National Australia Bank

September 2013

The Bigger Picture – A Global & Australian Economic Perspective

<u>Global:</u>* Recent business surveys show a solid and synchronised lift in business confidence across the advanced economies whose annualised 3-month industrial growth now exceeds that of the emerging economies. This shift in the composition of global economic expansion back to the advanced economies has long been forecast and reflects the impact of their stimulative economic policy and the passing of recession in Western Europe. Big emerging market economies have been hit by financial market volatility as money moves back to the US in anticipation of better returns with impending Fed policy changes. Growth expectations revised down for India, emerging Asia and Brazil as their monetary policy will have to be tighter than would have been the case if there had been a more gradual market adjustment to the Fed's planned moves.

- Global financial markets remain focussed on policy actions of the big central banks. We expect the US Federal Reserve to soon start cutting back on its asset purchases and end them in mid-2014 before beginning to lift interest rates in the second half of 2015. Other central banks in the UK, Euro-zone and Japan have signalled that they are likely to keep their policy running along its current lines for quite some time, so the Fed is leading the way in cutting back on the stimulus it is giving its economy. The biggest market consequence of the Fed's expected policy changes have been felt in the emerging economies where share markets and currencies have come under pressure in India, SE Asia and Latin America as money moves back to the US.
- Although annual data still show the pace of growth in GDP and industrial output in the emerging market economies clearly exceeding that in the big advanced economies, the latest industrial data suggest that the long forecast switch in the composition of global growth toward advanced economies is under way. The 3-month annualised data for industrial output show expansion in the advanced economies outpacing that of emerging markets. Global growth remains sub-trend with the big advanced economies, despite their recently much brighter business surveys, still only growing modestly. This helps explain why global measures of trade and industrial output show growth running under 2% yoy in mid-2013.
- Mid-2013 finally saw a synchronised upturn across almost all of the big advanced economies. Output expanded in the US, Euro-zone, UK, Japan and Canada and the main areas of weakness remained in the peripheral Euro-zone nations (Italy, Spain). The pace of G7 growth also gained some momentum with June quarter annualised growth reaching over 2%. While advanced economy growth is now quite broadly based, the last five years have been a lost period for economic growth in many key economies. The level of output is still below its early 2008 level across the UK, Japan and the Euro-zone. By contrast, GDP in the US and Canada is around 6% above its pre-GFC level. This protracted period of sub-par economic performance means that there should be plenty of idle resources around the advanced economies that can be pulled back into production (8½% jobless rate, 20% unused industrial capacity).
- Several of the key emerging market economies have been experiencing difficulties in recent months. Financial market pressure and political difficulties have either seen policy tightened or likely interest rate cuts postponed in India, Brazil and Indonesia. Recent GDP numbers for India and a range of East Asian emerging markets have been disappointing with Indian growth falling below 5% and downward revisions to growth prospects across ASEAN. Fortunately, Chinese growth has held up, with the latest crop of monthly data showing domestic demand and industrial growth stabilising, exports remaining the area of weakness but credit growth slowing. Exports and industrial output remain weak in emerging Asia.
- Business surveys in the big advanced economies suggest that firms are expecting the upturn to continue. Results from the US, Germany, Japan and the UK are consistent with ongoing growth while the French results point to a slower rate of decline in activity. It is this acceleration in advanced economy growth that underpins the pick-up in global economic expansion anticipated next year. The world economy should expand by just under 3% this year before rising to a slightly below trend 3½% next year. Growth in the emerging market economies is expected to remain around 5% in both 2013 and 2014. Given Australia's trade dependence on the emerging markets, growth in our major trading partners forecast for 2014 is 4.2%, compared with 4.0% for 2013.

<u>Australia:</u> June quarter national accounts confirm that the Australian economy grew below trend in the first half of this year. GDP forecasts broadly unchanged this month: GDP growth to soften to 2.3% in 2013 before gradually rising to 2.5% in 2014 and 2.9% in 2015. Unemployment to exceed 6% by end 2013 and reach 6¾% by end 2014. Consistent with soft activity outlook, core CPI expected to edge down to 2.3% by end 2013, lifting modestly to 2.6% by end 2014; rising unemployment to keep the brakes on inflation in 2015. While confidence has kicked higher on political developments, we wonder if it will be maintained in the face of continued weak demand. As a result, we still see the need for another 25 bp rate cut (probably November) to help industries squeezed by the mining investment slowdown.

- The Australian economy grew by 0.6% in Q2 or by 2.6% compared with a year earlier. Quarterly GDP growth has been range bound between 0.5% and 0.8% for the past five quarters and has barely kept pace with population (GDP per capita grew by just 0.9% last year). Household consumer spending growth remained tepid, at just 0.4%, in line with the weakness in the retail sector, which seems to be persisting into Q3. New private business investment declined by 1.2%. The latest capex survey expectations and recent engineering construction commencements imply a substantial decline in mining investment in 2013-14. At the same time, there is little evidence that investment outside the mining sector is strengthening.

- The accounts also highlighted the continued cautiousness of consumers, with the household savings rate remaining elevated at around 11% of household disposable income. This is consistent with the weakness in retail trade data this year, with no growth recorded in volumes in Q2. Consumer caution appears to have persisted into Q3, with retail values hardly rising in July and NAB survey retail trend conditions falling to the weakest outcome in almost five years in August. While lower interest rates may be expected to support consumer sentiment over coming quarters, much of this is likely to be offset by concerns about job security.

- On a more positive note, business confidence strengthened considerably in August, with the index rising to its highest level since May 2011. The cash rate cut in August and a lower AUD may have helped sentiment but it appears more important were political factors – including an expectation of political change and more certainty about the future policy framework (this survey was conducted prior to the Federal election on 7 September). Confidence lifted in all industries and states. Business conditions edged marginally higher but fundamentally were “unchanged at soggy levels”. Forward indicators edged up a touch but also remained subdued.

- Wage growth has eased considerably in recent quarters as the labour market has weakened. Annual wage price index growth has declined from 3.7% in June quarter last year to 2.9% in June quarter this year at the same time as the unemployment rate has risen from 5.1% to 5.6% (quarterly averages). Further reductions in wage inflation as the unemployment rate continues to drift upward may encounter resistance from consumer inflation expectations. We expect annual wage growth to remain moderate at around 3% over the forecast horizon.

- Our GDP growth forecasts are broadly unchanged compared to last month. We expect quarterly growth to soften to 0.4% in the September quarter, before strengthening to 0.6% in Q4, yielding 2.3% in 2013 (was 2.2%). Growth of that magnitude will not be sufficient to prevent the unemployment rate rising to above 6% by the end of this year. 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 improve a little in 2014 to 2.5% (was 2.6%), though this still represents below-trend growth.

- The RBA left the cash rate on hold at 2.50% at its September meeting, with its accompanying statement suggesting little, if any, change in view since its previous meeting. Inflation is unlikely to be a barrier to further policy easing. While a lower AUD and accommodative monetary policy should provide some relief for trade-exposed sectors and assist a rebalancing of growth towards greater sustainability over time, there will be a need for substantial recapitalisation of those industries that have endured a protracted squeeze from mining investment. As such, with weakness in the domestic demand outlook likely to continue in coming quarters, a modest inflation read in October is expected to pave the way for another 25 bp cut in November, taking the cash rate to 2.25%.

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