Australian Economic Update

by NAB Group Economics

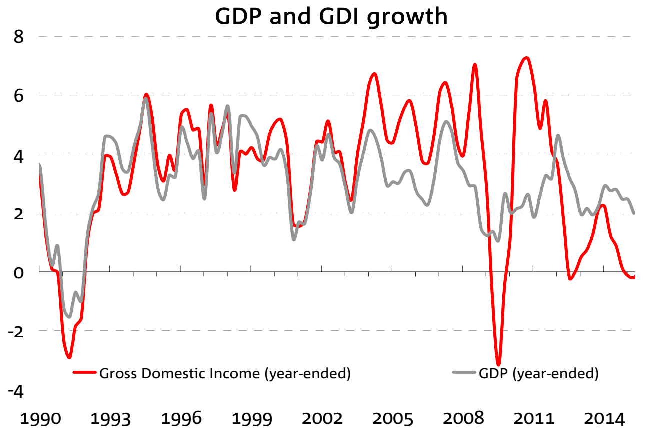
2 September 2015

Growth, but in fits and starts

- **Variability in Australia's growth outcomes by quarter indicates an economy undergoing significant structural change as it attempts to transition away from mining-investment led growth.** Real GDP expanded by just 0.2% in Q2, following an unrevised solid 0.9% increase in Q1. Year-ended growth running at 2.0%, the slowest since Q3 2013.
- **A number of one-offs in recent quarters however, suggest there has not been a fundamental shift in underlying momentum, and we are reluctant to extrapolate the weak Q2 outcome going forward.** One-offs include the decline in dwelling construction (at a time of record approvals) and the large subtraction from exports (which is unlikely to reflect weaker demand from China, but more likely reflects some payback following a surprisingly strong Q1, as well as changed weather patterns). This should more than offset any reversal of the sharp increase in government investment in Q2.
- **That said, the smaller-than-expected rise in household consumption does present a downside risk to our (and the RBA's forecasts) which are reliant on renewed declines in the household savings ratio.** Weakness in Q2 however is at odds with strength in retail sales in the quarter, as well as strong business conditions reported in retail and recreational & personal services.
- **As well flagged, measures of income growth were particularly weak given the decline in the terms of trade,** although nominal GDP remained in positive territory. This is flowing through to weak corporate profits as well as labour earnings.
- **Meanwhile, there was some evidence that growth outcomes are broadening across the non-mining economy, outside of the dwelling sector.** Lower interest rates and AUD are helping drive broader growth. Industry GVA data suggest service industries are benefiting most, particularly ITC and finance & insurance, as well as hospitality.
- Broadly speaking, **there is little in today's release to prompt a re-think of our (or the RBA's) slow expected recovery in 2016/17, as lower imports and improvements in the non-mining sector, consumer spending and dwelling consumption help to offset business investment – although the starting point will be lower.** The RBA was also expecting a quarterly outcome of between 0.1% and 0.4% q/q. **We do acknowledge however that offshore risks stemming from financial market volatility and a slower China are pronounced.** We (and the RBA) must wait for the dust to settle before assessing whether these represent a material change to the Australian outlook.

Key details

Real GDP growth was low at 0.2% q/q, following a surprisingly strong 0.9% q/q in Q1. **Given a number of one-offs influencing both figures, it may be more appropriate to average the past two quarters, which suggests the economy is growing at an average quarterly rate of 0.55% q/q, or 2.2% annualised.** This is still a slow rate, but should be viewed in the context of the significant drag on national income due to the decline in the terms of trade.



Measures of income were negative given the 3.4% decline in the terms of trade amidst weak commodity prices. Real gross domestic income (real GDP adjusted for the terms of trade) declined (-0.4% q/q and 0.2% y/y). Real net national disposable income was also down (-0.9% q/q and -1.1% y/y); **this decline is more pronounced on a per capita basis** (-1.2% q/q and -2.3% y/y), suggesting that population growth is still supporting the aggregate figures, despite some recent slowing.

Expenditure components mixed

GDP (E) summary table

Australian National Accounts (a)	Q/Q		Y/Y	Contribution to Q/Q
	Mar-15	Jun-15	Jun-15	Mar-14
Household Consumption	0.6	0.5	2.5	0.3
Dwelling Investment	5.6	-1.1	7.4	-0.1
Underlying Business Investment	-3.1	-0.7	-6.8	-0.1
Machinery & equipment	**-1.8**	**-0.7**	**2.2**	**0.0**
Non-dwelling construction	**-5.0**	**-0.1**	**-12.3**	**0.0**
New building	**2.7**	**0.9**	**5.2**	**0.0**
New engineering	**-9.3**	**-0.8**	**-20.6**	**0.0**
Underlying Public Final Demand	0.3	2.7	2.3	0.6
Domestic Demand	**0.3**	**0.8**	**1.2**	**0.8**
Stocks (a)	0.3	-0.2	-0.3	-0.2
GNE	**0.6**	**0.6**	**0.9**	**0.6**
Net exports (a)	**0.2**	**-0.6**	**1.1**	**-0.6**
Exports	3.7	-3.3	4.5	-0.7
Imports	3.2	-0.7	-0.7	-0.1
GDP	0.9	0.2	2.0	0.2

(a) Contribution to GDP growth

Despite the lower headline GDP number, **domestic demand has held up reasonably well amidst surprising strength in government spending and a much more moderate decline in business investment** than might be expected given the current phase of the mining investment cycle. Nevertheless, **household consumption was a little on the soft side, while dwelling investment recorded a surprise decline** – inconsistent with the pipeline of residential construction that has accumulated to date.

Household consumption growth was a little softer in the quarter, rising just 0.5%. The loss of momentum appears consistent with persistently weak growth in household income – although there was a modest rise in average compensation per employee in the quarter (up 0.2%) – and high levels of consumer caution. The household savings rate lifted back to 8.8%. While the strength in residential markets is somewhat apparent in the consumption numbers (growth in dwelling services and household furnishings), it is not clear yet what impact government Budget incentives for small business is having – it did not appear to lend much support to vehicle purchases in the quarter, with growth easing from 6.2% to just 0.7%.

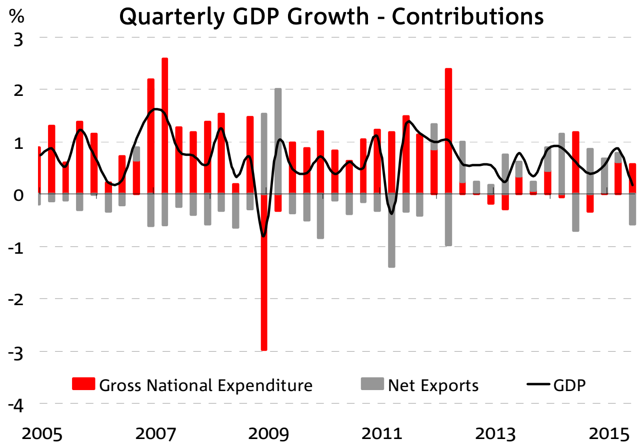
Interestingly, hotels, cafes & restaurants consumption was weak in the quarter, which appears somewhat inconsistent with strength in recreation & personal services according to the NAB Business Survey, and retail sales data showing an increase in cafes, restaurants & takeaway food services spending in Q2. This may partly be explained by improvements in international tourism as spending in this area would fall under service exports rather than consumption. However, we also recognise the service sectors of the economy are particularly difficult to measure.

The fall in **dwelling investment** was particularly surprising given the strength in building approvals and a very elevated stock of residential projects in the construction pipeline. New dwelling construction declined 1.9% in the quarter, although this did follow growth of over 6% in each of the two preceding quarters. We suspect that this weakness is only temporary given record levels of work to be done, although given the large share of apartment construction, which tends to be lumpy and have longer lead times, we could continue to see a degree of volatility in the profile.

Private business investment declined 0.7% in the quarter, with machinery & equipment (-0.7%) and intellectual property (-2.8%) down. Non-residential building increased 0.4% q/q, with engineering construction holding up surprisingly well given the current wind down phase of the mining investment cycle. Engineering construction was down just 0.8% following a 9.3% decline last quarter and falls of more than 5% in each of the two preceding quarters. This quarter's result likely reflects an element of 'lumpiness' in mining projects and we expect to see further significant declines in coming quarters. Equally, near completion of the several LNG projects will see less of a drag from here, as will the near completion of the Roy Hill iron ore project that is set to start shipping in the months ahead.

Government spending was much stronger than previously expected, with underlying public final demand increasing 2.7% in the quarter, forming the single largest contribution to GDP and domestic demand (0.6 ppts). General government consumption was up more than 2%, but capital spending was particularly strong, up 4% (underlying up 5%). The largest growth in government capital spending was in defence spending, up 41.5% q/q and accounting for most of the rise in public capital spending. The first of the Air Warfare Destroyers (HMAS Hobart) was launched at the end of May, a project of three ships with a total project value of $A9bn. The Statistician would normally account for spending on these ships progressively as they are built, and given the size of spend, they could easily account for most of the public spending rise.

Inventories subtracted 0.2 ppts from GDP in Q2, with much of the drag coming from wholesale and retail trade. This could suggest that uncertain consumer demand and an elevated AUD (supply costs) have discouraged restocking.



Net exports – The contribution to growth was much weaker than expected at -0.6% as exports declined at a faster pace than imports. Many of the drivers behind the decline in exports appear to be temporary in nature and could suggest some pay back in coming quarters.

The decline in export volumes was largely concentrated in goods exports, which fell 4% in the quarter compared to a modest 0.2% rise in services. Within the goods component, there were particularly pronounced declines in commodity exports, with the largest falls occurring in coal, "other mineral fuels" (LNG) and gold. While there is likely an element of weaker demand at play here – as the slowing in China's industrial sector continues – supply disruptions (eg. from bad weather) and shipment variations would have contributed. This suggests some potential unwinding of these declines in the current quarter. We also suspect an element of seasonality as non-seasonally adjusted export volumes actually rose 1.6% in the quarter (goods exports lifting 2.7%), which could suggest a somewhat milder than usual cyclone season early in the year.

Imports fell at a slower rate than exports, down 0.7% in the quarter, following a relatively solid rise in Q1. Services imports fell more than goods, with the higher AUD having a noticeable impact on areas such as passenger transport (down 3.3%) and travel services (down 2.1%). On the goods side, weakness was largely confined to capital imports (down 9.3%) as both consumption (up 4%) and intermediate imports (up 1.2%) were higher in the quarter.

Income measures weak as anticipated

Measures of corporate profitability was unsurprisingly weak given the decline in the terms of trade, with the gross operating surplus of private non-financial corporations down 4.4% in quarterly terms (-7.2% y/y). Profits for "other" sectors, which includes the public sector and financial corporations was reasonable at 0.7% q/q and 5.5% y/y.

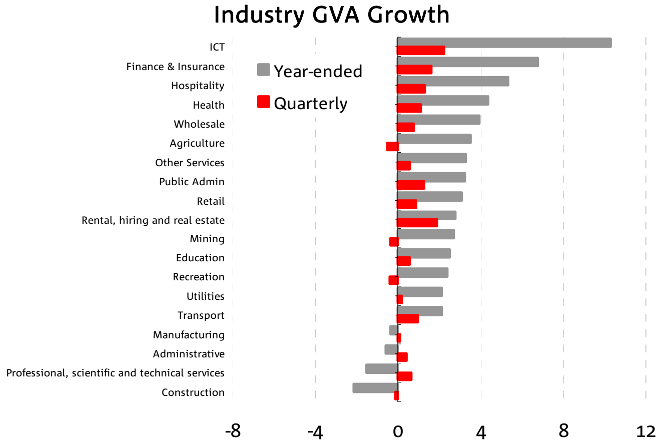
The wage bill only increased modestly in the quarter, despite strong employment, with compensation of employees up 0.9% q/q and 2.2% y/y. Average compensation per employee increased just 0.2% in the quarter and 0.5% y/y, consistent with employment shifting back to lower paid industries, and away from the mining sector.

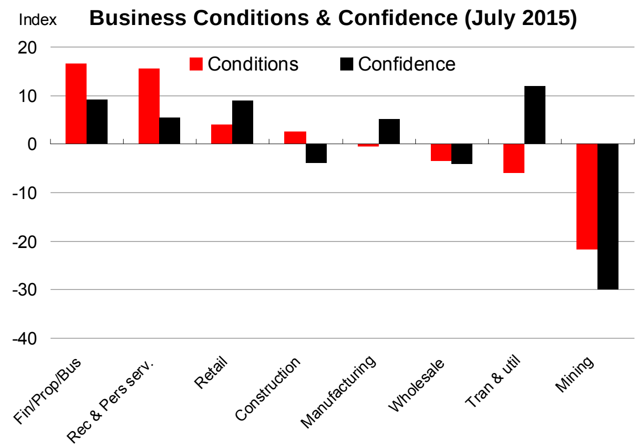
Some encouraging signs in industry data

Industry GVA data continue to highlight the patchwork economy, although growth appears to be broadening beyond the dwellings sector across the non-mining economy. Service sectors appear to be performing best, with ICT, real estate services, and financial & insurance services rounding out the three top spots in terms of quarterly growth. In year-ended terms, we have also seen considerable strength in health and hospitality services. These outcomes are largely consistent with the NAB Business Survey, which has consistently seen services sectors of the economy outperform.

In contrast, declines in GVA were recorded for agriculture, recreation, mining and construction. The deterioration in mining and construction are largely expected given the falls in commodity exports and drag from engineering construction – the surprise (but likely temporary) fall in dwelling construction would have also contributed. The decline in recreation, however, is a little difficult to reconcile with the NAB Business Survey and improving tourism, although domestic consumers are continuing to show reluctance to spend on discretionary items.

Industry GVA Growth





Growth mixed across the states

Across the states, final demand was solid in NSW (0.8% q/q) and Victoria (0.9% q/q). Government consumption was strong in both states due to solid employment growth, but household consumption was disappointing, particularly in Victoria). Business investment dragged significantly on state final demand in Queensland (-0.8% q/q) and the NT (-3.4% q/q), despite household consumption holding up in both states.

State final demand was moderate in Tasmania (0.5% q/q) due to strong investment, but weak consumption. Weak private investment were significant drags in state final demand in Queensland (-0.87% q/q; completion of LNG project spending most likely) and the NT (-3.4% q/q). Meanwhile, a surprise increase in private investment in WA saw its final demand increase strongly (1.5% q/q) ; again this could well be ramped-up spending to complete Roy Hill).

Prices and productivity

- Labour productivity was disappointingly flat (0.0% q/q and 0.3% y/y), although this may reflect a pickup in employment in the public sector, as market sector productivity picked up (0.5% q/q and 1.1% y/y).
- Measures of unit labour costs were higher in Q2, although this largely unwound declines in the previous quarter. Annual growth in real non-farm unit labour costs (1.1% y/y) and nominal non-farm unit labour costs (0.5% y/y) is subdued, which should help keep inflation contained.
- Measures of domestic prices were moderate. The household consumption chain price index was up just 0.3% q/q, while the household consumption deflator was up 0.7% q/q.
- The deflator for domestic final demand was solid at 0.7% q/q. However with the terms of trade down 3.3%, the GDP deflator was softer at 0.2% q/q and -0.3% y/y. The GDP chain price index was negative at -0.5% q/q.

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