National Australia Bank

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Global & Australian Forecasts

July 2013

Global growth forecasts unchanged. A few signs that activity is picking up in some advanced economies but India and Brazil still soft and growing concerns over pace of Chinese growth. Markets focussed on central bank policy driving greater volatility in equities and currencies. Australian economy softer again in June. NAB activity forecasts unchanged but AUD now expected to be lower and next rate cut now moved forward to August (with emerging risk of one more). Labour market to deteriorate throughout remainder of 2013.

- Equity and currency market volatility reflects uncertainties over the pace at which the Fed might alter US monetary policy, Chinese authorities might clamp down on shadow banking and the potential impact of the Bank of Japan's move to greater monetary easing. Recent industrial and trade data plus business survey readings show slightly better activity outcomes in big advanced economies but growth in India and Brazil remains disappointing and there are growing concerns that China might be unable to manage a smooth transition to slower more consumer-led economic growth. After two years of growth around 3%, we still expect global growth to move back to trend in 2014.
- The domestic economic outlook remains soft. The latest NAB survey reported the weakest readings for business conditions & capacity utilisation for more than four years. Business conditions in retail, manufacturing and mining are particularly weak. Labour market forward indicators still point down and transition from mining investment is creating a big structural adjustment task.
- Domestic weakness, softness in China and financial volatility have encouraged us to revise down our track for the USD/AUD (reaching 88c by end 2013 and 83c by end 2014) and bring our next expected rate cut forward to the next meeting on 6 August (previously November), assuming no surprises from unemployment or inflation. We expect the bias to easing to continue beyond August.
- Our inflation forecasts are unchanged at 2.4% in mid-2013 and 2.5% in mid-2014, well within the RBA target band. We have left GDP growth unchanged at 2.3% in 2013 and 2.8% in 2014 but with greater downside risk to the outlook. Unemployment rate is still expected to exceed 6% by the end of this year.

Key global GDP forecasts (calendar years)

Country/region	*IMF weight*	2010	2011	2012	2013	2014
				% change		
United States	*19*	2.4	1.8	2.2	**1.8**	**2.7**
Euro-zone	*14*	1.9	1.5	-0.6	**-0.6**	**1.1**
Japan	*6*	4.7	-0.5	1.9	**1.6**	**2.3**
China	*15*	10.4	9.3	7.8	**7.5**	**7.3**
Asian Tigers	*8*	7.8	4.2	3.8	**3.7**	**4.3**
Global total	*100*	5.5	4.0	3.1	**3.0**	**3.7**
Australia	*2*	2.6	2.4	3.6	**2.3**	**2.8**

Key Australian forecasts (fiscal years)

GDP components	11/12	12/13	13/14	Other indicators	11/12	12/13	13/14
		% annual average				*% through-year*	
Private consumption	3.3	**2.5**	**2.3**	Core CPI	2.2	**2.4**	**2.5**
Domestic demand	5.3	**2.2**	**0.5**			*% end of year*	
GDP	3.4	**2.8**	**2.3**	Unemploy. rate	4.9	**5.6**	**6.3**

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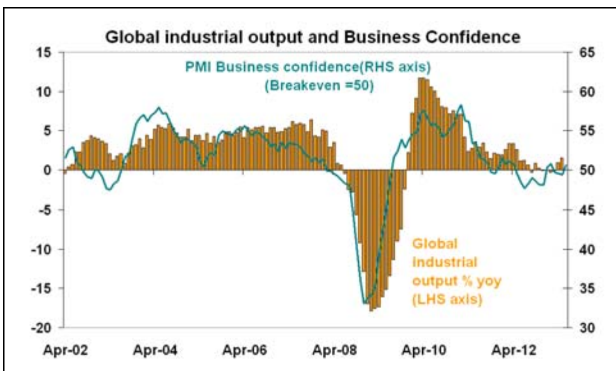
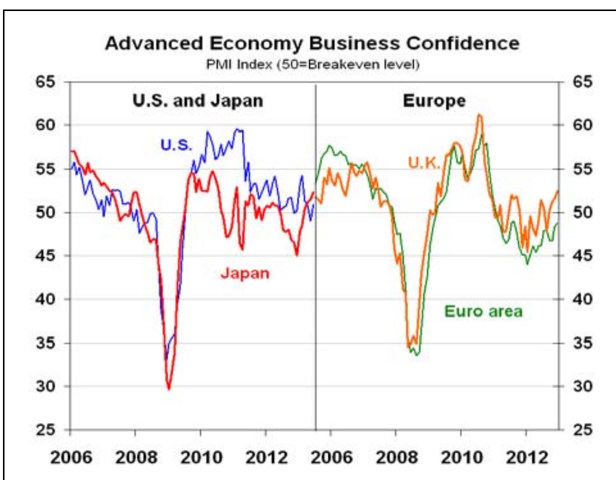
Global outlook

Key Points

- Recent volatility in equity and currency markets reflects concerns over central bank policy – uncertainty over the pace at which the Fed withdraws its QE stimulus, the impact of the Bank of Japan's monetary expansion and how the Chinese authorities will manage the transition to lower and better balanced growth without triggering instability in the financial sector.
- Global equity markets have come under downward pressure, but the latest data on activity is slightly more positive. Business sentiment about current conditions has picked up in advanced economies and growth in global industrial output is faster.
- Increasingly concerns focus on the extent to which Chinese growth is slowing. Conversely, there are signs of improved conditions in the previously weak Japanese and UK economies.
- While year-average 2013 global growth is predicted to be 3%, just below last year's pace, we are still expecting an upturn toward the end of the year that takes 2014 growth back to around 3¾% (a touch below trend).



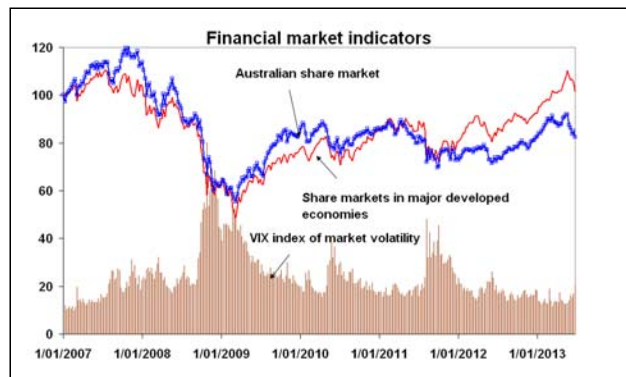


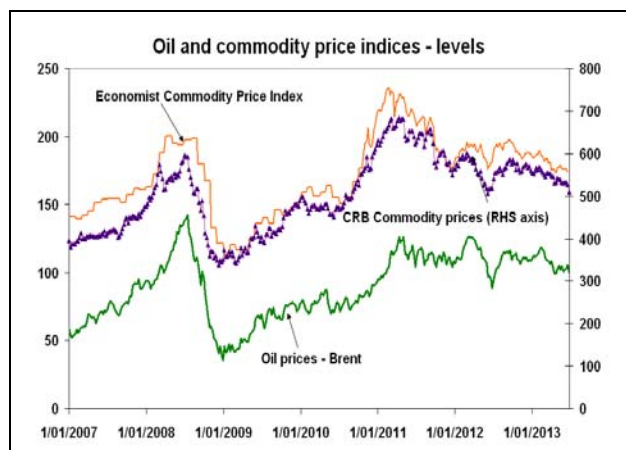
Financial & commodity markets

Statements from the US Federal Reserve Bank that it could soon be time to start winding back the stimulus provided to economic activity by its very loose monetary policy have had a marked impact on global financial markets.

There was previously a disconnect between sluggish global growth and the big rise in equity values, rationalised by a flood of central bank liquidity boosting investor appetite for higher yielding assets and risk. Recently this has reversed with G7 equity markets falling at the time when there are some brighter signs for their growth outlook. This reflects the fear that there will be less central bank liquidity injected to support asset values as the economic situation improves. The withdrawal of central bank stimulus from global economic activity should be a long and gradual affair – the Fed's likely timetable would not see an end to QE until next year with no rate rises until 2015 and the Japanese central bank has ramped up its stimulus.

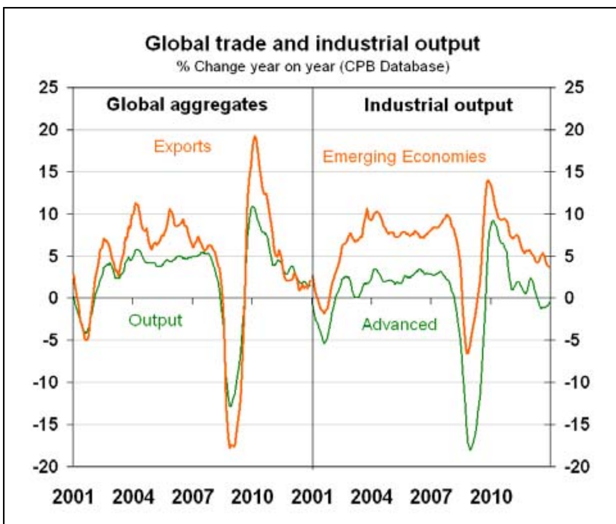
Less buoyant equity markets would be in line with the generally weak trend evident in global commodity markets through the last year, the latter being far more in accordance with the sub-trend pace of global economic growth that has led to only sluggish growth in commodity demand.



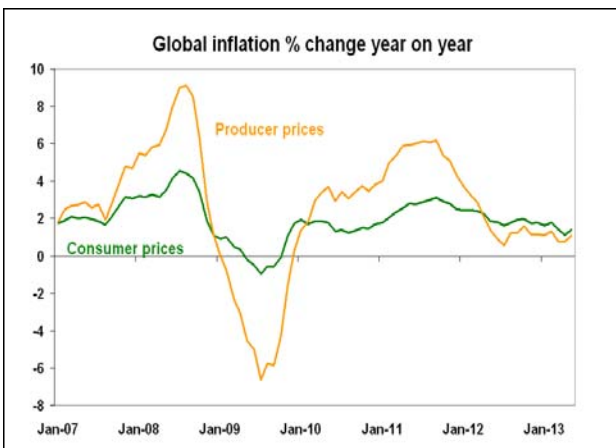


Global trends

Global industry and trade experienced a marked slowing in growth through the last couple of years. By the early months of this year global industrial production and trade volumes were both growing by less than 2% yoy, a sub-trend outcome. Comprehensive figures on global activity are only available up to April and they show a mixed picture – the momentum of industrial growth seemed to be picking up slightly through the closing months of 2012 and early 2013 but world trade growth remained very weak. This modest up-tick in industrial growth was centred on the previously weak advanced economies with growth in the emerging economies still slowing. More recent – but less comprehensive – data on industrial activity and business surveys suggest that activity continued to strengthen through May and June.

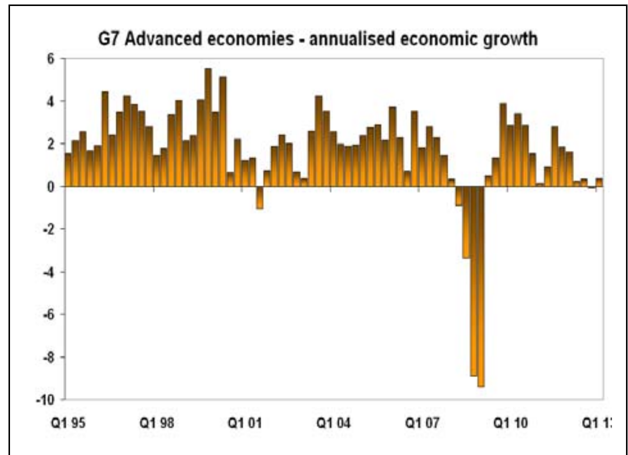


The sluggish pace of economic expansion combined with the overhang of unemployment and idle capacity left from the deep recession of 2008/09 has led to very little inflationary pressure around most of the world. Global consumer and producer price inflation is under 2%, enabling central banks to keep interest rates down.

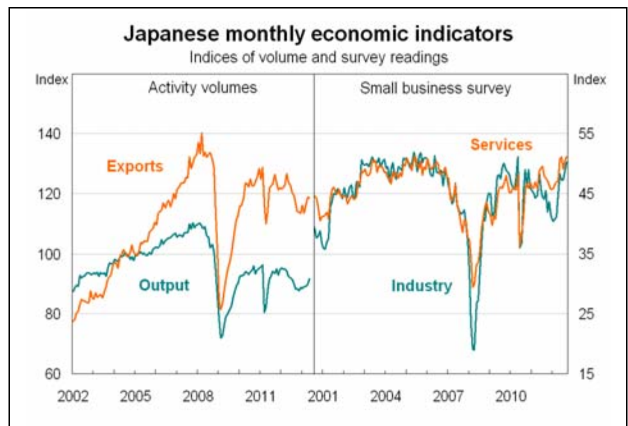


Advanced economies

Growth remains subdued in the big advanced economies with output growing by only 0.4% in the March quarter. Continental Europe remains the worst performing area with production falling by 0.2% in early 2013, the latest in a string of output declines. The US remains one of the best performing big advanced economies with moderate expansion continuing, but partial data suggest that growth could have slowed in the June quarter. The UK and Japan have experienced a prolonged period of weak demand and there are finally signs that conditions are improving and that recovery is expected to continue.



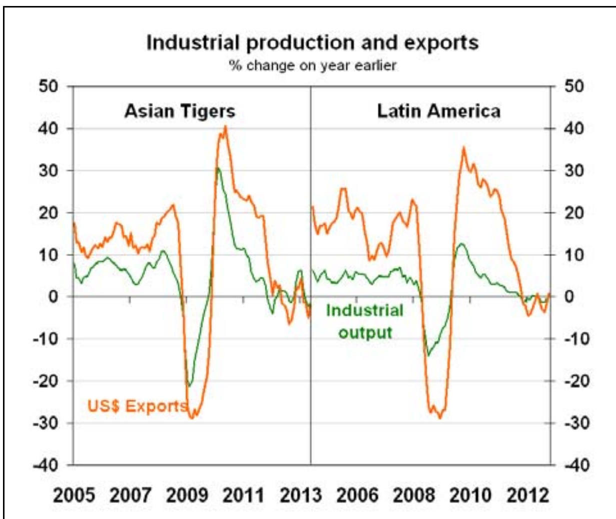
The performance of the Japanese economy is attracting particularly close attention as investors assess the impact of "Abenomics" – the combination of monetary and fiscal easing plus reform intended to end deflation and boost growth. Yen depreciation will boost exports, output and profits as well as help re-start inflation but getting sustained recovery requires a broader upturn in domestic demand. The partial data and the surveys show evidence of an industrial upturn as well as a promising looking lift in consumer spending and business sentiment in the service sector – marking a good start for Abenomics.



Emerging economies

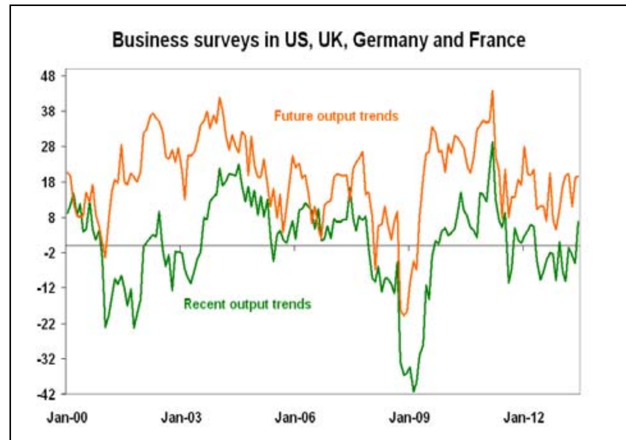
The three big emerging market economies of China, India and Brazil are still driving most of the 3% global growth forecast for 2013 but they too have experienced a slowdown. This reflects the lagged effects of past policy tightening as well as the sluggishness of global trade. Comparatively slow growth in Brazil and India has been a concern for some time but it is China that is easily the biggest concern for the markets. There is clear evidence of a major slowdown in Chinese exports but domestic market oriented measures of demand such as fixed investment or retail sales still show solid growth. Market anxieties focus on the problems of fast credit growth and the shadow banking system and the associated dangers of financial instability and policy error by the authorities. We have cut our 2013 and 2014 Chinese growth forecasts to 7½% and 7¼% respectively.

The export oriented economies of East Asia and Latin America also experienced a sharp slowdown through 2011 and 2012 with a period of renewed softness in the last 6 months.



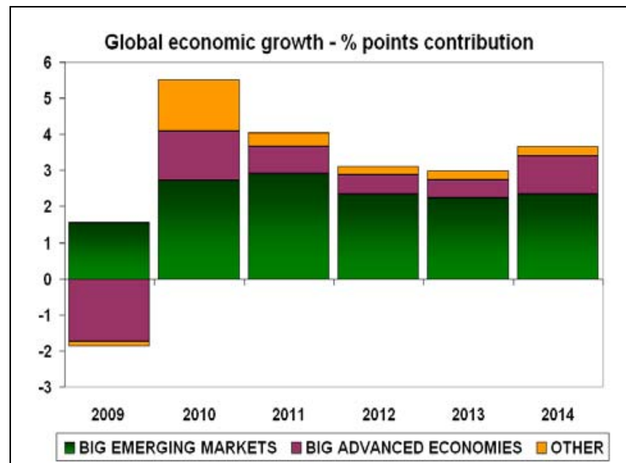
Forecasts

While recent activity trends have been generally disappointing, firms in most of the big advanced economies remain optimistic that things will get better. Our measure of current trading conditions in these big advanced economies shows a sizeable improvement in sentiment in the month of June and there is still a fair degree of optimism that the big advanced economies will see recovery in demand through the next year.



We expect global growth to remain fairly sluggish through much of 2013 with the full-year figure staying around 3% before strengthening to 3¾% in 2014. The emerging market economies still account for the bulk of global growth – around 2½ ppts – but the contribution of the big advanced economies is expected to increase as Euro-zone recession ends and Abenomics lifts Japanese growth.

For more detail, see our International Economic Reports.



Australian outlook

Key Points

- The soft outlook for China continues to weigh on the Australian resources sector. We have revised down our track for the AUD (reaching $US0.88 by end 2013 and $US0.83 by end 2014). While this can be expected to help other trade-exposed sectors, they will need to overcome several years of low investment and ageing capital before they are able to contribute to the transition from mining investment.
- The domestic sector weakened further in June. The latest NAB survey reported the weakest reading for business conditions for more than four years. We have left GDP growth unchanged at 2.3% in 2013 and 2.8% in 2014 but with greater downside risk to the outlook. Unemployment rate is still expected to exceed 6% by the end of this year.
- Domestic weakness, softness in China and financial volatility have encouraged us to bring our next expected rate cut forward to the next meeting on 6 August (previously November). We expect the bias to easing to continue beyond August.
- Our core inflation forecasts are unchanged at 2.4% in mid-2013 and 2.5% in mid-2014, well within the RBA target band.

National trends

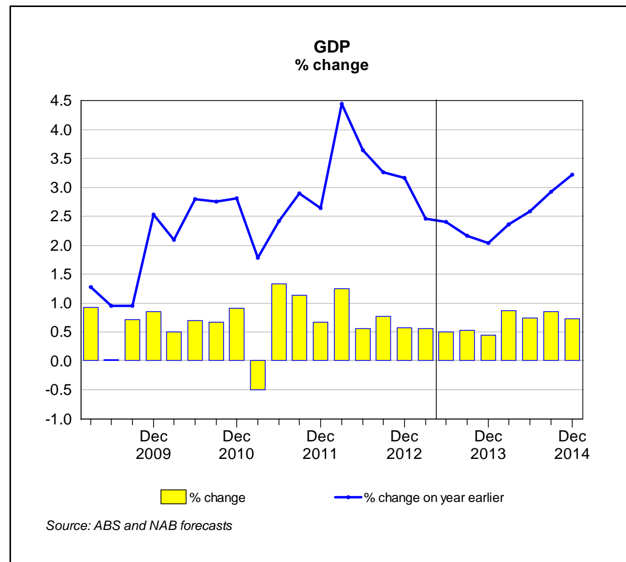
The Australian economy appeared to weaken further in June in the face of the combined effects of softness in Chinese growth and minerals commodity prices, volatility in financial markets and weaker domestic partials, including our own survey. We now expect a weaker track for the terms of trade and the AUD: by end-2013 we expect the AUD to fall to $US0.88 (was $US0.93) and by end 2014 to $US0.83 (was $US0.87) (for more detail, see Global FX Strategist).

Two prominent issues are how quickly the labour market can absorb the frictions associated with the winding down of mining investment and whether the non-mining sector can assume the role of growth engine.

The decline in the AUD should provide some relief for trade-exposed sectors, but the exchange rate nevertheless remains historically elevated. Overall, we still expect the RBA will need to cut again and, in fact, have brought forward our rate cut call from November to the next meeting in August.

The NAB survey suggests that demand and GDP growth remained below trend in Q2. Based on forward orders, the survey implies 6-month annualised demand growth was around 2¼% in Q1, much higher than the actual level of -0.2%. If we use average monthly forward orders for the three months to June the survey implies 6-monthly annualised demand growth will be around 2½% in Q2 2013, a little stronger than Q1 growth but still below trend.

Similarly, based on average business conditions for Q1, the survey implies 6-month annualised GDP growth (excluding mining) of around 3-3¼% in Q1, higher than actual growth of 2¼%. Using average monthly business conditions in the three months to June, the implied growth rate would be around 2¼-½% in Q2.



Source: ABS and NAB forecasts

Partial indicators continue to point to a weak labour market. There are also clear signs that employment in the mining sector is declining.

Retail trade barely grew in value terms in May and the demand for personal credit has kept declining. Although house prices lifted in June, the impact of lower interest rates is likely to continue to struggle against a deteriorating labour market and job security.

Forward indicators for dwelling construction are also soft. Although mining engineering commencements picked up in Q1, the pipeline of incomplete work continues to decline in an environment of weak and volatile commodity prices.

Our GDP growth forecasts are broadly unchanged. We expect quarterly growth to soften slightly to 0.5% for the next two quarters before softening to 0.4% in Q4, yielding 2.3% in 2013 (unchanged). Growth of that order will not be sufficient to prevent the unemployment rate edging up to just over 6% by the end of 2013.

In 2014, export volumes should help drive growth as major minerals and energy projects begin the

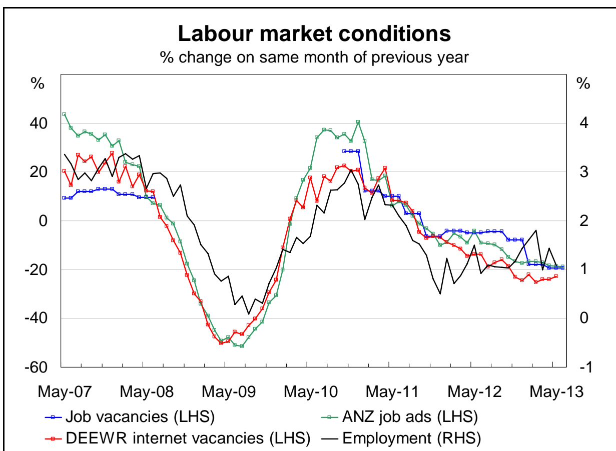
transition from construction to production and export. GDP growth is expected to recover towards trend in 2014 at 2.8%. The lower labour-intensity of mining exports relative to mining investment will have implications for labour market adjustment in 2014 and beyond.

In financial year terms, GDP is expected to be:

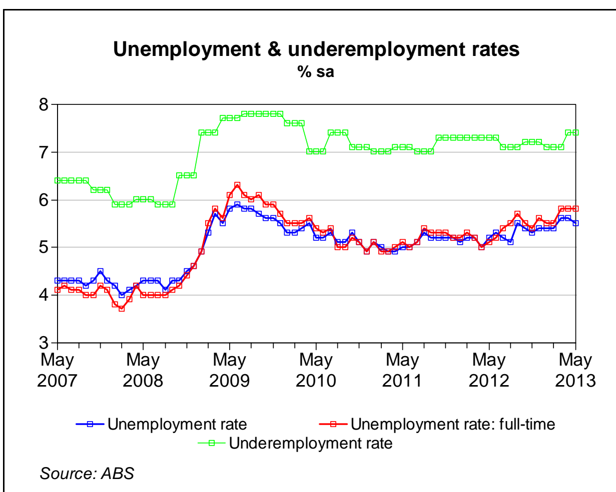
- 2.8% in 2012/13, and
- 2.3% in 2013/14.

Labour market

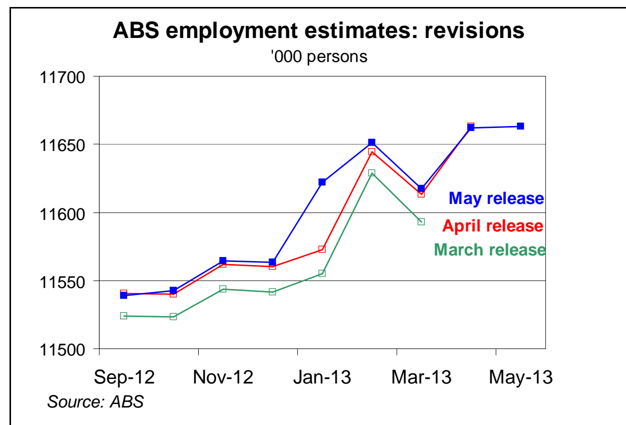
The labour market remained weak during the June quarter, according to partial indicators. Job vacancies fell by 7.3% in the June quarter and, although DEEWR internet vacancies increased marginally (0.3%) in May, there was a 0.5% decline in its trend. ANZ job ads fell by 1.8% in June to be 19% lower over the year. The NAB employment conditions index for June remained in deeply negative territory, at -6 points, and has been negative for 14 consecutive months.



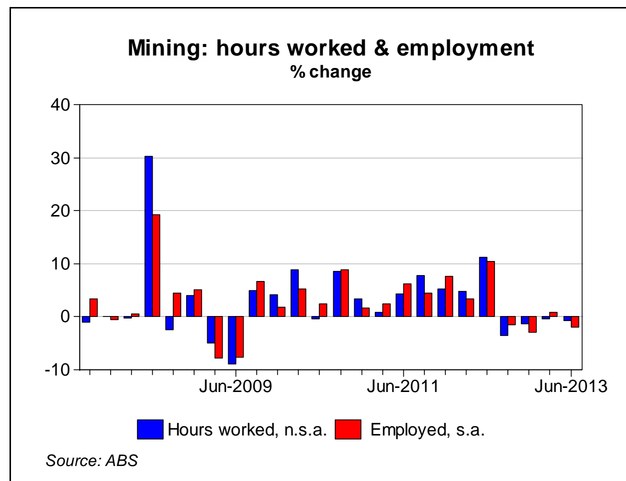
The unemployment rate edged down to 5.5% in May, although the full-time unemployment rate was unchanged at 5.8%. The underemployment rate (part-timers seeking longer hours) increased to 7.4% in the June quarter.



According to the ABS, employment was virtually unchanged in May and aggregate hours worked declined by 0.7%. Official ABS labour force employment data have been subject to significant revision affecting the growth rate of employment. In the April release, new population benchmarks resulted in an increase in the employment estimates across all recent months without an appreciable impact on monthly growth rates. However, in the May release the former employment surge in February was reallocated across both January and February. What may have been interpreted as the commencement of a reasonably strong expansion in employment using the April release now looks like the start of a flat period using the May publication.



Mining sector employment has declined in three of the past four quarters and mining hours worked have not risen for a year.



Consumer demand & housing market

Retail spending remains subdued. Retail turnover grew by just 0.1% in May, but the level remains 0.5% below its most recent peak in February. In trend terms, the weakest areas have been clothing, footwear & accessories, household goods and department stores. Recent monthly retail turnover growth numbers were revised down, from 0.2% to -0.1% in April and from 0.4%

to -0.6% in March. For June, the NAB survey indicated that retail trading conditions worsened sharply (from -18 to -34 index points), while capacity utilisation fell to 78.4%. Personal credit, contracting since mid-2011, had been showing signs of stabilising earlier this year, but fell away again in May (down 0.2%). It seems likely that Q2 retail volumes (abstracting from price movements) will turn out to be quite weak.

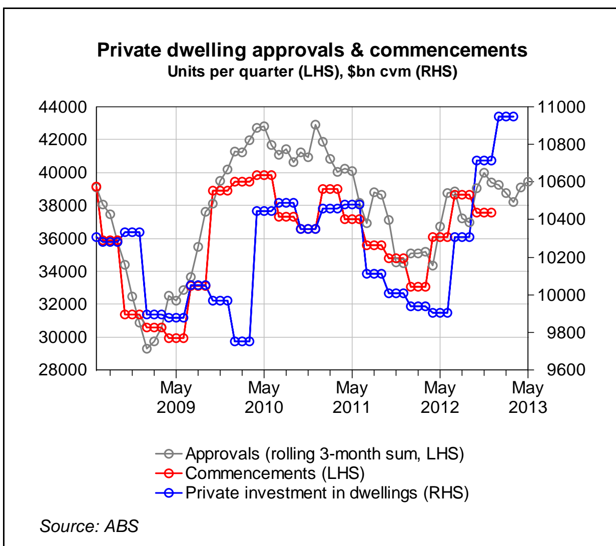
Annual growth in online retail sales pulled back to 18% in May, with the strong April outcome possibly affected by the Mothers' Day 'Click Frenzy' promotion (for more detail, see NAB online retail sales).

Declines in the national RP Data-Rismark house price series in April and May were largely reversed by a 1.9% increase in June, so that Q2 recorded a modest gain of 0.2% (with quarterly rises only in Sydney and Adelaide). Housing credit continued to grow at a modest pace in May (up 0.4% overall, with investor credit maintaining its edge over owner-occupiers). House price growth is expected to be modest as the effects of low interest rates are offset by rising concerns about job security.

New home sales rose again in May, up 1.6% to their highest level in 18 months. There were particularly strong increases in detached house sales in Victoria (up 8.8%), SA (up 6.9%) and NSW (up 4.3%), but sales declined in Queensland and WA.

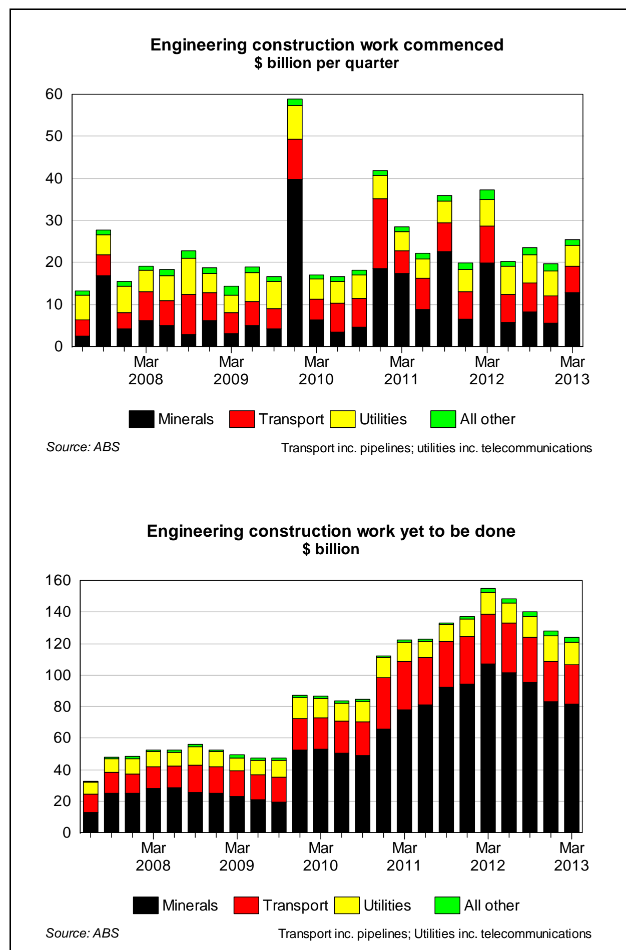
Overall, with continuing soft labour market conditions and modest growth in household wealth, it seems likely that private consumption growth will remain below trend, at 2.5% in 2012/13 and 2.3% in 2013/14.

Investment



Residential building approvals declined in May although they have staged a mild recovery on a 3-month rolling sum basis. Despite lower interest rates, we expect that a soft labour market and a weak economic environment will continue to restrain dwelling investment, with growth of just 1% in 2012/13 and again in 2013/14.

The mining sector has been the key driver of overall business investment but there are clear signs that it is no longer contributing to growth and that mining investment is now in decline. While there are several major LNG projects under way that will keep mining construction elevated, these should all be completed by early 2017. There was some resurgence in the March quarter, when an above average $12.7 billion of engineering construction projects were commenced. However, in the absence of the commencement of a new mega project, there is a risk that mining investment will fall sharply in 2014 and beyond.



The pick up in commencements was not sufficient to prevent a decline in the pipeline of mining investment projects in the quarter.

Business investment outside the mining industry remains weak. This has important implications for the capacity of the economy to respond to the opportunities created by a declining exchange rate and accommodative monetary policy, especially in terms of the quality and level of technology embodied in much of the non-mining

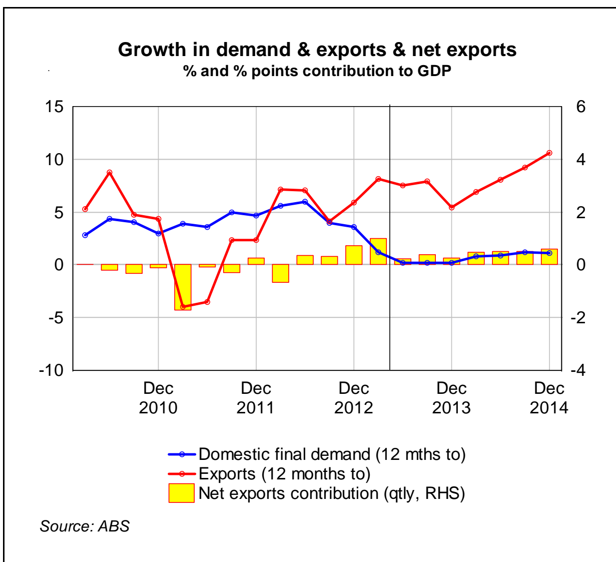
capital stock. Actual real capex of other selected industries has declined for six consecutive quarters in the March quarter to be 16.5% below its previous peak, its lowest level since September quarter 2007.

Commodity prices and net exports

The slowing in the Chinese economy and heightened volatility in financial markets led to a general decline in minerals and energy commodity prices in June. As a result, forecasts for some industrial commodities have been revised down. In US dollar terms, the NAB non-rural commodity price index fell by around 20% over 2012. We are expecting another decline of around 8½% through 2013, before falling by 1¼% over 2014. We have also revised down our track for the AUD/USD. Given its expected depreciation over the remainder of the forecast horizon, AUD prices are expected to rise by 8¼% through the year to December 2013, before rising by a further 4¾% over 2014.

Grain markets are still bearish on signs of record global output and reduced demand from big consumers such as China. Wheat and other grain prices fell sharply over June on bigger-than-expected estimates of US corn sowings. Global dairy prices moderated gradually in June after a record high in April from global stock rebuilding. Sugar prices fell in June but then stabilised as they approached mill production costs in Brazil. Cotton prices continued to benefit from strong Chinese demand.

For more detail, see our Minerals & Energy Commodities Research and Rural Commodities Wrap.



Source: ABS

The terms of trade fell 10.4% in 2012. The decline in 2013 is now expected to be 5.5% (was 4.7%) followed by a decline in 2014 of 5.3% (was 3.4%).

We have revised down our track for the exchange rate: by end-2013 we expect the AUD to fall to $US0.88 (was $US0.93) and by end 2014 to $US0.83 (was $US0.87). Partly this change reflects expected strength in the USD on the back of the continuing US recovery. Adding to this is the AUD-specific effect of weakness in the Chinese economy and weaker path for the terms of trade.

The weaker track for the terms of trade has implications for export supply, although volumes can be expected to continue to gain momentum as major minerals projects are commissioned. The higher exchange rate can be expected to weaken import volumes. Overall, the expected contribution to GDP growth from net export volumes is little changed.

Interest rates

The RBA left the cash rate on hold again in July, with a statement that was broadly similar to the previous month. The Bank continues to maintain an easing bias provided inflation remains contained. It expects inflation to remain consistent with the medium-term target over the next "one or two years, notwithstanding the effects of the recent depreciation of the exchange rate."

The RBA Governor's statement in July was brief and similar to last month's. The rise in sovereign bond yields, increased volatility in financial markets and widening of credit spreads was noted but overall global conditions were seen as very accommodative. The RBA believes that recent interest rate cuts have supported interest-sensitive spending and asset prices and that there are signs of increased demand for credit by households. The Australian economy was expected to continue growing "below trend" as it adjusted to declining mining investment. Inflation was expected to remain "consistent with the medium-term target" over the next one or two years. The statement gave the green light to a further decline in the AUD to help rebalance economic growth. The RBA retained its easing bias provided inflation remained subdued, which it expected even with a decline in the AUD.

RBA research provides some explanation about why the RBA is relatively unperturbed about the inflationary consequences of the recent and prospective depreciations of the AUD. It suggests that exchange rate impacts on the domestic price level are surprisingly protracted and, in the short term, small. The elasticity of *trimmed mean* annual domestic inflation with respect to annual import inflation after one year was estimated at less than 0.04 by the RBA[1]. Other modelling

[1] See Norman and Richards, 'Modelling inflation in Australia,' RBA Discussion Paper 2010-03, Figure 3.

finds the exchange rate passes through fully into import prices within a year, so we can treat (the negative of) this as the within-year elasticity of core inflation with respect to the exchange rate. A possible reason for a low estimate is that some exchange rate sensitive items could be 'trimmed out' of the underlying rate when there are sharp exchange rate movements. However, our own estimates suggest that the elasticity of the *tradeables* component of the CPI with respect to the $US exchange rate is 0.08 after a year. With tradeables representing around 40% of the CPI, this suggests an overall elasticity of 0.03, ignoring indirect effects on the non-tradeables component. However, like the RBA, we also find exchange rate effects persisting well beyond a year.

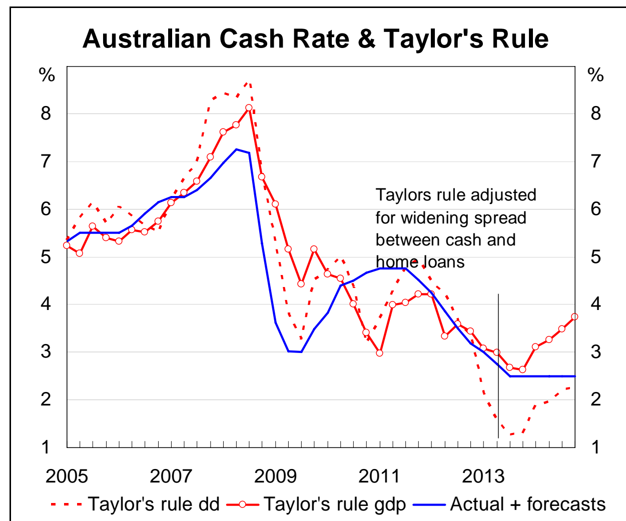
These estimates suggest that our own downward revision to the exchange rate forecast track (averaging around 5% over the next year) might be expected to add about 0.1% to the level of the CPI by mid-2014, a negligible effect.

Core inflation is expected to edge down to 2.3% by late 2013, before lifting to 2.6% by late 2014.

The weakness in the domestic economy confirmed by the latest NAB survey, along with the softness in China, the lower track for the terms of trade and the heightened volatility in financial markets have encouraged us to bring our next expected rate cut forward to the next meeting on 6 August (previously November). In making this call, we expect that the June labour force release will be soft and the June quarter CPI will not surprise. While the lower AUD is acting to take pressure off the non-mining sector, it is largely providing a buffering role.

We see the risks for the remainder of 2013 beyond August as skewed towards another cut, but heavily data dependent, particularly relative to the labour market deterioration we have currently factored in.

Beyond 2013, monetary policy is likely to remain very accommodative for some time as the full impacts of stimulus take effect. In many ways, the dilemma for policy makers is summarised by the Taylor's rule, and in particular, the differences in the rule calculated using domestic demand versus GDP. In essence, both versions show an accommodative stance of policy until at least the end of 2014.



Key global GDP forecasts (calendar years)

Country/region	*IMF weight*	2006	2007	2008	2009	2010	2011	2012	2013	2014
					% change					
United States	*19*	2.7	1.9	-0.3	-3.1	2.4	1.8	2.2	1.8	2.7
Japan	*6*	1.7	2.2	-1.1	-5.5	4.7	-0.5	1.9	1.6	2.3
Euro-zone	*14*	3.3	2.9	0.2	-4.3	1.9	1.5	-0.6	-0.6	1.1
United Kingdom	*3*	2.8	3.4	-0.8	-5.2	1.7	1.1	0.2	1.0	1.9
Asian Tigers	*8*	5.6	6.0	3.2	0.2	7.8	4.2	3.8	3.7	4.3
Latin American 4	*9*	5.7	5.8	4.1	-1.9	7.2	4.8	2.3	2.0	2.7
China	*15*	12.7	14.2	9.6	9.2	10.4	9.3	7.8	7.5	7.3
Canada	*2*	2.6	2.0	1.2	-2.7	3.4	2.5	1.7	1.5	2.3
India	*6*	9.6	9.7	8.1	6.5	9.7	7.5	5.1	5.5	6.2
Africa	*3*	6.4	7.0	5.6	2.7	5.4	5.3	4.8	5.6	6.1
CIS	*4*	8.8	8.9	5.3	-6.4	4.9	4.8	3.4	3.4	4.0
Eastern Europe	*3*	6.4	5.4	3.1	-3.6	4.6	5.2	1.6	2.2	2.8
Middle East	*6*	6.7	6.3	5.0	2.9	5.3	3.9	4.7	3.7	3.4
Other advanced	*5*	4.5	4.7	1.7	-1.1	5.8	3.3	1.8	2.5	3.4
Global total	*100*	5.9	6.0	3.2	-0.3	5.5	4.0	3.1	3.0	3.7

Australian Economic and Financial Forecasts (a)

	Fiscal Year			Calendar Year		
	2011-12	**2012-13 F**	**2013-14 F**	**2012**	**2013-F**	**2014-F**
Private Consumption	3.3	2.4	2.3	3.3	2.1	2.3
Dwelling Investment	-3.6	1.0	1.0	-3.8	2.4	1.3
Underlying Business Fixed Investment	24.1	7.3	-7.0	18.8	-4.1	-5.4
Underlying Public Final Demand	2.1	-1.8	0.7	1.9	-1.4	1.3
Domestic Demand	**5.3**	**2.2**	**0.5**	**4.7**	**0.4**	**1.0**
Stocks (b)	-0.1	-0.2	-0.1	0.0	-0.4	0.1
GNE	**5.2**	**1.9**	**0.4**	**4.7**	**-0.1**	**1.1**
Exports	4.6	6.4	7.0	6.0	7.2	8.7
Imports	11.9	-0.2	-0.9	6.4	-3.0	1.5
GDP	**3.4**	**2.8**	**2.3**	**3.6**	**2.3**	**2.8**
– Non-Farm GDP	3.3	3.0	2.3	3.8	2.3	2.8
– Farm GDP	8.8	-7.0	2.5	-2.5	-1.0	2.0
Federal Budget Deficit: ($b)	44	26	18	39	NA	NA
Current Account Deficit ($b)	40	47	47	33	55	40
(-%) of GDP	2.7	3.1	3.1	2.3	3.7	2.6
Employment	1.2	1.3	0.9	1.1	1.4	0.4
Terms of Trade	0.5	-10.1	-6.1	-10.4	-5.5	-5.3
Average Earnings (Nat. Accts. basis)	5.3	1.9	3.6	4.0	2.1	4.1
End of Period						
Total CPI	1.2	2.5	2.0	2.2	1.9	2.3
Core CPI	2.2	2.4	2.5	2.4	2.3	2.6
Unemployment Rate	4.9	5.6	6.3	5.3	6.1	6.3
RBA Cash Rate	3.50	2.75	2.50	3.00	2.50	2.50
10 Year Govt. Bonds	3.04	3.60	3.70	3.27	4.15	4.00
$A/US cents :	1.02	0.95	0.85	1.04	0.88	0.83
$A - Trade Weighted Index	76.5	72.6	68.0	77.1	68.9	66.6

(a) Percentage changes represent average annual growth, except for cash and unemployment rates. The latter are end June. Percentage changes for CPI represent through the year inflation.

(b) Contribution to GDP growth

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