AUSTRALIAN ECONOMIC UPDATE

Contraction in Q3 GDP raises questions about non-mining recovery

NAB Group Economics 7 December 2016

KEY POINTS

- **Today's National Accounts saw real GDP growth come in well below market expectations at -0.5 % q/q, with year-ended growth dropping to just 1.8%** – below Australian growth potential. This is the first contraction in GDP since Q1 2011 and highlights the lingering risks to the growth outlook. **Growth is forecast to remain well below 3% in the medium term.**
- **While the slowdown was relatively broad-based, our assessment is that the headline figure is probably overstating magnitude of the decline in the economy.** Indeed, we do not anticipate another negative print in the December quarter - our early forecast is approximately 0.9% q/q, as a few one offs (such as weather disruptions affecting dwelling and non-dwelling construction, and the unwinding of strong public investment in Q2), although year-ended growth still only picks up to 2% y/y. **That said, softness in key categories such as household consumption and non-mining business investment, as well as in Victoria and NSW are troubling.**
- Today's figures, in conjunction with slowing employment and weaker business conditions, **raise the possibility that the non-mining recovery has run out of steam earlier than expected.** We remain comfortable with our view that **the RBA will need to cut rates further in 2017** (see below for further detail).
- **The weakness in GDP growth was relatively broad based in the quarter**, with investment, public spending and trade all contracting. Dwelling investment saw a surprise decline in the quarter (-1.4%), largely related to weather disruptions, although the extremely elevated construction pipeline suggests an increase in activity going forward.
- **Household consumption was the only expenditure component to show positive, albeit fairly modest growth** at 0.4% q/q. Nevertheless, indications going forward look somewhat mixed. Retail sales data has improved in recent months, but the NAB Business Survey has shown a clear deterioration in business conditions for retailers of late. As expected, mining investment contracted again in the quarter (as evidenced by another fall in engineering construction), with further declines still likely in coming quarters. Resource exports failed to provide an offset – despite the recent strength in prices – with net exports contracting 0.2 ppts from GDP. Non-mining private investment was a little more upbeat than expected, but that is not a trend that extends into investment plans for the year ahead. Public investment also declined, following strong growth last quarter, although given the large infrastructure initiatives underway, this component is likely to remain 'lumpy'.
- **The recovery in the non-mining economy has become much less pronounced**, although the services sector still appears to be performing reasonably well – **our estimates of non-mining GDP decreased by 0.2% in the quarter and year-ended growth eased to 2.6%**. The agricultural sector was a clear standout in the quarter, consistent with a bumper grain harvest. Elsewhere outcomes were generally soft. In particular, construction subtracted 0.3 ppts from GDP growth in the quarter. Some services continue to outperform. Finance & insurance, health and education meanwhile have enjoyed consecutive quarters of positive growth.
- **State final demand (SFD) was soft across most states, with the weakness most pronounced in WA** – driven by big declines in investment (both private and public). Tasmania and the ACT also saw declines in SFD, but **Victoria's decline was the most surprising** – driven by a big contraction in public spending. **NSW SFD growth also slowed noticeably** to 0.1%, in line with softening employment and business conditions in the state. Queensland meanwhile encouraging signs of pickup in household consumption and private investment, although SFD was weak at 0.1% q/q.
- **The terms of trade rose by 4.5% in Q3, and added to income growth** – following a prolonged period of decline. However, the sustainability of recent rallies in commodity prices remains questionable. Nevertheless, the temporary support saw real gross domestic income rising 0.4% q/q and real net national disposable income per capita rising 0.5% q/q. Nominal GDP saw similar growth at 0.5% q/q and 3% y/y.

Date **September 2016** | Author **Riki Polygenis – Head of Australian Economics**

- **Labour productivity measures took a noticeable step backwards in the quarter**, with GDP per hour worked falling by 1% q/q and market productivity down 0.9%, as aggregate hours worked rose in the quarter despite the weak GDP outcome. However, data released by the ABS earlier in the week suggested multifactor productivity grew at 0.6% in 2015/16, an improvement on the previous year.
- **Price indicators in the National Accounts were mixed in the quarter.** The GDP deflator – the broadest measure of inflation – rose 1.1% q/q. However measures of consumer prices were subdued overall to be consistent with the modest outcome seen in the Q3 CPI.
- **In terms of labour income, the growth in total compensation of employees rose to 1.3% in Q3,** which is a little surprising considering some of the soft trends evident in the employment data and appears to reflect higher average hours worked in the quarter. **Average compensation of employees rose by a slightly more modest 0.8%** q/q, but weaker than other price measures in y/y terms at 1.1%.

MONETARY POLICY IMPLICATIONS

Today's GDP figures paint a more pessimistic picture of the Australian economy than anticipated by the RBA in recent months, and the RBA's annual growth forecasts will need to be revised down substantially.

The RBA will be questioning whether the non-mining recovery is running out of steam earlier than expected, especially given the similar signal being sent by employment data and business conditions. It is possible that the impetus to the economy from the exchange rate depreciation between 2013 and 2015 has largely run its course (with the currency having appreciated modestly through 2016). The RBA's forecasts are particularly reliant on solid growth in household consumption and non-mining business investment, both of which were weak this quarter.

At this stage, we remain comfortable with our view that the RBA will be forced to cut rates further in mid-2017 amidst low inflation and a softening outlook for GDP into 2018. If anything, today's figures suggest that the risk is for an earlier move, particularly if house price growth slows into the new year. Attention between now and the RBA's next meeting in February will be on whether partial data remains weak, or picks up again, signalling that this has just been a temporary mid-cycle slowdown.

Key figures

Australian National Accounts (a)	Q/Q		Y/Y
	Jun-16	Sep-16	Sep-16
GDP (A)	0.6	-0.5	1.8
GDP (E)	0.9	-0.5	2.5
GDP (I)	0.4	-0.7	1.0
GDP (P)	0.6	-0.2	1.8
– Non-Farm GDP	0.7	-0.6	1.8
– Farm GDP	-3.0	8.0	2.3
Nominal GDP	1.4	0.5	3.0
Real gross domestic income	1.0	0.4	2.0
Real net national disposable income per capita	0.1	0.5	1.7
Terms of trade	2.3	4.4	1.4

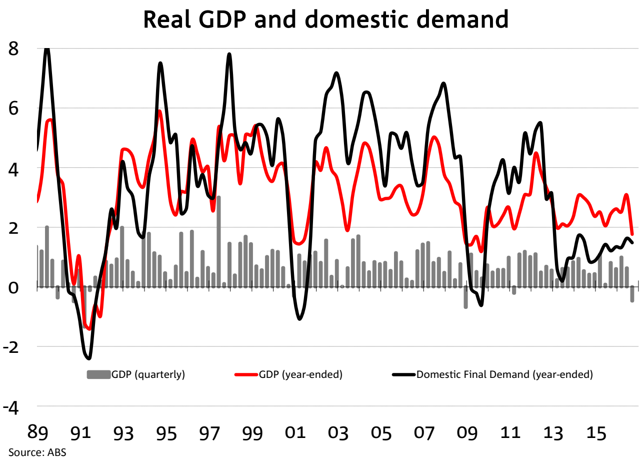
EXPENDITURE COMPONENTS SHOW BROAD-BASED WEAKNESS

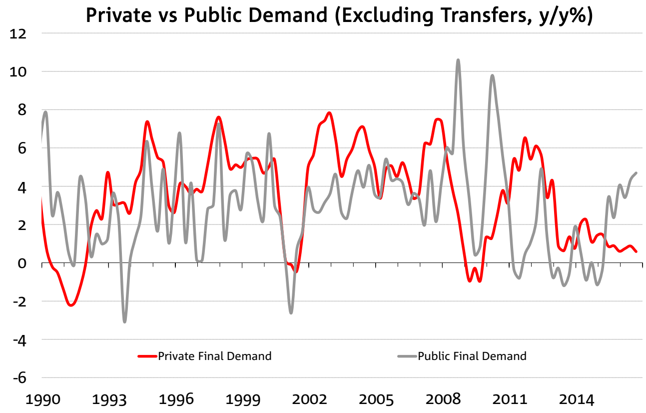
GDP (E) by component

	Q/Q % ch		Y/Y % ch	Contribution to Q/Q % ch
	Jun-16	Sep-16	Sep-16	Sep-16
Household Consumption	0.5	0.4	2.5	0.3
Dwelling Investment	2.6	-1.4	7.2	-0.1
Underlying Business Investment	-1.4	-3.2	-8.5	-0.4
Machinery & equipment	**3.2**	**0.6**	**6.0**	**0.0**
Non-dwelling construction	**-5.6**	**-8.3**	**-22.0**	**-0.5**
New building	**0.2**	**-11.5**	**-12.6**	**-0.3**
New engineering	**-10.0**	**-5.6**	**-28.0**	**-0.2**
Underlying Public Final Demand	2.8	-0.6	4.7	-0.1
Domestic Demand	**0.8**	**-0.5**	**1.5**	**-0.5**
Stocks (a)	0.2	0.1	0.3	0.1
GNE	**1.0**	**-0.3**	**1.8**	**-0.3**
Net exports (a)	**-0.1**	**-0.2**	**0.7**	**-0.2**
Exports	2.1	0.3	6.0	0.1
Imports	2.9	1.3	2.3	0.3
GDP	**0.6**	**-0.5**	**1.8**	**-0.5**

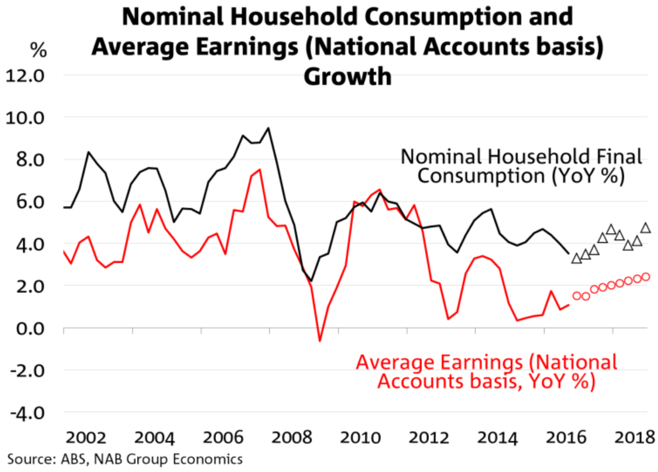
(a) Contribution to GDP growth

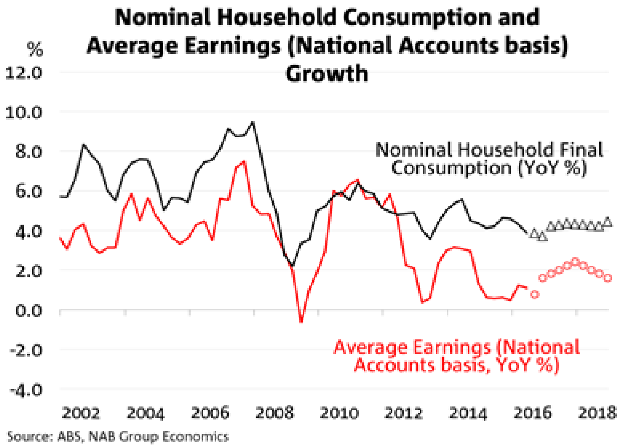
On the expenditure side, the composition of growth largely reflected earlier indications from partial data. The mining cycle continues to exert a negative impact on domestic demand via sharp declines in business investment. At the same time, previous signs of rebalancing elsewhere in the economy were somewhat lacking this quarter. However, some of the factors contributing to the drag on growth could have been due to volatility or one off factors. Dwelling investment declined, despite a solid pipeline of new construction approvals; and the same could be said for public investment, which declined (following strong growth last quarter) despite a number of infrastructure projects underway. Meanwhile, consumption had a positive impact in the quarter, albeit staying at subdued rates. Net exports made a slight subtraction from growth this quarter.





Household consumption growth was lacklustre in Q3 to be at 0.4% q/q (2.5% y/y), largely reflecting the weakness in real retail activity (which fell by 0.1% in the quarter). The subdued household consumption reading was despite a lower household saving ratio (at 6.3%) and notable pick-up in household income growth in the quarter, reflecting more hours worked at the aggregate level. The growth in total compensation of employees (a measure of the national wage bill, a function on wages and employment) rose by 1.3% in the quarter to be 3.1% y/y, compared to 0.4% q/q (0.8% y/y) in Q2. Contribution from services consumption continued to dominate goods consumption in the quarter, with hotels, cafes and restaurants; insurance and other financial services; as well as rent and other dwelling services being the largest positive contributors to overall consumption growth, while food and purchase of vehicles were the biggest detractors. Looking forward, the continuous slowing in retail activity and subdued wages growth overall are likely to weigh on consumption growth, with some offset likely to come from an expected gradual decline in household saving ratio.

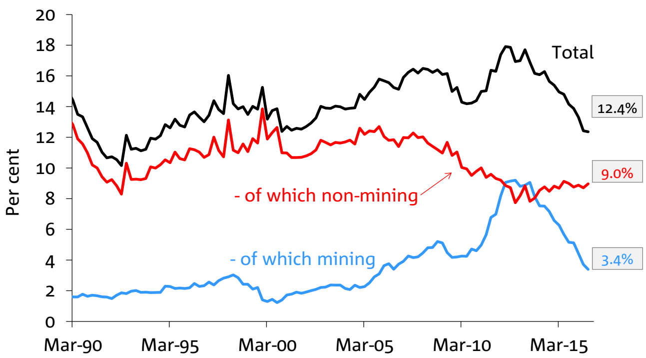




Dwelling investment recorded a decline of 1.4% in the September quarter, which is a weak outcome in the context of the Australian housing construction cycle, but was consistent with results from last week's Construction Work Done release. According to the ABS, weather-related events amidst above-average rainfall weighed noticeably. Declines were seen across both new & used dwellings (down 1.6%) and alterations & additions (renovations, down 1%). While there are signs elsewhere (e.g. building approvals) that the construction cycle is reaching its peak, the elevated pipeline of approved projects was expected to sustain construction activity. New dwelling construction is still up 10.5% over the year.

Underlying **private business investment** fell by a further 3.2%, with engineering construction again being a major driver (down 5.6%). However, weakness was relatively broad-based, with non-residential building construction falling 11.5% (affected by weather-related disruptions, as well as some large projects being completed), while equipment investment rose by a relatively modest 0.6%. Nevertheless, this result is marginally better than indicated by the recent ABS Private New Capital Expenditure (Capex) Survey and Construction Work Done (CWD) release. Our estimates suggested that the mining investment 'cliff' is potentially around three-quarters complete, 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.

Private Investment Share of GDP



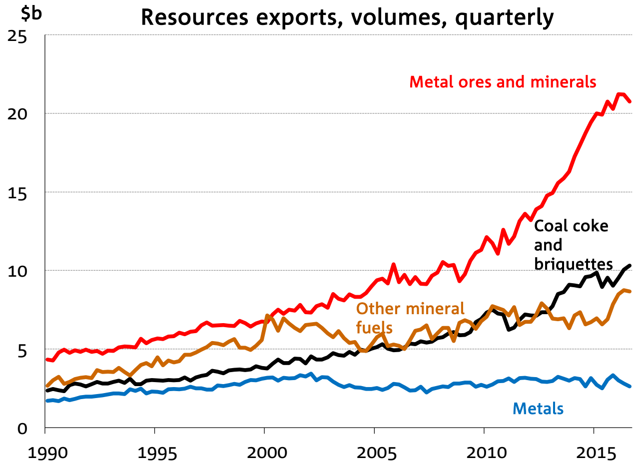
Source: ABS, National Australia Bank

Government spending was soft in Q3, following a strong contribution seen last quarter. Government consumption eased by 0.2%, while underlying public investment dropped -3.2% as the temporary impact from procurements, including a Chinook helicopter, washed out. Overall defence spending declined in the quarter, but the largest contribution to the decline came from non-defence spending. General government defence spending fell 4.6% q/q (defence investment down 30% and defence consumption up 5.9%). All other general government spending fell 14.8%.

The contribution from **inventories** to GDP in Q3 was relatively modest at 0.1 ppts. Most of the increase in private inventories during the quarter came from retail trade stocks, but most increased. Mining was the main exception.

Net exports subtracted 0.2 ppt from GDP growth in Q3. A small increase in exports (up 0.3% q/q) was more than offset by a 1.3% increase in imports. Goods exports were down 0.3%, dragged down by a 1.0% decline in resources exports. A 2.1% decline in metal ores and minerals exports (mostly iron ore) was behind this weakness, despite stronger coal exports. Both services exports and imports rose strongly, netting a small negative, after contributing positively to GDP growth since beginning of the year. The recent strength in the AUD could have dampened net services exports, and may continue to do so in Q4. Goods imports were flat. Of those, consumption goods imports weakened significantly, consistent with weak consumer spending.

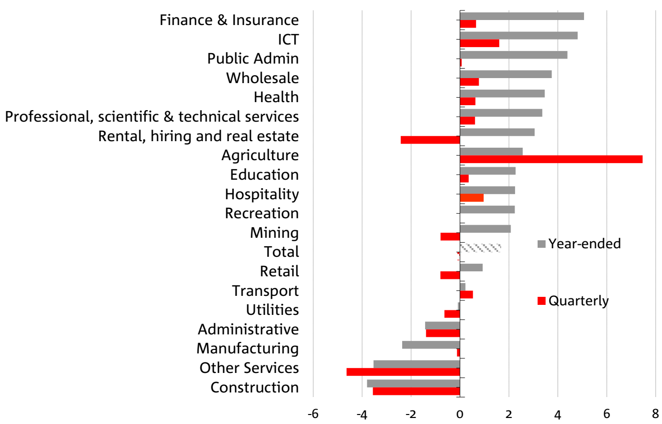
Resources exports, volumes, quarterly

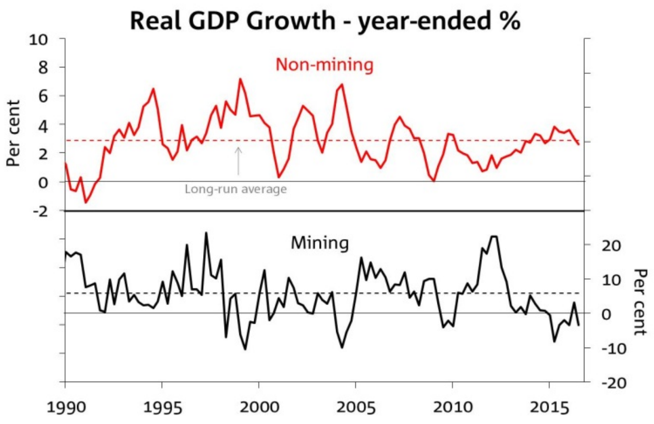


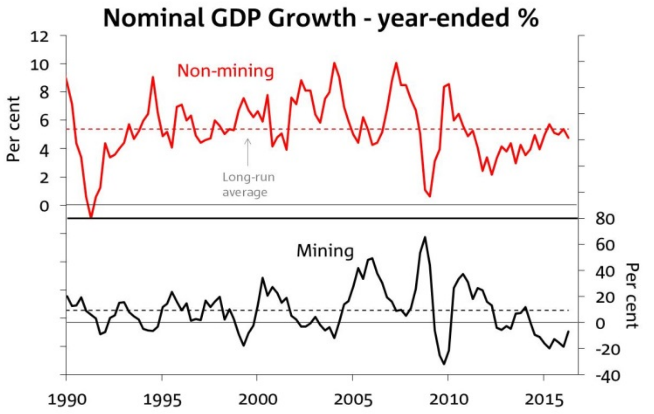
SERVICES INDUSTRIES AGAIN OUTPERFORMED

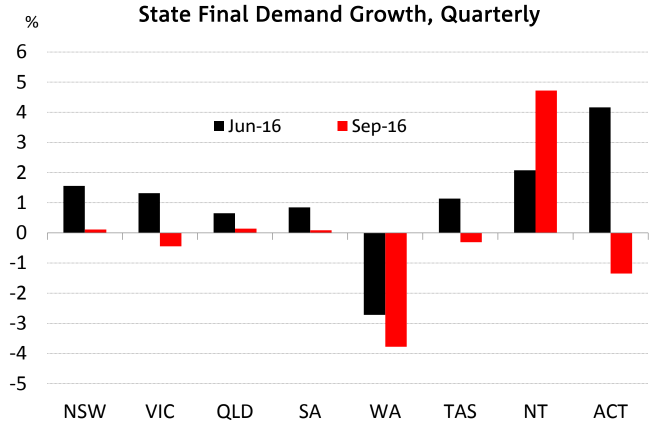
Across industries, services continued to outperform. Finance & insurance, health and education had enjoyed consecutive quarters of positive growth. Agriculture enjoyed a healthy winter crop and outperformed this quarter. On the other hand, other services, construction and manufacturing continued to slow. A slowdown in both dwelling and non-dwelling construction investment saw the construction industry suffer a negative growth. Despite higher commodity prices, mining output was down this quarter, consistent with the weaker resources export compared to Q2.

Industry GVA Growth









State final demand

State/ Territory	Q/Q Jun-16	Q/Q Sep-16	Y/Y Sep-16
ACT	4.2	-1.3	6.4
NSW	1.6	0.1	5.0
VIC	1.3	-0.4	2.5
SA	0.8	0.1	1.6
NT	2.1	4.7	1.5
QLD	0.7	0.1	1.2
TAS	1.1	-0.3	1.1
WA	-2.7	-3.8	-9.5

WEAKNESS IN PUBLIC DEMAND SLOWED DOWN STATES GROWTH BUT ENCOURAGING SIGNS IN QUEENSLAND

The momentum in the previously outperforming states of NSW and Victoria slowed down during the September quarter as a result of weaker public demand, especially in Victoria. Subdued public demand detracted from growth across all states and territories apart from the NT, which was the outperformer this quarter.

What's encouraging is the pickup in household consumption growth in Queensland and WA, the two states plagued with falling mining investment. Private investment in Queensland also rose strongly this quarter, overall helping the state posting a positive state final demand growth despite sharply lower public demand. WA still recorded the most negative growth on the back of falling private and business investments.

INCOME AND PRODUCTIVITY

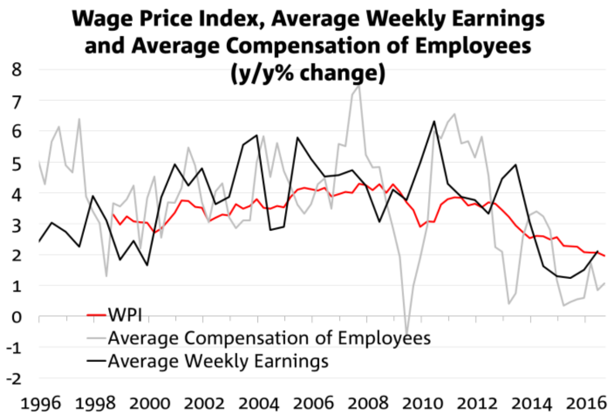
Measures of income were reasonably robust in the quarter, with company profits growth maintaining momentum at around 1.0% q/q (0.7%y/y), while labour income growth gained traction on the back of higher aggregate hours worked. Growth in real gross domestic income (real GDP adjusted for the terms of trade) eased in the quarter, likely to reflect the notable rise in terms of trade. Encouragingly, real net national disposable income, which is a better indicator of Australians' well-being, accelerated in the quarter (0.8% q/q, 3.2% y/y) but continued to be weaker in per capita terms (0.5% q/q, 1.7% y/y), suggesting that population growth is still supporting the aggregate figures.

Key income and productivity measures

Income measures	Q/Q Jun-16	Q/Q Sep-16	Y/Y Sep-16
Real GDI	1.0	0.4	2.0
Real net disposable income per capita	0.1	0.5	1.7
Compensation of employees	0.2	1.3	3.1
Compensation per employee	-0.4	0.8	1.1
Corporate GOS	1.3	1.0	0.7
Non-financial corporations	1.4	0.8	-0.8
Financial corpoarations	1.0	1.6	5.5
General government GOS	1.2	1.2	4.8
Productivity & unit labour costs			
GDP per hour worked	1.3	-1.0	1.0
Non-farm productivity	1.7	-0.9	0.6
Non-farm nominal unit labour costs	-0.5	0.9	-0.2
Non-farm real unit labour costs	-1.3	-0.1	-1.3

Aided by stronger terms of trade in Q3, measures of corporate profitability were relatively resilient. Growth in non-financial corporate gross operating surplus (GOS) eased in the quarter, but this was offset by a pick-up in the profitability of financial corporations (see table above). Meanwhile, growth in general government sector GOS was stable.

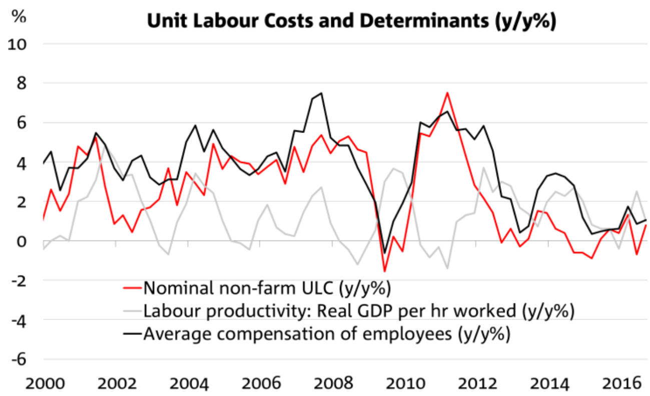
In terms of labour income, growth in total compensation of employees gained significant traction to 1.3% in Q3, relative to 0.2% in the previous quarter, reflecting a pick-up in number of hours worked on aggregate. Growth in average compensation of employees also improved in the quarter, although rising by a more modest 0.8% in the quarter (1.1%y/y) 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.



Source: ABS, NAB Group Economics

Given a sharp contraction in GDP and higher level of aggregate hours worked in the quarter, labour productivity languished. GDP per hour worked fell by 1.0% q/q but managed to rise by 1.0% in year-ended terms. Meanwhile market sector productivity growth fell by less in the quarter (-0.9% q/q, 0.6% y/y).

Against the backdrop of a fall in productivity relative to a rise in average earnings in the quarter, nominal non-farm unit labour cost growth rebounded 0.9% q/q and -0.2% y/y). In real terms, non-farm unit labour cost also picked up in the quarter (0.1% q/q and -1.3% y/y). The rise in unit labour costs in Q3 is not expected to prompt us to revise our outlook on wages growth significantly, which is expected to remain subdued (and hence likely to put a cap on inflationary pressure) given the ongoing dominance of part-time jobs in recent jobs created.



Source: ABS, NAB Group Economics

AUTHORS

Riki Polygenis, Head of Australian Economics
riki.polygenis@nab.com.au
+613 8697 9534 or +61 475 986 285

James Glenn, Senior Economist

Vyanne Lai, Economist

Amy Li, Economist

Group Economics

Alan Oster
Group Chief Economist
+61 3 8634 2927

Jacqui Brand
Personal Assistant
+61 3 8634 2181

Australian Economics and Commodities

Riki Polygenis
Head of Australian Economics
+(61 3) 8697 9534

James Glenn
Senior Economist – Australia
+(61 3) 9208 8129

Vyanne Lai
Economist – Australia
+(61 3) 8634 0198

Phin Ziebell
Economist – Australia
+61 (0) 475 940 662

Amy Li
Economist – Australia
+(61 3) 8634 1563

Behavioural & Industry Economics

Dean Pearson
Head of Behavioural & Industry Economics
+(61 3) 8634 2331

Robert De Iure
Senior Economist – Behavioural & Industry Economics
+(61 3) 8634 4611

Brien McDonald
Senior Economist – Behavioural & Industry Economics
+(61 3) 8634 3837

Steven Wu
Economist – Behavioural & Industry Economics
+(613) 9208 2929

International Economics

Tom Taylor
Head of Economics, International
+(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

Australia

Economics
Ivan Colhoun
Chief Economist, Markets
+61 2 9237 1836

David de Garis
Senior Economist
+61 3 8641 3045

Tapas Strickland
Economist
+61 2 9237 1980

FX Strategy
Ray Attrill
Global Co-Head of FX Strategy
+61 2 9237 1848

Rodrigo Catril
Currency Strategist
+61 2 9293 7109

Interest Rate Strategy
Skye Masters
Head of Interest Rate Strategy
+61 2 9295 1196

Alex Stanley
Senior Interest Rate Strategist
+61 2 9237 8154

Credit Research
Michael Bush
Head of Credit Research
+61 3 8641 0575

Simon Fletcher
Senior Credit Analyst – FI
+61 29237 1076

Andrew Jones
Credit Analyst
+61 3 8641 0978

Distribution
Barbara Leong
Research Production Manager
+61 2 9237 8151

New Zealand

Stephen Toplis
Head of Research, NZ
+64 4 474 6905

Craig Ebert
Senior Economist
+64 4 474 6799

Doug Steel
Senior Economist
+64 4 474 6923

Kymberly Martin
Senior Market Strategist
+64 4 924 7654

Jason Wong
Currency Strategist
+64 4 924 7652

Yvonne Liew
Publications & Web Administrator
+64 4 474 9771

UK/Europe

Nick Parsons
Head of Research, UK/Europe, and Global Co-Head of FX Strategy
+44207710 2993

Gavin Friend
Senior Markets Strategist
+44 207 710 2155

Derek Allassani
Research Production Manager
+44 207 710 1532

Asia

Christy Tan
Head of Markets Strategy/Research, Asia
+852 2822 5350

Julian Wee
Senior Markets Strategist, Asia
+65 6632 8055