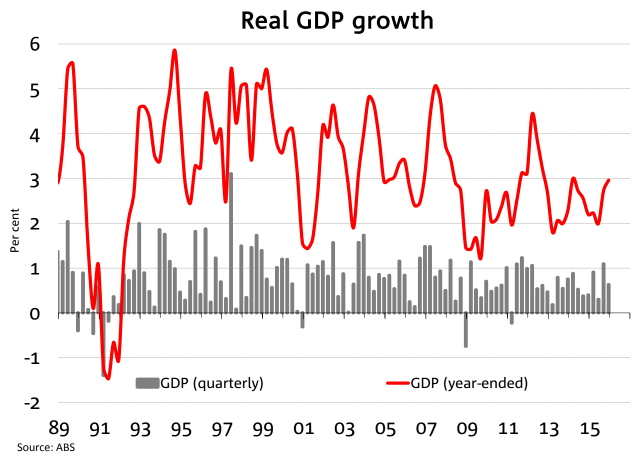
Australian Economic Update
by NAB Group Economics

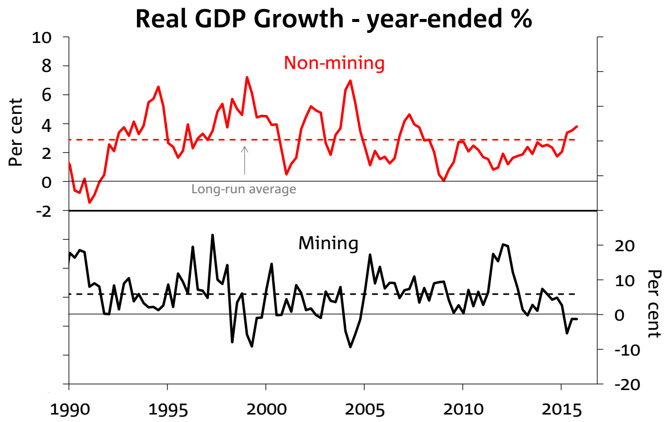
2 March 2016

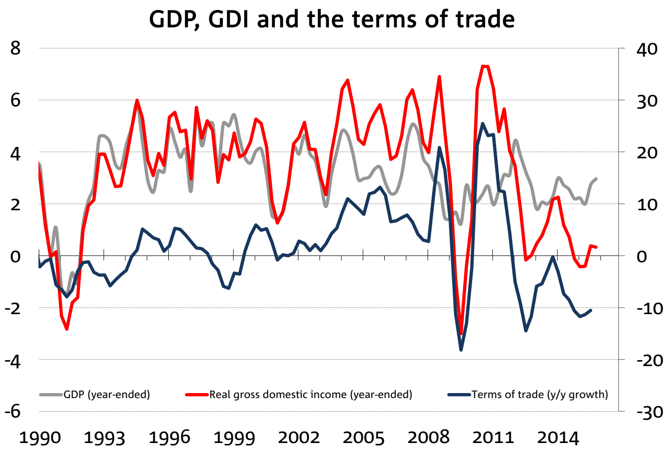
National Australia Bank

Reassuring growth

- **Today's GDP figures provide reassurance that the Australian economy remains resilient amidst an uncertain global backdrop and weak commodity prices. Real GDP expanded by 0.6% q/q in Q4 (Mkt: 0.4%, NAB: 0.6%), following growth of 1.1% q/q in Q3 (revised up from 0.9% q/q). Year-ended growth was 3.0%, the strongest rate since Q1 2014.**
- **The composition of the figures was particularly encouraging. Household consumption was strong** at 0.8% q/q, and the household savings ratio dipped to 7.6%, the lowest since before the GFC. **Also notable was the smaller-than-expected decline in business investment** (-2.7% q/q in underlying terms). While mining investment continued to drag, machinery & equipment and non-residential building investment were positive. Together with higher government investment, this saw domestic demand expand 0.4% q/q. Net exports meanwhile disappointed, although the expected surge in LNG exports was apparent.
- **Industry data suggests the recovery across the non-mining economy gathered steam in late 2015.** Output in labour-intensive services industries such as real estate, IT, financial services, health, public administration and arts & recreation were strong, consistent with the NAB measure of business conditions and strong employment. Retail and wholesale trade output were also solid. Indeed, **our estimate of non-mining GDP is now running at above its long-run average in year-ended terms.**
- **By state, NSW, Victoria and Tasmania continued to outperform, while the downturn in state final demand in WA and the NT was more pronounced.** State final demand growth in SA ran behind its eastern neighbours, but ahead of Queensland.
- **Income measures were largely unchanged in Q4,** with real gross domestic income flat and real net national disposable income down 0.1% (-0.4%q/q on a per capita basis). **While weak income growth is an ongoing challenge, these measures were surprisingly stable given the 3.2% decline in the terms of trade. In particular, corporate profits were positive in Q4,** in keeping with strong employment and better-than-expected business investment in the quarter. **The main area of weakness was wages,** with average compensation of employees declining 0.6% q/q, reflecting the tilt towards lower-paid services jobs.
- **Overall, today's figures suggest the recovery across Australia's non-mining economy remains on track despite considerable challenges. Strong output growth in Q3 and Q4 also gives more substance to the fast growth in employment in the second half of 2015. While the RBA remains alert to heightened global risks and retains a clear easing bias, resilience in the domestic economy suggests the bar for further easing is high.**







Expenditure components show encouraging signs of rebalancing

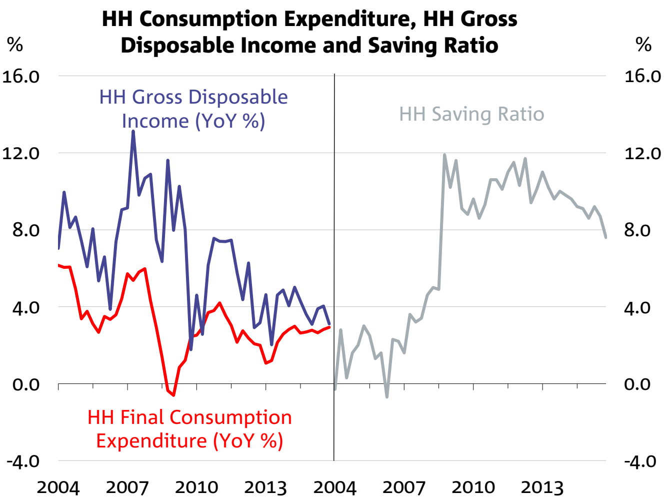
On the expenditure side, the composition of the figures was particularly encouraging, conforming to the narrative of economic rebalancing. Household consumption was even stronger than expected, while dwelling investment was robust, supported by an extremely elevated pipeline of construction. Public demand also jumped in the quarter, underlined by defence spending (which we largely attribute to the commissioning of the Landing Helicopter Dock (HMAS Adelaide)).

GDP (E) summary table

	Q/Q Sep-15	Q/Q Dec-15	Y/Y Dec-15	Contribution to Q/Q Sep-15
Household Consumption	0.9	0.8	2.9	0.4
Dwelling Investment	1.9	2.2	9.8	0.1
Underlying Business Investment	-4.5	-2.7	-12.0	-0.4
Machinery & equipment	**-6.6**	**1.8**	**-10.2**	**0.1**
Non-dwelling construction	**-4.8**	**-6.1**	**-15.8**	**-0.4**
New building	**-1.6**	**3.8**	**6.0**	**0.1**
New engineering	**-6.7**	**-12.3**	**-26.8**	**-0.6**
Underlying Public Final Demand	-0.7	1.3	3.7	0.3
Domestic Demand	**-0.3**	**0.4**	**1.1**	**0.4**
Stocks (a)	-0.2	0.2	0.4	0.2
GNE	**-0.4**	**0.5**	**1.5**	**0.5**
Net exports (a)	**1.6**	**0.0**	**1.0**	**0.0**
Exports	5.4	0.6	5.7	0.1
Imports	-2.3	0.6	1.2	0.1
GDP	**1.1**	**0.6**	**3.0**	**0.6**

(a) Contribution to GDP growth

Household consumption growth was solid at 0.8%, following growth of 0.9% in Q3 (revised up from 0.7%). However, this represents a very strong outcome relative to recent history, possibly a reflection of the sustained improvement in employment growth over 2015. That said, growth in household income has remained very weak of late, suggesting a compositional shift in the labour market towards lower-paid jobs. Total compensation of employees (a measure of the national wage bill) only rose by a relatively muted 0.4% in the quarter. As such, the strength in household consumption was supported by a notable decline in the household savings rate, which fell to 7.6% from 8.7% in Q3, to be below 8% for the first time since the GFC.



Source: ABS, NAB

Direct impetus from housing market strength on consumption has visibly weakened since Q3, with furnishing and household equipment growth growing at a significantly slower rate compared to Q4 2014 (0.5% q/q, from 1.9% in Q4 2014). However, there was a broad-based pick-up in spending on services in general, led by recreation, utilities and health. Apart from purchase of vehicles, spending on essential and discretionary goods such as food, alcoholic beverages, as well as clothing and footwear, also rose reasonably strongly in the quarter. The greatest contributions to household consumption growth in Q4 came from recreation, food and rent.

Our NAB Business Survey has flagged strength in personal and recreational services for some time. While this may partly reflect improvements in international tourism which would fall under service exports rather than consumption, the recent gain in momentum by recreational spending in national accounts suggests increasing support to these sectors from domestic sources.

Dwelling investment grew by a solid 2.2% in the December quarter, a result that is broadly consistent with expectations given the highly elevated level of residential construction work in the pipeline. 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 9.8% 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 1.9% in the quarter (underlying down 2.7%), once again driven by a sharp contraction in engineering construction. This result is actually 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 3% in the quarter). The difference in result likely reflects 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 rose by 1.8% and intellectual property declined by 0.3%. Non-residential construction dropped by 6.1% q/q, with engineering construction more than offsetting a solid increase in non-residential building construction – consistent with the well progressed downturn in the mining investment cycle. Engineering construction was down 12.3% following a 6.7% decline last quarter (this was the ninth consecutive quarterly decline). Our estimates suggest that the mining investment ‘cliff’ has run 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 increased solidly in the quarter, driven by a surge in public investment – coinciding with the commissioning of HMAS Adelaide during the quarter. Consequently, public investment jumped 11.3% in the quarter, with underlying public investment rising almost 5%. General government consumption was up by a more modest 0.7% in the quarter, likely assisted by solid employment growth. Overall, underlying public demand increased 1.3% in the quarter, providing a notable contribution to GDP growth. Consistent with the commissioning of the Landing Helicopter Dock, general government defence spending rose 4% q/q (defence investment up 28.6%). Non-defence spending rose 0.7% as higher consumption (up 0.9%) more than offset a decline in non-defence investment (down 1.3%).

Inventories made a surprise positive contribution of 0.2 ppts to GDP in Q4. Most of the increase in inventories during the quarter came from retail trade stocks. Elsewhere, outcomes suggested that firms tightened up their inventory management further.

Net exports disappointed in the quarter, making a flat contribution to GDP growth. Both exports and imports were up 0.6%. The smaller than expected increase in exports was mostly driven by larger than expected falls in our key commodity exports, with iron ore and coal exports both down by more than 3% over the quarter. Offsetting these declines somewhat was the ramp-up in LNG exports. Rural goods exports also rose a strong 10%. Services exports increased by 1.6% as well.

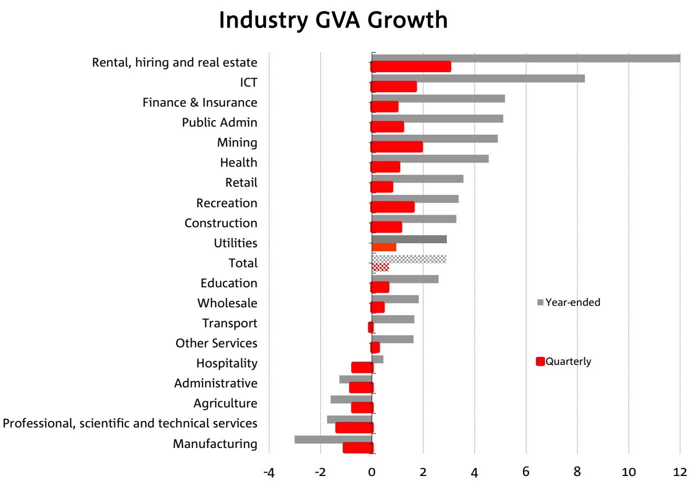
On the imports side, a 0.5% increase in goods imports was driven by a 3.7% increase in intermediate goods (with its biggest component 'fuels and lubricants' imports rising by 6.0%, potentially encouraged by lower world oil prices). Although a smaller component, services imports also increased by 1.0%. Travel imports grew by 0.5%, after two consecutive quarters of declines.

Services industries again outperform

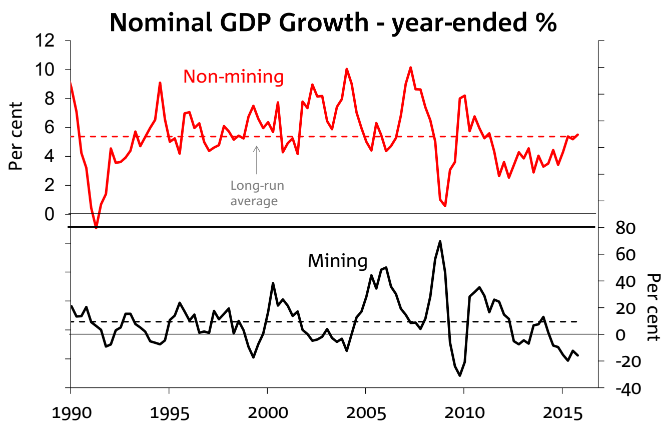
Most industries recorded positive production growth in the quarter. Services sectors again outperformed, consistent with recent outcomes from the NAB business survey. In Q4, this was particularly apparent in industries related to the strong household consumption and housing market conditions, although strong ICT spending is consistent with positive machinery & equipment investment in the quarter.

The top three spots again went to real estate services, ICT and finance & insurance. Public administration and health also grew strongly. Construction and utilities potentially benefited from strong residential construction activity. Mining reported positive growth as LNG production and exports ramped up. The declines in hospitality and administrative services this quarter were somewhat surprising given strong consumption growth and overall positive services industries performance.

On the other hand, agriculture and manufacturing seem to be in a structural decline and despite the low interest rate low exchange rate environment, failed to produce a positive growth result.



As further evidence of the recovery across the non-mining economy, our estimates of non-mining GDP suggest year-ended growth is running above its long-run average in real terms (see chart on page 1), and in line with its long-run average in nominal terms (chart below).

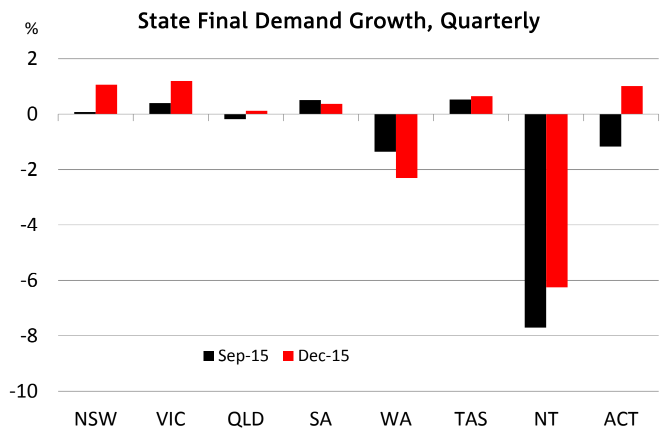


Domestic demand improved in eastern states

State final demand growth improved strongly in all eastern states. The improvements were particularly encouraging in NSW, Victoria and the ACT while Tasmanian growth also improved slightly. Queensland enjoyed the first positive outcome for state final demand since June quarter 2014. On the other hand, WA and NT had disappointingly negative state final demand in the quarter.

The improvement in the non-mining sectors saw the more diverse economies of NSW and Victoria bounce back from the subdued growth in the previous quarter to record 1.1% and 1.2% quarterly growth respectively. (The small contraction in NSW in Q3 has been revised up to be a flat outcome.) Strong household consumption was the biggest contributor to the positive outcomes while private investment in NSW and public investment in Victoria also helped.

Household consumption growth was also behind the improvement in Tasmanian domestic demand, while the ACT was also helped by increases in government consumption and investment.



In Queensland, while declines in business investment continued to detract from state final demand (down 7.3% in the quarter) as large LNG projects were completed, a 12.2% boost in state/local government investment provided an offset.

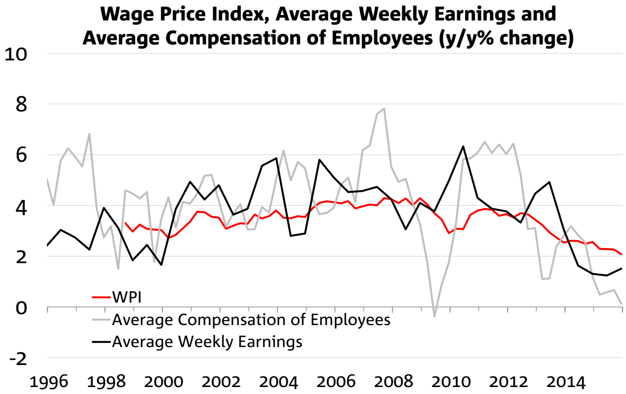
The other two mining regions of WA and the NT had even more significant declines in business investment over the quarter, at -9.5% and -18.0% respectively, and their increases in public investment was insufficient to offset these falls, leaving the total domestic demand growth negative.

Income and productivity

Measures of income remained weak in the quarter, but are deemed to be relatively resilient in the context of a 3.2% q/q decline in the terms of trade. Real gross domestic income (real GDP adjusted for the terms of trade) was flat in the quarter (0.0% q/q after rounding and 0.3 y/y). Real net national disposable income declined slightly (-0.1% q/q and -1.1% y/y), although the declines remain more pronounced on a per capita basis (-0.4% q/q, -2.3% y/y), suggesting that population growth (while slower) is still supporting the aggregate figures.

Measures of corporate profitability surprised on the upside in Q4 given the lower terms of trade, but not inconsistent with employment and better-than-expected business investment in the quarter. Lower oil prices may also be reducing input costs for businesses. Financial corporations gross operating surplus was the standout performer in the quarter, accelerating to 2.1% q/q (5.8% y/y) from 1.2% q/q in Q3. Meanwhile, profits for private non-financial corporations (0.9% q/q) and the general government (1.2% q/q) also held up.

The optics across wage measures remained weak. Despite strong employment, the wage bill only increased modestly, with compensation of employees up 0.4%. However average compensation of employees declined 0.6% 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).



Source: ABS, NAB Group Economics

Labour productivity fell in Q4 with hours worked rising ahead of aggregate output growth. GDP per hour worked fell 0.6% q/q and 0.4% y/y, while market sector productivity growth was weaker at -0.9% q/q (0.9% y/y).

Measures of unit labour costs softened moderately in the quarter to remain subdued over the year. Nominal non-farm unit labour cost growth was down 0.5% q/q and 0.1% y/y. In real terms, non-farm unit labour cost moderated by a lesser extent in the quarter (- 0.3% q/q and 0.9 % y/y). This suggests that wage costs remain constrained and are not expected to contribute significantly to inflationary pressure in the near term.

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