National Australia Bank

April 2014

The Bigger Picture – A Global & Australian Economic Perspective

<u>Global:</u> The upward trend in the advanced economy business surveys faltered toward the end of 2013 and this has continued into early 2014. Some of this reflected the disruptive impact of bad weather on supply chains but the March business survey results suggest an underlying levelling out in the pace of growth. Although unemployment rates and margins of idle capacity are trending down in the big advanced economies, they remain high by historical standards – allowing central banks to persist with historically low policy rates even as their economies pick up. Conditions remain very mixed in the emerging economies with Chinese growth slowing, Indian economic performance remaining disappointing and subdued activity growth across the rest of emerging East Asia and Latin America. High inflation remains a problem in many of these economies.

- Advanced economy central banks face divergent economic conditions, but their policy responses appear very similar: prolonged periods of low interest rates. The US Fed has updated its guidance on interest rates to allow for faster than expected progress toward lower unemployment. Instead of setting a 6½% threshold for the jobless rate to fall to before it reviews interest rates, it will assess progress toward "maximum employment". The upshot is that interest rates look set to stay between zero and 0.25% for "a considerable time" after its asset purchase program ends (which we expect by the end of this year). The Bank of England faces a similar situation and rates look set to stay low for years. The ECB expects its policy rates to stay around or below their current low levels for "an extended period of time" as inflation is running well below its target rate.
- Although global growth is currently running around its trend rate and the above-trend pace predicted for next year should slightly erode spare capacity, inflation is not posing a problem in the advanced economies. Their jobless rates and idle industrial capacity are trending down but remain high by historical standards. Headline CPI inflation in the big advanced economies is expected to gradually pick-up from last year's 1.3% to 1.7% in 2014 and 1.9% in 2015 – still meeting most central bank targets for price stability. This should allow advanced economy central banks to maintain low policy interest rates in years to come. Inflation is more of a problem in the big emerging economies. China is an exception with its 2% yoy inflation rate. Central banks in these economies either have lifted rates through the last year or are warning that hikes may be needed to curb inflation.
- Behind the inevitable monthly volatility in the data (some weather related) and divergence between individual economies, there is a flattening out in the growth rate in the main advanced economies. March industrial business surveys give the most up to date picture showing readings consistent with solid but no longer accelerating growth for the early months of the year. This follows a ramp up in growth through 2013. Headline purchasing manager business survey measures have dipped slightly across the UK, Japan and the Euro-area while the US numbers had turned down even earlier (partly reflecting weather related disruptions).
- Services account for a much larger share of economic activity, but also show signs that growth has stalled. While the UK and US surveys show good growth, their recent trends have been downwards. The Euro-zone was picking up from weak levels but fell slightly in March and Japan's service sector expects markedly lower levels of activity in April as the rise in indirect taxes takes effect. The long running Tankan survey also shows growth slowing post-tax hike.
- The slowing trend in the big emerging economies continued into the early months of 2014. Chinese industrial output, fixed investment and retail trade all showed a slight softening in their still robust growth in the opening months of the year. The export data has been especially weak but it is distorted by a crack-down on false invoicing. All Chinese numbers are distorted by the timing of the Lunar New Year holiday but there is not much sign of brighter conditions across the other emerging economies of East Asia. Similarly, the Indian monthly data on output and foreign trade shows little sign of the upturn that was signalled in some of the business surveys.
- Behind the forecast acceleration in global growth from 3% in 2013 to 3.5% this year lie quite divergent conditions between advanced and emerging market economies. Growth in the former is expected to rise from 1.3% last year to 2.2% this year. Most of that acceleration has already been delivered as GDP grew by just over 2% yoy in the G7 Advanced economies in late 2013. Growth in the emerging market economies, by contrast, should barely change between 2013 and 2014 – the slowing trend in China offsets a pick-up in growth elsewhere.

Australia: ***Australian business conditions remained soft in March and there are signs the weak environment is taking a toll on business confidence, which continues to slide. Labour market indicators are weak and, although better than in the depths of mid-2013, still look too soft to prevent a further deterioration in the labour market. Growth is likely to be supported by dwelling investment, growing minerals and energy exports and declining capital goods imports. Business investment, government demand and welfare support should provide significant headwinds. Domestic forecasts are unchanged. Jobless growth expected to continue through 2014 with unemployment rate still to reach 6½% by end-2014 when a final rate cut predicted (possibly November).***

- Partial indicators released since the national accounts suggest that the Australian economy continues to grow below trend with the employment outlook vulnerable to the large structural adjustment task associated with the end of the mining investment boom. There are few signs that business investment outside the mining sector is in a position to offset the impending decline in mining construction activity. Mining investment continued at a high rate in Q4 but the pipeline of work yet to be done continues to decline, and is now one-third below its peak in late 2012: this represents a decline from 26 to 16 months of work at current rates of construction. At some point in 2014 work done will begin to fall because of project completion. Additionally, the improvement in retailing since mid-2013 stalled in February and personal credit declined. NAB retail business conditions were still soft in March. On a more positive note, dwelling investment should be a source of demand strength in the first half of 2014, particularly apartment projects, while minerals and energy exports are expected to be growth supportive on a more permanent basis as new projects come on stream.

- Forward indicators suggest little change to the outlook. Forward orders improved slightly and the employment index rose, although it is still in negative territory, but capacity utilisation declined. It is also disappointing to see that business confidence declined again in March and, although still positive, is now at its lowest reading since the post-election bounce. Rather than conditions rising to confirm the improvement in confidence, it seems that confidence is beginning to succumb to the continuing softness in conditions.

- Business conditions for March imply GDP growth will rise to around 3% in Q1, but in our judgment growth will not be this strong once allowance is made for factors not captured in these simple relationships. In particular, we expect weakness in mining sector investment and public sector spending (largely outside the scope of the survey) to appear in the early part of 2014. In contrast, our wholesale leading indicator suggests much weaker underlying conditions, pointing to further below trend economic growth in the first quarter of 2014 of around 2½% and continuing weakness into Q2.

- Labour market indicators remain mixed. There are signs of improvement among the forward indicators, but probably not sufficient to avert further rises in the unemployment rate through 2014. ABS job vacancies increased by 2.6% between the Q4 and Q1 readings, although vacancy levels remain soft, especially in the public sector. The Department of Employment internet vacancy index fell 3.3% in February although it is well above its recent trough in mid-2013. However, ANZ job ads jumped by 5.1% in February and 1.4% in March. The unemployment rate remained at 6.0% in February, the net result of rises in both employment and the participation rate. Our outlook for the labour market has barely changed: we still see the unemployment rate peaking at 6.5% by the end of this year before it declines to 6.1% by the end of 2015.

- Our GDP forecasts are broadly unchanged: growth to be broadly constant at 2.8% through 2013/14 and 3.0% (was 2.9%) through 2014/15. In financial year terms, GDP growth forecasts are unchanged: 2.7% in 2013/14, and 3.0% in 2014/15. However, with GDP increasingly driven by the capital-intensive minerals energy sector and given recent softness in the labour market, we see modest employment growth in the near term before it begins to recover: 0.8% (was 0.3%) to mid-2014, and 1.6% (was 2.0%) to mid-2015.

- We have not changed our view that the next movement in rates will be a cut of 25 basis points in late 2014 (November). By this time, the RBA will have two more inflation readings and we expect these to be relatively benign. More importantly, the unemployment rate is likely to be well above 6% and steadily deteriorating.

Alan Oster
Group Chief Economist
National Australia Bank
03 8634 2927 (Mobile 0414 444 652)

Macroeconomic, Industry & Markets Research

Australia		
Alan Oster	Group Chief Economist	+(61 3) 8634 2927
Jacqui Brand	Personal Assistant	+(61 3) 8634 2181
Rob Brooker	Head of Australian Economics & Commodities	+(61 3) 8634 1663
James Glenn	Senior Economist – Australia & Commodities	+(61 3) 9208 8129
Vyanne Lai	Economist – Agribusiness	+(61 3) 8634 0198
Karla Bulauan	Economist – Australia & Commodities	+(61 3) 8641 4028
Dean Pearson	Head of Industry Analysis	+(61 3) 8634 2331
Robert De Iure	Senior Economist – Property	+(61 3) 8634 4611
Brien McDonald	Economist – Industry Analysis & Risk Metrics	+(61 3) 8634 3837
Amy Li	Economist – Industry Analysis	+(61 3) 8634 1563
Tom Taylor	Head of International Economics	+(61 3) 8634 1883
Tony Kelly	Senior Economist – International	+(61 3) 9208 5049
Gerard Burg	Senior Economist – Asia	+(61 3) 8634 2788
John Sharma	Economist – Sovereign Risk	+(61 3) 8634 4514
Global Markets Research		
Peter Jolly	Global Head of Research	+(61 2) 9237 1406
Spiros Papadopoulos	Senior Economist – Markets	+(61 3) 8641 0978
David de Garis	Senior Economist – Markets	+(61 3) 8641 3045
New Zealand		
Stephen Toplis	Head of Research, NZ	+(64 4) 474 6905
Craig Ebert	Senior Economist, NZ	+(64 4) 474 6799
Doug Steel	Markets Economist, NZ	+(64 4) 474 6923
London		
Nick Parsons	Head of Research, UK/Europe & Global Head of FX Strategy	+(44 20) 7710 2993
Tom Vosa	Head of Market Economics – UK/Europe	+(44 20) 7710 1573
Gavin Friend	Markets Strategist – UK/Europe	+(44 20) 7710 2155

	Foreign Exchange	Fixed Interest/Derivatives
Sydney	+800 9295 1100	+(61 2) 9295 1166
Melbourne	+800 842 3301	+(61 3) 9277 3321
Wellington	+800 64 642 222	+800 64 644 464
London	+800 747 4615	+(44 20) 7796 4761
New York	+1 800 125 602	+1877 377 5480
Singapore	+(65) 338 0019	+(65) 338 1789