AUSTRALIAN ECONOMIC UPDATE

GDP Q2 2018 – Another decent outcome

NAB Group Economics 5 September 2018

Bottom line: GDP recorded another solid outcome in Q2 (+0.9% q/q and +3.4% y/y). Growth was again supported by domestic demand - both from the household and government sectors. The outcome for non-mining business investment was surprisingly weak, while mining was strong. However, this does not change our view that non-mining investment growth will pick up, in part supported by spill overs from the public sector infrastructure pipeline. Encouragingly, the rise in mining investment, though likely to be volatile as the drag wanes, suggests that there may be some underlying strength in the sector as recent anecdotes suggest. This outcome will provide comfort for the RBA that growth is tracking according to their forecasts and that spare capacity will be gradually reduced. The focus for policy over the next year will remain on the pace at which wage growth and inflation lift, which at this point still looks to be gradual. Indeed, wage and price measures from the national accounts suggest inflation pressures currently remain subdued.

HIGHLIGHTS

- **Growth was again supported by domestic demand.** Growth in consumption, dwelling investment and the government sector all contributed to this quarter's outcome, while the business sector weighed. Net exports made a small contribution with the continued growth in mining exports, somewhat offset by the increase in imports in the June quarter. Interestingly, the expenditure side was the weakest of the three measures, with both the income and production sides recording strong outcomes
- **Household consumption growth recorded another reasonable outcome in the face of constrained income growth.** At around 3.0% in year-ended terms, consumption continues to track at a moderate rate but continues to outpace the growth in household income. The result in the quarter saw the savings rate fall further, reaching its lowest level since 2007. Consumption has tracked slightly above our expectations, but given the persistence of headwinds facing households, we expect growth to slow slightly from here, without the pick-up in wages the RBA is looking for. That said, for now, it's an increase in hours worked and numbers employed that is supporting consumer spending rather than an increase in wages. Weak wage growth, high debt levels and slowing growth in household wealth mean we have forecast consumption to average only around 2.5% over the next few years. That's slower than the RBA – and there is upside risk if wages do pick-up or hours worked continue to strengthen.
- **Underlying business investment eased slightly** (-0.2% q/q) due to falls in machinery & equipment and engineering construction investment**. The fall occurred in the non-mining sector** – although it follows strong recent gains. Offsetting this, mining investment rose in the quarter by 5.1% q/q (but is still down 9.7% over the year as the tail end of the mining investment boom winds down). Looking through the quarterly ups and downs, the drag from the mining downturn has faded, while non-mining investment has moved up and we expect this broad pattern to continue. Encouragingly, there are anecdotes of stronger mining investment and a number of new and replacement mines have recently been announced.
- **Dwelling investment** rose 1.7% in the quarter (following a small rise last quarter), with investment in new dwellings offset by a decline in alterations & additions. While we expect some weakening in dwelling investment over the next few years, recent outcomes likely reflect the ongoing volatility in activity given the large pipeline of investment in the sector and, possibly, drier than usual conditions in the June quarter in NSW and Vic.
- **Underlying government demand growth eased due to a decline in public investment.** On an annual basis underlying public investment growth has eased to 4% y/y, which is below our expectations. That said, it remains at a strong level and there remains a large pipeline of public infrastructure works. Government consumption posted another solid result – growing 1.0% q/q (5.1 y/y) reflecting Federal government spending on health, aged care and disability services (ie the NDIS roll-out). While there is some concern that government spending is supporting growth, it's worth noting that this is not likely to be a temporary situation given strong defence and infrastructure spending plans.
- **Export volume growth moderated but was still solid at 1.1% q/q.** A positive sign was that contributions came from each of the main categories (rural, manufacturing, resources and services). Over the last year, resource export growth has been the standout – up over 10% y/y, and we expect further gains as the last of the new major LNG projects reaches full capacity before exports level out at a high level. **Farm exports however will be a substantial though temporary drag over 2018-19, given the significant drought in NSW and QLD.**

- **Compensation of employees rose by 0.7% in the quarter.** This almost entirely reflects increases in employment and hours worked with average COE per employee only recording a 0.1% q/q rise, suggesting relatively weak wage pressures in the economy. That said, employment and hours worked usually lead wages.
- **Growth in productivity outpaced that of wages, which saw unit labour costs fall for the second quarter in a row.** While this measure is somewhat volatile, unit labour cost growth (a key determinant of price pressures and RBA inflation modelling) continues to be weak and is tracking at well below growth rates consistent with inflation of 2.5%. Consistent with this, the accounts suggest that **inflation pressures remain weak -** both the domestic final demand and consumption deflators continue to track at around 1.5% y/y.
- **By industry,** generally the best performers were either in mining or areas underpinned by government spending decisions. Mining rose 1.5% on a quarterly basis, led by coal mining and mining exploration. Construction was up 1.9%, led by heavy and civil engineering construction, largely for public infrastructure. Information media and telecommunications grew 1.8% as the NBN build continues, while health care gained 1.3% on both higher public and private healthcare. Professional services were up 1.9%, while rental, hiring and real estate grew 1.7%. Elsewhere, retail recorded a 1.1% increase, although we remain cautious in our outlook for the industry. Manufacturing was down 1.5% (after a strong last quarter), while other services grew 2.2%. It was interesting that just two sectors weakened in the quarter (the smallest number for some time) and eight sectors are now growing above trend.
- **By state,** the ACT recorded the strongest growth in state final demand, gaining 1.8% in Q2, led by government consumption. South Australia was second at 1.3%, largely reflecting higher private capital investment, while Victoria followed closely behind (up 1.2%) on higher private consumption and government spending. Tasmania grew 0.6% while NSW was up 0.3%. The NSW result was a noticeably weaker than last quarter, underlining our view that momentum is slowing. Western Australia was up 0.2% while growth in Queensland was also underwhelming (at 0.1%). The NT was the weakest performer – down 2.3% - largely reflecting lower private capital investment as the Ichthys LNG project nears completion.
- **Farm GDP** grew by 1.1% in Q2, the first quarterly rise since March 2017. Both livestock and grain were up, although the former was largely due to high slaughter rates as a result of the drought in eastern Australia. In contrast, WA should produce an above average winter crop, offsetting some of the weakness in NSW and elsewhere. Still, we expect a smaller wheat crop than last season and downside risk for farm GDP, with the BoM pointing to a roughly 50% chance of El Nino developing in 2018.

Implications for monetary policy

Today's outcome was in line with RBA forecasts released in the August statement on monetary policy (though revisions saw an even stronger outcome in year-ended terms). Overall, with growth above 3%, these figures will provide comfort that actvitiy is tracking broadly as expected and that demand driven employment growth will likely continue to outpace increases in the labour supply. This should see the labour market continue to tighten and spare capacity in the economy reduced further.

A key question remains around the pace of this tightening and how quickly this is passed through to wage growth and more broadly inflation. Price and wage measures from the accounts (though conceptually different to the RBA's preferred measures) suggest that this process is likely to be gradual. The dynamics around household income growth and the weak outlook for the household sector remain concerns/downside risks for the RBA, though we expect the labour market to continue to tighten and unemployment to fall a little faster than the RBA forecasts. We still expect the first rate rise to occur around mid-next year though should the unemployment rate decline at a slower rate, or the pass through to inflation occur more slowly, this could well be delayed.

Key figures

Key aggregates	q/q % ch		y/y % ch
	Mar-18	Jun-18	Jun-18
GDP (A)	1.1	0.9	3.4
GDP (E)	1.4	0.7	3.4
GDP (I)	1.1	0.9	3.7
GDP (P)	0.9	1.0	3.1
– Non-Farm GDP	1.2	0.9	3.7
– Farm GDP	-0.5	1.1	-9.7
Nominal GDP	2.4	1.0	5.5
Real gross domestic income	2.0	0.6	3.9
Real net national disposable income per capita	2.0	-0.2	2.1
Terms of trade	3.5	-1.3	2.1

GDP (E) by component

GDP Expenditure Components	q/q % ch		y/y % ch	Contribution to q/q % ch
	Mar-18	Jun-18	Jun-18	Jun-18
Household Consumption	0.5	0.7	3.0	0.4
Dwelling Investment	3.6	1.7	3.8	0.1
Underlying Business Investment^	0.7	-0.2	4.1	0.0
Machinery & equipment	2.4	-1.7	5.4	-0.1
Non-dwelling construction	-0.6	0.0	3.1	0.0
New building	-2.4	1.0	5.9	0.0
New engineering	0.8	-0.8	0.9	0.0
Underlying Public Final Demand	1.5	0.6	4.8	0.1
Domestic Demand	**1.0**	**0.6**	**3.4**	**0.6**
Stocks (a)	0.2	0.0	0.5	0.0
GNE	**1.1**	**0.5**	**4.0**	**0.6**
Net exports (a)	**0.2**	**0.1**	**-0.7**	**0.1**
Exports	3.0	1.1	3.7	0.2
Imports	1.7	0.4	6.2	0.1
GDP	**1.1**	**0.9**	**3.4**	**0.9**

(a) Contribution to GDP growth ^ Excluding transfers between the private and public sector

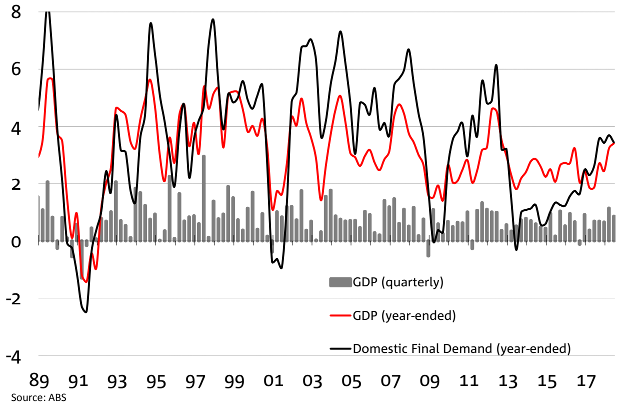
State final demand

State/ Territory	Q/Q Mar-18	Q/Q Jun-18	Y/Y Jun-18
ACT	-0.2	1.8	5.8
VIC	2.5	1.2	5.2
SA	0.4	1.3	3.7
TAS	2.0	0.6	3.7
NSW	1.0	0.3	3.5
QLD	1.0	0.1	3.4
WA	-1.2	0.2	0.8
NT	-1.7	-2.3	-8.2

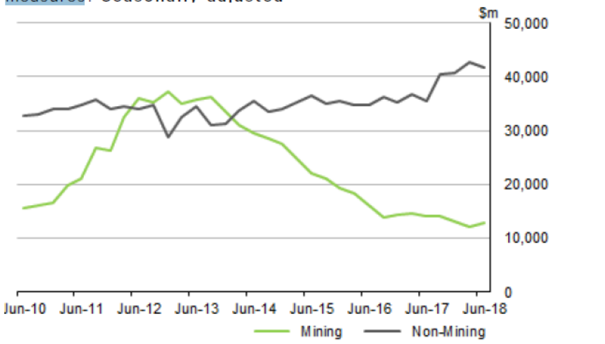
INCOME MEASURES

Income measures	q/q % ch Mar-18	q/q % ch Jun-18	y/y % ch Jun-18
Real GDI	2.0	0.6	3.9
capita	2.0	-0.2	2.1
Compensation of employees	1.1	0.7	4.8
Average compensation of employees (average earnings)	0.6	0.1	1.6
Corporate GOS	5.4	1.0	8.8
Non-financial corporations	6.3	0.8	9.6
Financial corpoarations	2.4	1.4	6.2
General government GOS	0.7	0.7	2.9
Productivity & unit labour cost			
GDP per hour worked	-0.4	0.0	0.1
GVA per hour worked mkt sector	-0.2	0.0	1.0
Non-farm nominal unit labour cost	-0.7	-0.4	0.4
Non-farm real unit labour cost	-2.0	-0.5	-1.6

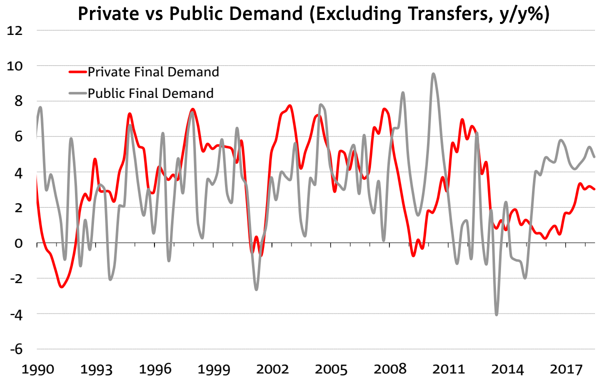
Real GDP and domestic demand



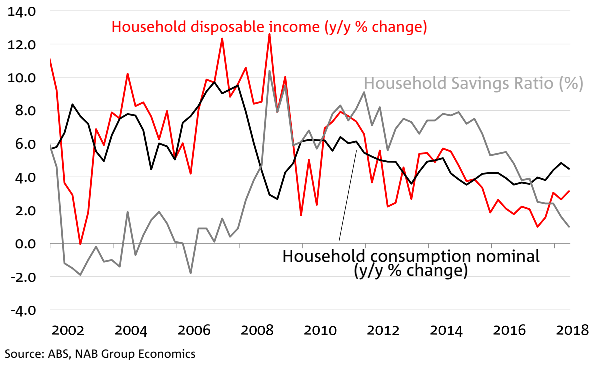
PRIVATE BUSINESS INVESTMENT - MINING AND NON-MINING, Volume measures: Seasonally adjusted



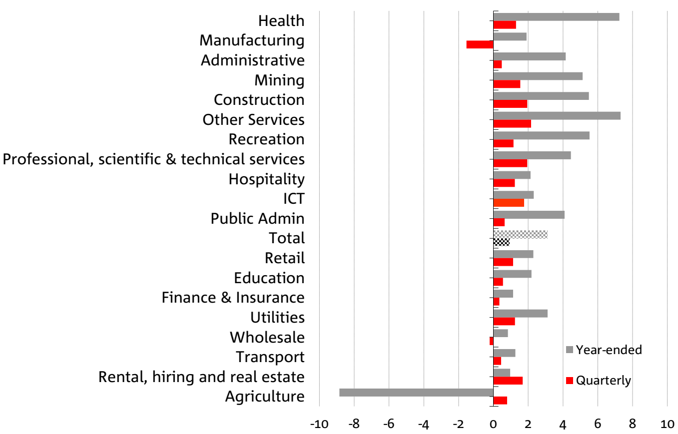
Private vs Public Demand (Excluding Transfers, y/y%)



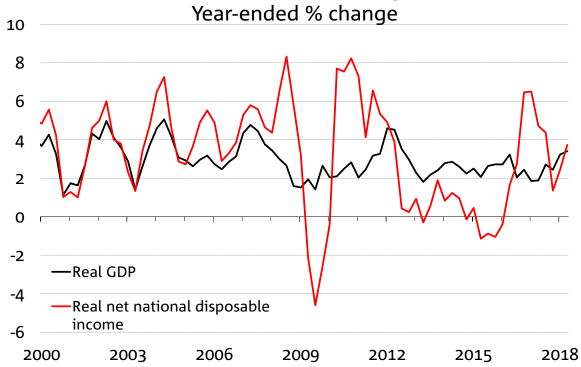
Household Consumption and Income Growth

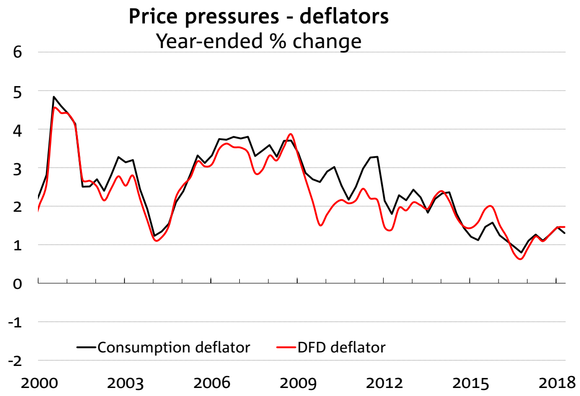


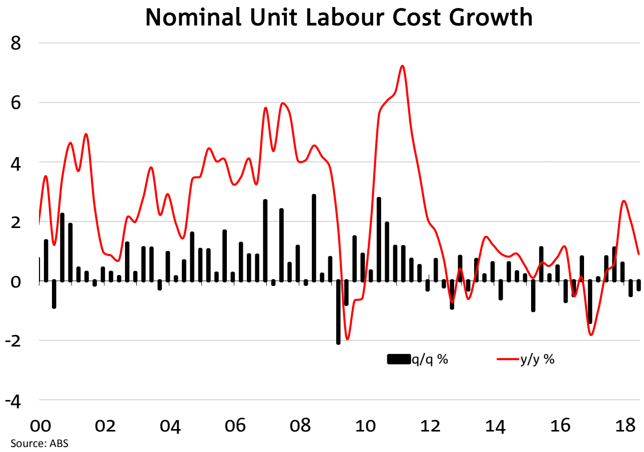
Industry GVA Growth

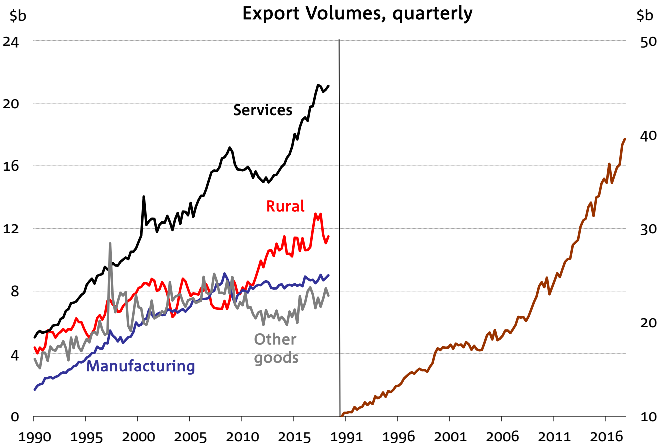


GDP and national income growth
Year-ended % change









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