easing before the next CPI release (released 27 July).

Real GDP growth



GDP, GDI and the terms of trade



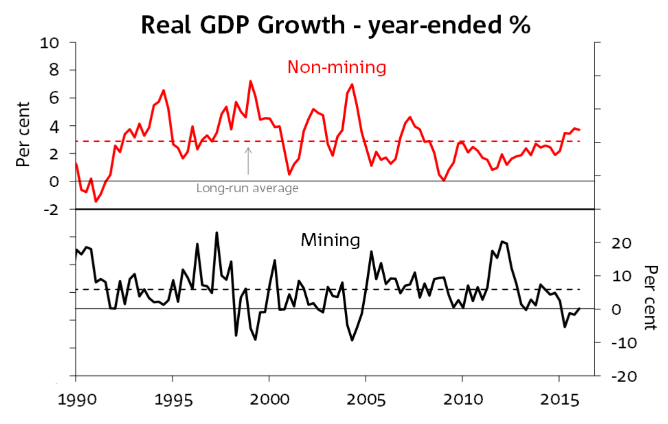
GDP (E) summary table

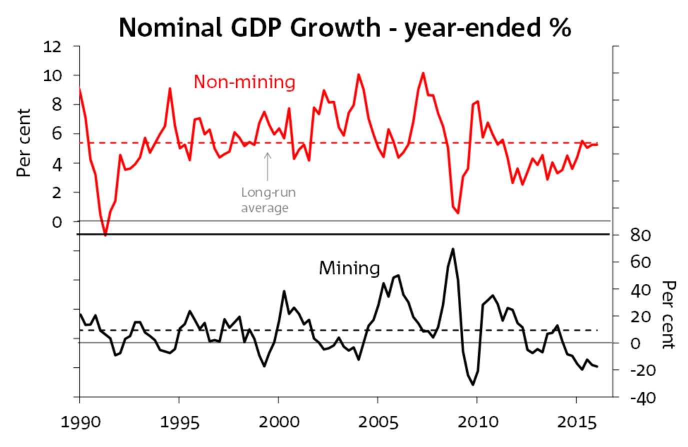
	Q/Q		Y/Y	Contribution to Q/Q
	Dec-15	Mar-16	Mar-16	Mar-16
Household Consumption	0.8	0.7	3.0	0.4
Dwelling Investment	2.8	1.4	7.0	0.1
Underlying Business Investment	-2.4	-3.4	-12.6	-0.5
Machinery & equipment	**3.4**	**-1.0**	**-6.4**	**0.0**
Non-dwelling construction	**-6.5**	**-6.6**	**-19.7**	**-0.4**
New building	**1.8**	**-6.9**	**-7.6**	**-0.2**
New engineering	**-11.8**	**-6.4**	**-26.7**	**-0.2**
Underlying Public Final Demand	1.4	0.4	3.2	0.1
Domestic Demand	**0.5**	**0.1**	**0.9**	**0.1**
Stocks (a)	0.3	0.0	0.1	0.0
GNE	**0.8**	**0.2**	**1.0**	**0.2**
Net exports (a)	**0.0**	**1.1**	**1.9**	**1.1**
Exports	0.4	4.4	6.6	1.0
Imports	0.5	-0.8	-2.0	-0.2
GDP	**0.7**	**1.1**	**3.1**	**1.1**

(a) Contribution to GDP growth

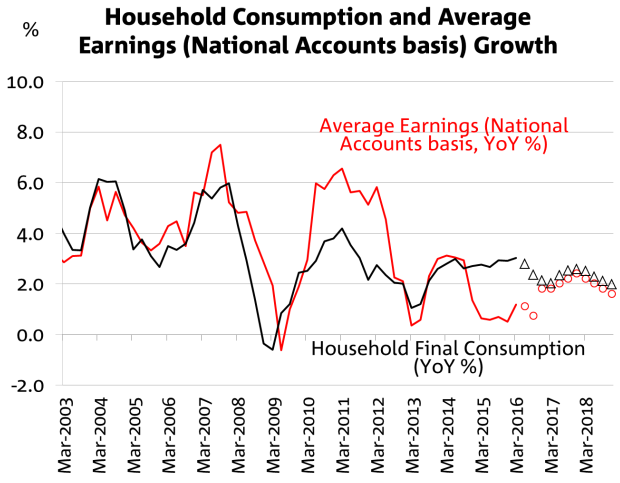
Expenditure components show exports driving growth, but rebalancing still evident

On the expenditure side, the composition of the figures show the importance of the mining sector – as we shift into the production phase of the mining boom – but also sticks to the narrative of economic rebalancing. As expected, household consumption was solid and made the second biggest contribution to growth behind net exports (table above). Dwelling investment also increased as suggested by last week's Construction Work Done release from the ABS, although the pace of growth was perhaps a little disappointing given the size of the residential construction pipeline at present. Public demand was also better in the quarter, in part driven by a continued surge in defence spending.





Household consumption growth was relatively resilient at 0.7% q/q despite a rise in the household savings ratio, following growth of 0.8% in Q4. Household income picked up strongly in Q1 despite slowing employment growth, but the overall trend is still downwards due to a compositional shift in the labour market towards lower-paid jobs and adverse effects of the declining terms of trade. Total compensation of employees (a measure of the national wage bill, a function on wages and employment) rose by a solid 0.8% in the quarter to be 3.6% y/y. The household savings ratio reversed much of its fall in Q4 to be at 8.1% in the quarter, but the overall trend continues to be a moderating one. We expect a gradual decline in the household savings ratio and further improvement in the labour market to provide support to household consumption over the coming year.

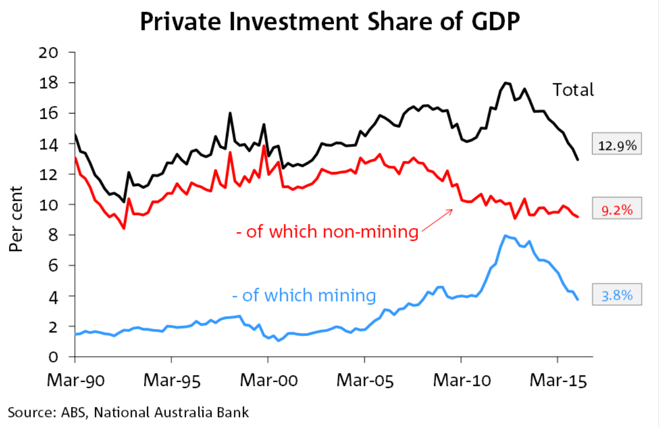


Source: ABS, NAB Group Economics

Most consumption categories recorded positive growth in the quarter, except for "cigarettes and tobacco", "hotels, cafes and restaurants" and "purchase of vehicles". The fall in expenditure on vehicle purchases possibly reflected the effects of a weaker AUD, which render car imports more expensive. The main contributors to consumption growth in the quarter were food, rent and insurance and financial services, while cigarettes and tobacco were the biggest detractor. A waning direct impetus from the housing market on consumption was also apparent in the weaker growth in furnishing and household equipment expenditure, which rose by 0.4% in the quarter, compared to the recent peak of 1.9% in December 2014.

Dwelling investment grew by a reasonable 1.4% in the March quarter, which is consistent with our expectations following last week's Construction Work Done release, but suggests that the extremely elevated pipeline of residential construction work has not further accelerated the pace of dwelling investment growth. While there is a high concentration of medium-density projects in the pipeline, suggesting a lumpy profile for construction activity, dwelling investment is still up 7% over the year. The profile for dwelling investment is expected to remain lumpy going forward, but the overall trend is expected to continue rising through 2016.

Private business investment declined by 3.4% in underlying terms, driven by a sharp contraction in both engineering and building construction, although machinery and equipment also fell. This result is marginally stronger than indicated by the recent ABS Private New Capital Expenditure (Capex) Survey and Construction Work Done release (which pointed to a decline closer to 4% in the quarter). The difference in result might reflect compositional differences between the data releases. In particular, the Capex survey has a relatively limited scope in terms of the industries it covers – excluding firms classified to agriculture, forestry and fishing, education, and health and community services industries. The omissions are significant given that alternative indicators, including the NAB Business Survey, suggest that the personal services industry has been outperforming.



By component, machinery & equipment fell by 1% and intellectual property rose by 1%. Non-residential construction dropped by 6.6% q/q, with both engineering construction and non-residential building construction falling by similar amounts. Consistent with the well progressed downturn in the mining investment cycle, engineering construction was down 6.4% following a 11.8% decline last quarter (this was the tenth consecutive quarterly decline). Our estimates suggest that the mining investment 'cliff' has potentially run a little more than half its course, but further significant declines are still expected in coming quarters – although lumpiness in the profile can be expected given the nature of these mining projects.

Government spending was solid once again in the quarter, driven in large part by defence spending, although non-defence spending was also higher. Government consumption made the biggest contribution to public spending, increasing 0.9% in the quarter, with apparent increases in public employment likely providing additional support. Public investment increased 0.7%, which follows a solid increase recorded in the previous quarter. Overall, underlying public final demand increased 0.4% in the quarter, providing a modest contribution to GDP growth. General government defence spending rose 3.2% q/q (defence investment up 1.4% and defence consumption up 3.8%). Non-defence spending rose 1.8%, with higher consumption (up 1.2%) and non-defence investment (up 8.6%).

The contribution from **inventories** to GDP in Q1 was slightly smaller than expected at 0 ppts. Most of the increase in private inventories during the quarter came from wholesale trade stocks, while mining, manufacturing and 'other' all increased. In retail trade, firms appeared to tighten up their inventory management after expanding them notably in the previous quarter.

Net exports made the largest contribution to quarterly GDP growth in Q1, adding 1.1 ppts. Export growth was strong at 4.4%, while imports fell by 0.8%.

Resources exports rebounded strongly from the declines in the previous quarter, up 5.5%, with iron ore and coal exports both recovering. LNG exports continued to ramp up as scheduled, with volumes rising by 45% in the quarter despite falling prices. Rural exports fell by 6.6%, with grain exports lower and meat exports higher. Services exports also rose by a strong 6% in the quarter.

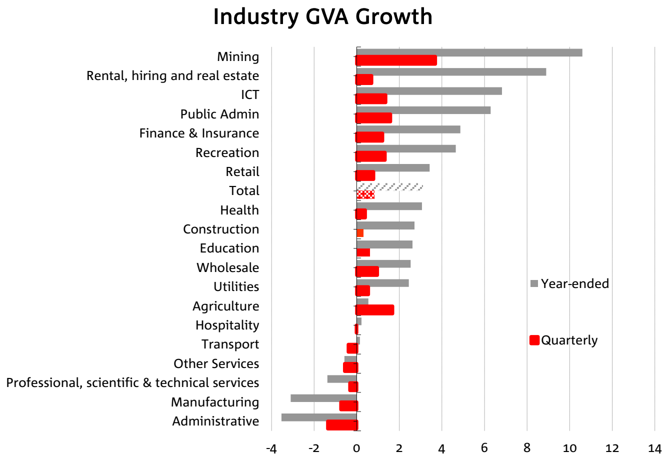
On the imports side, the small decline was driven by lower goods imports (down 1.7%) while services imports rose by 2.6%. Capital goods imports continued to decline as business investment remains subdued. Consumption and intermediate goods imports were largely flat.

Mining topped industry growth tally

Mining had the highest industry gross value added growth in Q1, with favourable production conditions and elevated levels of output and exports. While output is expected to continue to grow, such level of growth are not expected to persist over the medium-to-long term.

Growth has been slowly shifting towards the non-mining sectors, with most services industries expanding in the low exchange rate, low wage growth environment.

Growth in rental hiring and real estate services slowed somewhat, as dwelling investment grew at a slower pace. In combination with a large contraction in mining investment, activity in the construction industry also slowed down as a result.

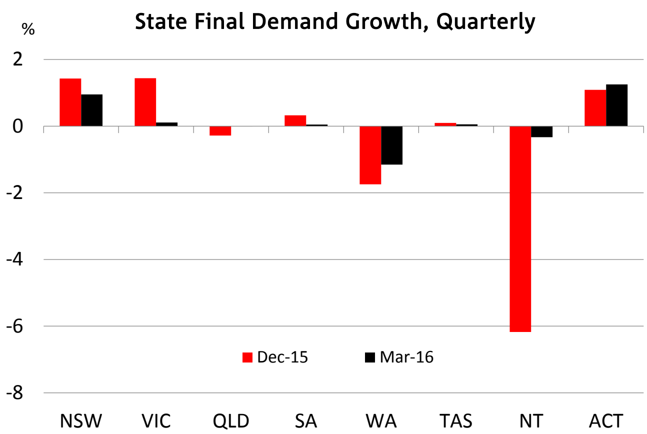


South-eastern states continued to outperform

The non-mining states continued to outperform those more reliant on mining investment, although the growth differentials narrowed somewhat, with NSW and VIC expanding less rapidly, and QLD, WA and NT contracting by less too.

Domestic demand grew the fastest in the ACT in the quarter, up 1.3%, driven by strong government consumption and private investment. NSW followed closely behind, growing by 1.0% with strong household consumption and private investment growth.

Growth in VIC slowed down noticeably to 0.1% from 1.4% in the December quarter, with public spending and private investment both contracting. TAS and SA continued with minimal growth, both struggling with subdued investment.



The more mining-dependent regions of QLD, WA and NT continued to be plagued by falling business investment, while household consumption is struggling to recover in a meaningful way and government consumption is being stepped up to support demand. Overall, the contractions were less severe, with a flat outcome for QLD, -1.2% and -0.3% for WA and NT respectively.

Income and productivity

Key income and productivity measures

	Q/Q		Y/Y
Income measures	Dec-15	Mar-16	Mar-16
Real GDI	0.1	0.5	0.6
Real net disposable income per capita	-0.5	-0.1	-2.6
Compensation of employees	0.6	0.8	3.6
Compensation per employee	-0.4	0.4	1.2
Corporate GOS	0.4	-1.7	-2.6
Non-financial corporations	-0.1	-2.5	-5.0
Financial corpoarations	2.1	0.7	5.4
General government GOS	1.2	1.2	5.1
Productivity & unit labour cost			
GDP per hour worked	-0.5	1.4	1.7
Non-farm productivity	-0.6	0.9	1.8
Non-farm nominal unit labour cost	-0.4	-0.5	0.7
Non-farm real unit labour cost	-0.1	0.1	1.8

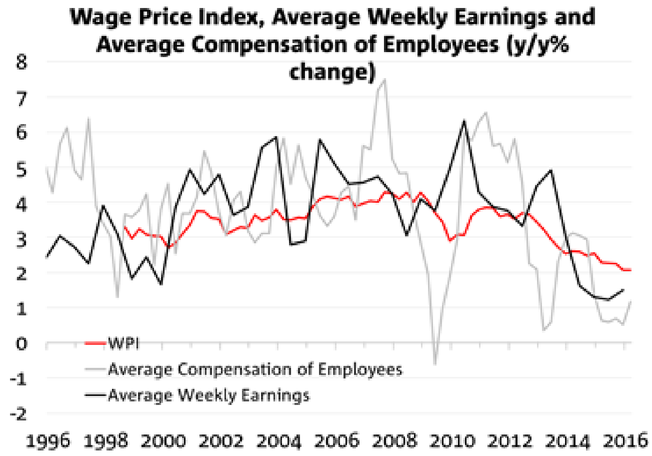
Measures of income picked up reasonably strongly in the quarter, especially in the context of a 1.9% q/q decline in the terms of trade. Real gross domestic income (real GDP adjusted for the terms of trade) rose by 0.5% (0.6% y/y), compared to 0.1% growth in Q4. Real net national disposable income grew modestly (0.2% q/q and -1.3% y/y), although it fell in per capita terms (-0.1% q/q, -2.6% y/y), suggesting that population growth (while slower) is still supporting the aggregate figures.

After a strong Q4, measures of corporate profitability fell notably in the quarter, possibly reflecting the fall in terms of trade and evidence of more competitive pricing. The growth in financial corporations' gross operating surplus still outpaced that of non-financial ones, although it decelerated in the quarter to 0.7% q/q (5.4% y/y) from 2.1% q/q in Q4. Profits for non-financial corporations fell sharply (-2.5% q/q). Meanwhile the operating surplus of the general government sector maintained its momentum at 1.2% q/q.

The optics across wage measures displayed signs of improvement in the quarter. While employment growth has eased in recent months from their exceptional growth in 2015, the wage bill increased solidly, with compensation of employees up 0.8%. Average compensation of employees rose more moderately at 0.4% q/q, reflecting the tilt towards lower-paid services jobs and continues to run at a slower rate than the wage price index (chart below).

On the back of a significant uplift in commodity production and exports, labour productivity picked up notably with aggregate output growth rising ahead of hours worked. As a result, GDP per hour worked rose 1.4% q/q and 1.7% y/y, while market sector productivity growth was softer than this at 0.9% q/q (1.8% y/y).

Given the relatively stronger uptick in productivity relative to average earnings in the quarter, nominal non-farm unit labour cost growth fell further to -0.5% q/q and 0.7% y/y. In real terms, non-farm unit labour cost rose marginally in the quarter (0.1% q/q and 1.8 % y/y). This suggests that wage costs remain constrained and are not expected to contribute significantly to inflationary pressure in the near term.



Source: ABS, NAB Group Economics

Price indices

Data from the national accounts further confirmed broad based price declines over the quarter, with the GDP deflator down 0.6%. The terms of trade continued to fall, down 1.9% in the March quarter to be 11.5% lower than a year ago, further weighing down on national income. For consumption prices, comparable with the 0.2% decline in the CPI, the chain price index for household final consumption expenditure from the National Accounts showed a 0.1% fall in the quarter.

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