AUSTRALIAN ECONOMIC UPDATE

Government spending drives Q2 GDP

NAB Group Economics

7 September 2016

KEY POINTS

- **Today's National Accounts revealed moderate real GDP growth of 0.5% q/q and 3.3% y/y in Q2,** slightly below our and market expectations for a 0.6% q/q. Q1's stellar growth rate was revised down slightly to 1.0% q/q from the originally reported 1.1% q/q. Year-ended growth picked up to 3.3% y/y from 3.0% y/y last quarter. **This was the fastest pace of growth in year-ended terms since mid-2012, although growth is forecast to ease back below 3% as the year progresses.**
- **Government spending has certainly surprised on the upside**, up 2.4% in underlying terms in the quarter and adding 0.5ppt to real GDP growth. This reflects stronger government investment (particularly at the state level, likely reflecting infrastructure spending) as well as government consumption (see within for further detail).
- **Otherwise growth outcomes by expenditure category were mixed. Household consumption growth was weak** at 0.4% q/q, down from 0.8% q/q in Q1. This is a trend which bears close watching and coincided with a softening in business conditions for retail trade in the same period. The household savings rate was steady in the quarter at 8.0% and slightly higher than the low of 7.5% in Q4 2015. **New dwelling construction was higher again, although this was mostly concentrated in renovation activity** rather than construction of new dwellings despite the strong pipeline of projects. **The contraction in mining investment has endured as a greater number of projects approach completion,** although the offset from higher resource export volumes was smaller in Q2 and net exports subtracted 0.2ppt from growth despite stronger services exports.
- **The recovery in the non-mining economy continued**, although did lose some momentum in Q2 – our estimates of non-mining GDP increased by 0.7% in the quarter and eased slightly to 3.1% in year-ended terms from almost 4% y/y in Q1. Strong production and exports saw mining outperforming again although the strength in services was also apparent and is expected to continue. Industries including professional services, wholesale, finance and real estate services outperformed in the quarter while agriculture, manufacturing and construction again lagged behind.
- **All states enjoyed positive domestic demand growth in Q2, except for WA** which struggled with falling business investment. Rising public spending and household consumption were able to offset falling private investment in most states, producing positive growth results.
- **The terms of trade rose by 2.4% in Q2,** and adding to income growth for the first time in approximately three years. This has supported measures of national income in the quarter, with real gross domestic income rising 0.9% q/q and real net national disposable income rising 0.2% q/q. Nominal GDP was even stronger at 1.3% q/q and 3.4% y/y.
- **Labour productivity measures were generally stronger in the quarter**, with GDP per hour worked rising by 1.2% q/q and market productivity at 1.5%, predominantly driven by a decline in aggregate hours worked in the quarter against a backdrop of relatively strong GDP outcome.
- **Price indicators in the National Accounts were mixed in the quarter.** The GDP deflator – the broadest measure of inflation – rose 0.7% q/q. However measures of consumer prices were subdued overall to be consistent with the modest outcome seen in the Q2 CPI.
- **In terms of labour income, the growth in total compensation of employees slowed to 0.5% in Q2,** which is not surprising considering employment growth in Q2 was largely dominated by part-time jobs rather than full-time jobs. **Average compensation of employees rose by an even more modest 0.2%** q/q, which is consistent with a still-soft outlook for wages growth.
- **Monetary policy implications:** Today's figures are somewhat stronger than anticipated by the RBA in August and continue to suggest reasonable growth across the non-mining economy, despite some modest loss of momentum. That said, the influence these figures have on the outlook for the economy and monetary policy will depend on

whether the support to growth from government spending continues. The RBA will also be watching indicators of household consumption closely given the slowdown in Q2. It is also important to note that growth in Q2 was not supported much by recent RBA cuts in May and August which will have more bearing on the remainder 2016 and 2017. **We do not expect any near-term shift in monetary policy, but retain our view that two cuts will follow in mid-2017** in response to the ongoing weak inflation and risk that the economy slows too sharply in 2018 as the dwelling construction cycle ends and LNG exports flatten off.

Key figures

	Q/Q		Y/Y
	Mar-16	Jun-16	Jun-16
GDP (A)	1.0	0.5	3.3
GDP (E)	1.3	0.6	3.7
GDP (I)	0.7	0.4	3.0
GDP (P)	1.2	0.6	3.2
– Non-Farm GDP	1.0	0.6	3.4
– Farm GDP	3.5	-4.3	-3.3
Nominal GDP	0.7	1.3	3.4
Real gross domestic income	0.5	0.9	1.9
Real net national disposable income per capita	1.7	0.2	1.0
Terms of trade	-2.1	2.4	-5.4

EXPENDITURE COMPONENTS SHOW A LIFT IN DOMESTIC DEMAND, SUPPORTED BY PUBLIC SPEND

On the expenditure side there were no major surprises when it comes to the composition of growth. The mining sector continues to be a major drag on domestic demand, contributing to a further decline in business investment, but elsewhere there were further indications of economic rebalancing. Public final demand made the largest contribution to growth (1 ppt), with both government consumption and public investment increasing, but while this suggests the rest of the economy contracted in the quarter, it does not account for second hand asset transfers – there appear to have been significant transfers to the public sector this quarter. In underlying terms (excluding these transfers), public demand contributed a reduced (but still large) 0.5ppts to growth in the quarter, suggesting flat outcomes elsewhere.

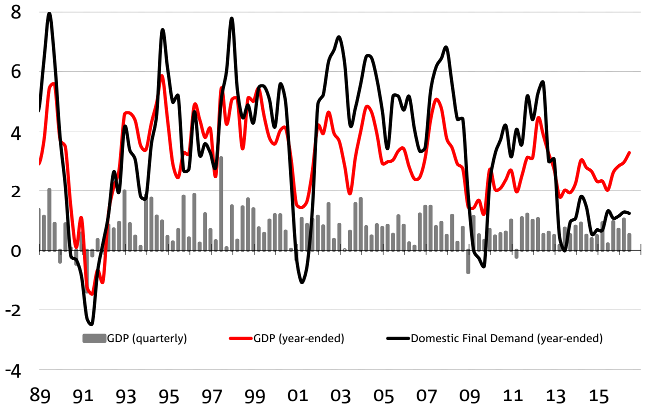
Meanwhile, consumption had a positive impact in the quarter, albeit slowing to its lowest growth rate since early 2013. Dwelling investment rose, although the outcome was largely driven by renovation activity – consistent with last week's Construction Work Done release from the ABS. Net exports made a slight subtraction from growth this quarter, following the large contribution in Q1, with imports rising and export growth slowing.

GDP (E) by component

	Q/Q		Y/Y	Contribution to Q/Q
	Mar-16	Jun-16	Jun-16	Jun-16
Household Consumption	0.8	0.4	2.9	0.2
Dwelling Investment	2.1	1.6	8.3	0.1
Underlying Business Investment	-2.0	-1.9	-10.6	-0.2
Machinery & equipment	**-0.8**	**1.4**	**-2.3**	**0.1**
Non-dwelling construction	**-3.8**	**-4.8**	**-18.8**	**-0.3**
New building	**-4.2**	**-1.1**	**-4.4**	**0.0**
New engineering	**-3.6**	**-7.4**	**-27.4**	**-0.3**
Underlying Public Final Demand	0.6	2.4	3.9	0.5
Domestic Demand	**0.4**	**0.6**	**1.2**	**0.5**
Stocks (a)	-0.2	0.3	0.2	0.3
GNE	**0.2**	**0.9**	**1.5**	**0.8**
Net exports (a)	**1.1**	**-0.2**	**2.2**	**-0.2**
Exports	3.1	1.3	9.6	0.3
Imports	-1.9	2.7	-0.5	0.5
GDP	**1.0**	**0.5**	**3.3**	**0.5**

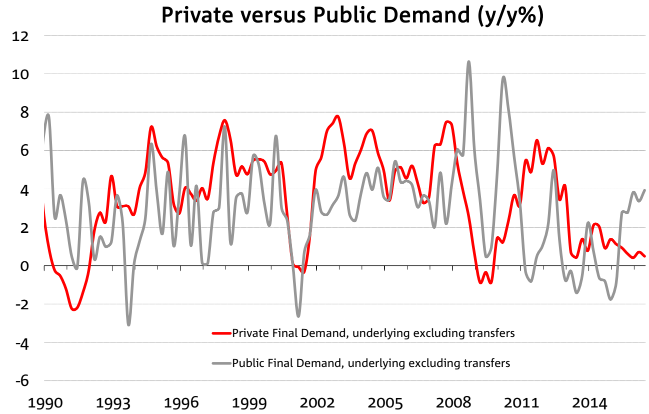
(a) Contribution to GDP growth

Real GDP and domestic demand

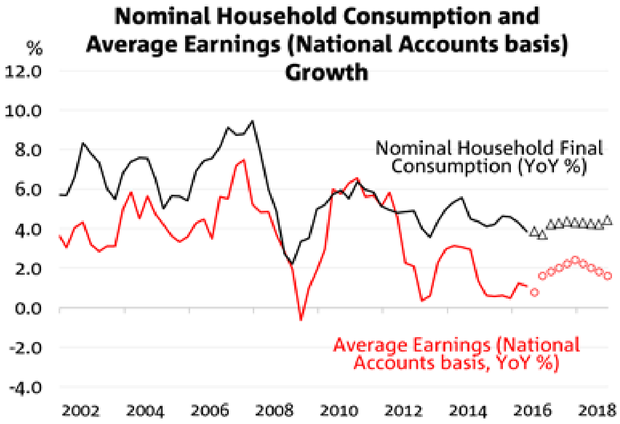


Source: ABS

Private versus Public Demand (y/y%)



Household consumption growth has lost further momentum in Q2 to be at 0.4% q/q (2.9% y/y), largely reflecting the recent slowdown in retail sales growth and stabilisation in the household saving ratio. In addition, household income growth also slowed in the quarter reflecting falling hours worked and subdued wages growth, consistent with compositional shifts in the labour market towards part-time jobs which tend to be lower-paid. The growth in total compensation of employees (a measure of the national wage bill, a function on wages and employment) rose by 0.5% in the quarter to be 3.1% y/y, compared to 0.9% q/q (3.6% y/y)in Q1. After a period of steady declines, the household saving ratio has stabilised in recent quarters at levels higher than the trough seen in Q4 last year of 7.5%. If this trend continues, the direct impetus to household consumption growth from a falling saving ratio may be more gradual and drawn out than previously anticipated, placing downside risks to our household consumption forecasts.



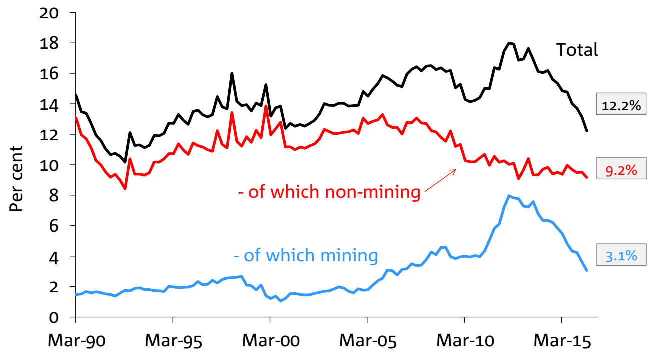
Source: ABS, NAB Group Economics

Despite most consumption categories showing improvements in the quarter, a larger number of categories posted negative growth relative to Q1, including food; recreation and culture; electricity gas and other fuel; cigarettes and tobacco and operation of vehicles. Contribution from services consumption continued to dominate goods consumption in the quarter, with health; hotels, cafes and restaurants; rent and insurance and other financial services being the largest positive contributors to overall consumption growth, while cigarettes and tobacco were the biggest detractor. The more subdued housing market was also apparent in the weaker growth in furnishing and household equipment expenditure, which rose by 0.2% in the quarter, compared to the recent peak of 1.9% in December 2014.

Dwelling investment grew by a decent 1.6% in the June quarter, which is reasonably consistent with results from last week's Construction Work Done release. However, most of the growth this quarter is stemming from alterations & additions (renovation) activity (up 4.5%), while the construction of new dwellings appeared to be relatively flat (up 0.1%). The flat result appears somewhat inconsistent with the record levels of residential construction projects (largely apartments) currently in the pipeline, although new dwelling construction is indeed up 10.5% over the year. Medium density construction tends to be quite lumpy, which may help to explain the result this quarter, pointing to a greater contribution from dwelling construction going forward.

Private business investment fell by a further 1.9% in underlying terms, once again driven by a large drop in engineering construction (down 7.4%) and a more moderate decline in non-residential building construction (down 1.1%). Nevertheless, this result is marginally better than indicated by the recent ABS Private New Capital Expenditure (Capex) Survey and Construction Work Done (CWD) release (which pointed to a decline in underlying private investment closer to 3% in the quarter). In particular, the CWD release pointed to a much larger decline in engineering construction.

Private Investment Share of GDP



Source: ABS, National Australia Bank

By component, machinery & equipment rose by 1.4% and intellectual property fell by 0.4%. Non-residential construction dropped by 12.4% q/q, although excluding the large second hand asset sales this quarter, underlying non-residential construction declined by a smaller 4.8%. Consistent with the well progressed downturn in the mining investment cycle, engineering construction has been in steady decline for the past 11 quarters, to be down 27.4% over the year and has almost halved from its late 2012 peak. Our estimates suggested that the mining investment 'cliff' has potentially run more than half its course, but further significant declines can still be expected in coming quarters – although lumpiness in the profile can be expected given the nature of these mining projects.

Government spending made the largest contribution to GDP in the quarter, supported by both an increase in government consumption (up 1.9%) and public investment (up 15.5%), coinciding with ongoing infrastructure spending and the listing of hep C drugs on the PBS, as well as one of drivers such as the procurement of a Chinook helicopter. Overall defence spending increased in the quarter, but the largest contribution came from non-defence spending. In particular, state and local government investment made a strong contribution to growth, which likely reflects spending on large infrastructure projects. Overall, underlying public final demand increased 2.4% in the quarter, providing a contribution to GDP growth of 0.5 ppts. General government defence spending rose 1.8% q/q (defence investment up 28% and defence consumption down 5.4%). General government non-defence spending rose 4.7%, with both consumption (up 2.6%) and non-defence investment (up 18.5%) rising.

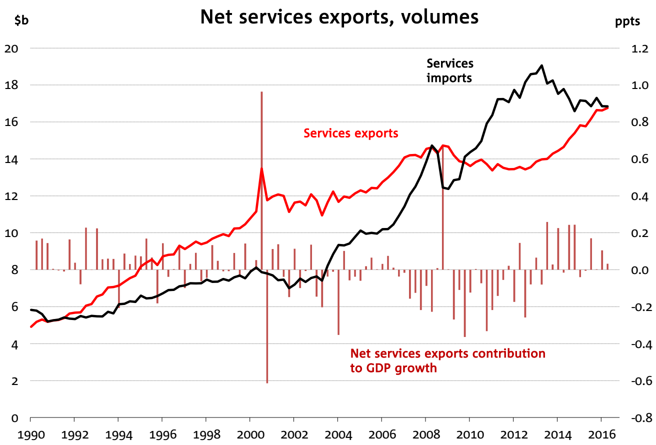
The contribution from **inventories** to GDP in Q2 was slightly larger than expected at 0.3 ppts. Most of the increase in private inventories during the quarter came from wholesale trade stocks, while mining and manufacturing also increased. In retail trade, firms appeared to tighten up their inventory management even further after last quarter's large decline – consistent with a deterioration in retail conditions in the NAB Business Survey.

Net exports were softer in Q2 following a seasonally strong Q1 result, detracting 0.2 ppt from GDP growth. The 1.3% increase in exports was more than offset by a 2.7% increase in imports.

Resources exports continued to expand, albeit at a slower pace. Exports of key commodities of iron ore, coal and LNG grew moderately, however LNG exports are expected to ramp up again next quarter as new trains are added. Rural goods exports fell slightly while manufacturing exports were up a touch.

Services exports showed a small increase (0.8% q/q) while services imports were unchanged, overall net services exports made a flat contribution to GDP growth, down from last quarter's 0.1 ppt contribution. Net tourism exports (in nominal terms) also increased strongly. The appreciation in the Australian dollar since that time might dampen net services exports growth in coming quarters.

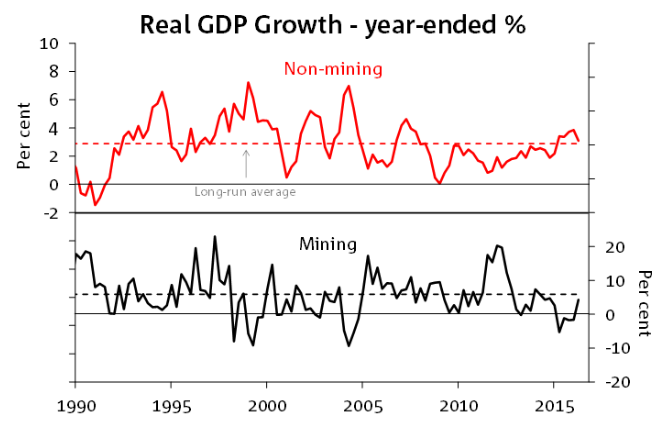
Imports rose strongly over the quarter, driven by a 3.4% increase in goods imports and no change in services imports. Consumption goods imports rose by a strong 6.5% q/q. Intermediate goods imports rose by 2.1% while capital goods imports showed no growth, compared to declines in the previous two quarters, as the economy faces subdued levels of business investment.



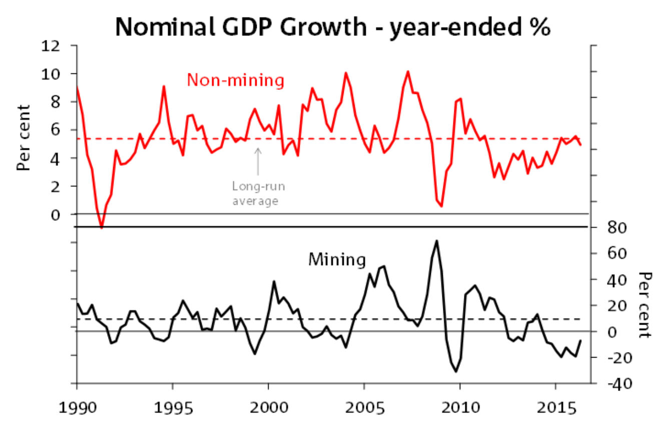
Net services exports, volumes

NON-MINING GDP GROWTH SOLID, BUT EASES SLIGHTLY

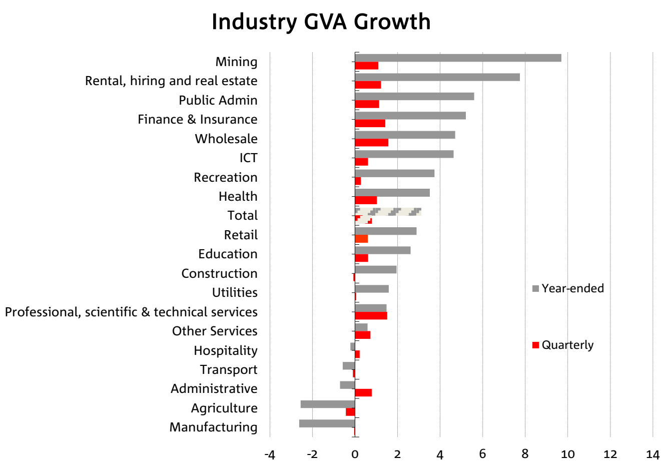
The recovery in the non-mining economy continued, although did lose some momentum in Q2 – our estimates of non-mining GDP increased by 0.7% in the quarter and eased slightly to 3.1% in year-ended terms from almost 4% y/y in Q1. The divide between non-mining and mining is even more stark in nominal terms, with nominal mining GDP continuing to contract in annual terms despite commodity prices improving in Q2.



Real GDP Growth - year-ended %



Nominal GDP Growth - year-ended %



Industry GVA Growth

Non-mining industries improved further, with real estate services, finance, wholesale and ICT outperforming both over the quarter and over the year. Growth also caught up over the quarter in professional, administrative and other services, another encouraging sign the non-mining sectors are improving.

On the other hand, agriculture and manufacturing continued to lag behind. Construction also faced tough conditions as rising dwelling investment was unable to offset the large falls in mining-related business investment.

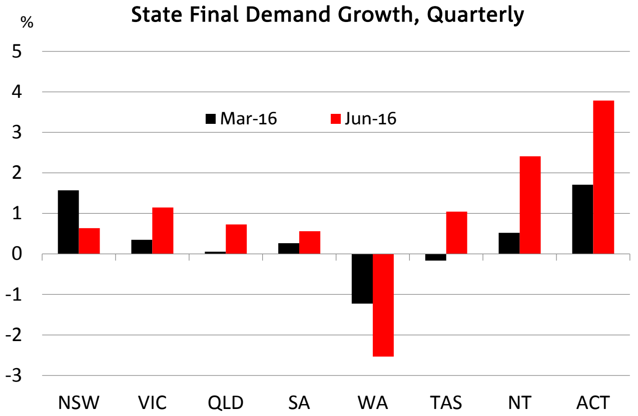
EASTERN STATES OUTPERFORM AGAIN

The eastern states outperformed over the quarter while the Western Australian economy struggled with sharply falling private investment.

NSW and Victoria were growing at above the national average at 3.8% y/y and 3.5% y/y respectively. The two states also faced declining private investment, which was however more than offset by rising public spending and household consumption. A similar profile was evident in Tasmania, where state final demand also rose strongly in the quarter (1.0% q/q), although growth is weaker in annual terms.

Strong government consumption was behind the ACT's outperformance (3.8% q/q and 6.0% y/y). A surge in private investment in the NT lifted its economic growth in the quarter, although state final demand had still contracted sharply over the year on falling investment and further falls are expected.

Private investment in Queensland was up for the first time since 2013. Combined with strong public investment, this saw overall state final demand up by 0.7% q/q. While the worst of mining investment declines could be behind us, we are mindful that the last of the Queensland's three major LNG project completions could see business investment decline further in the coming quarters.



State final demand

State/ Territory	Q/Q Mar-16	Q/Q Jun-16	Y/Y Jun-16
ACT	1.7	3.8	6.0
NSW	1.6	0.6	3.8
VIC	0.3	1.1	3.5
TAS	-0.2	1.0	1.9
SA	0.3	0.6	1.7
QLD	0.1	0.7	0.4
WA	-1.2	-2.5	-7.3
NT	0.5	2.4	-10.4

INCOME AND PRODUCTIVITY

Key income and productivity measures

	Q/Q		Y/Y
Income measures	**Mar-16**	**Jun-16**	**Jun-16**
Real GDI	0.5	0.9	1.9
capita	1.7	0.2	1.0
Compensation of employees	0.9	0.5	3.1
Compensation per employee	0.5	0.2	1.1
Corporate GOS	-1.9	2.5	1.5
Non-financial corporations	-2.9	2.9	0.3
Financial corpoarations	1.1	1.3	5.4
General government GOS	1.2	1.3	5.1
Productivity & unit labour cost			
GDP per hour worked	0.9	1.2	2.7
Non-farm productivity	1.0	1.5	2.8
Non-farm nominal unit labour cost	-0.4	-0.1	-0.5
Non-farm real unit labour cost	0.0	-0.9	-0.6

Measures of income were mixed in the quarter, with growth in company profits notably stronger than labour income. Supported by strong corporate profits in the quarter, real gross domestic income (real GDP adjusted for the terms of trade) rose by 0.9% (1.9 % y/y), compared to 0.5% growth in Q1. Real net national disposable income, which is a better indicator of Australians' well-being, grew more modestly (0.6% q/q and 2.3% y/y) and was even weaker in per capita terms (0.2% q/q, 1.0% y/y), suggesting that population growth is still supporting the aggregate figures.

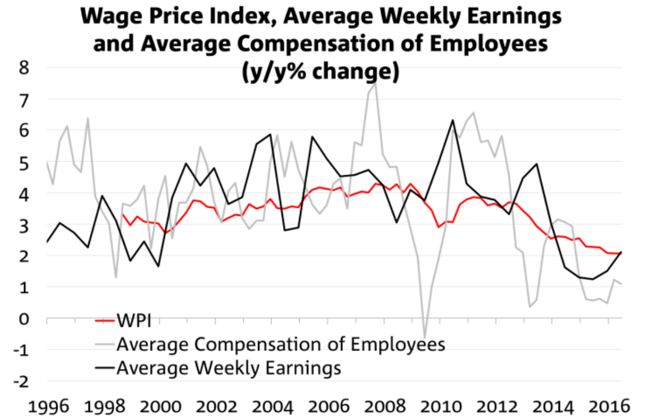
After a weak Q1, measures of corporate profitability surged in Q2, likely to be driven by the rise in terms of trade which in turn reflected the pick-up in commodity prices in the quarter. Partly owing to volatility in the quarterly series, non-financial corporate GOS reversed last quarter's fall to grow by 2.9% q/q, but year-ended growth was modest at 0.3% y/y. Meanwhile, profits for financial corporations accelerated to 1.3% q/q (5.4% y/y). The operating surplus of the general government sector also gained momentum in the quarter, rising by 1.3% q/q.

In terms of labour income, the growth in total compensation of employees slowed to 0.5% in Q2, relative to 0.9% in the previous quarter, which is not surprising considering employment growth in Q2 was largely dominated by part-time jobs rather than full-time jobs. Average compensation of employees rose by an even more modest 0.2% in the quarter and continues to run at a slower year-ended rate than the wage price index, which is consistent with a still-soft outlook for wages growth.

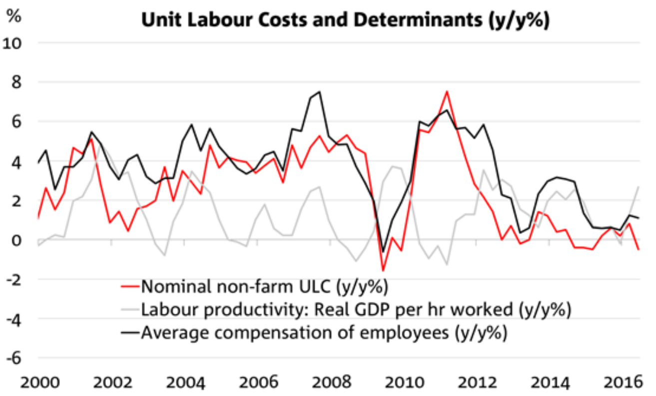
Against the backdrop of a relatively resilient GDP outcome and a declining trend in aggregate hours worked, labour productivity improved further in Q2. GDP per hour worked rose 1.2% q/q and 2.7% y/y, while market sector productivity growth was stronger than this at 1.5% q/q (2.8% y/y).

Given the relatively stronger uptick in productivity relative to average earnings in the quarter, nominal non-farm unit labour cost growth continued to fall (-

0.1% q/q and -0.5% y/y). In real terms, non-farm unit labour cost also declined in the quarter (-0.9% q/q and -0.6 % y/y). This suggests that wage costs remain constrained and are not expected to contribute significantly to inflationary pressure in the near term.



Source: ABS, NAB Group Economics



Source: ABS, NAB Group Economics

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