

Leading Index – growth slowing down

- The annualised growth rate of the Westpac–Melbourne Institute Leading Index, which indicates the likely pace of economic activity three to nine months into the future, was 6.0% in June well above its long term trend of 3.0%. The annualised growth rate of the Coincident Index was 3.8%, also above its long term trend of 3.2%.

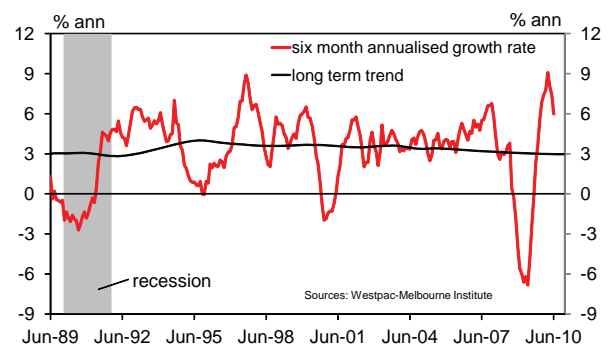
This is the third consecutive month when the growth rate of the Index has slowed. In absolute terms the growth rate of the Index is still high but it has clearly peaked. The growth rate of the Index is still consistent with a faster pace of growth in the economy than Westpac expects. Our current forecast is that growth through 2010 will be 3.5% with an even pace through the year despite some sizeable swings in different sectors. This is slightly above trend which we assess as 3¼%.

In 2011 and 2012 Westpac expects growth of a steady 3.4% – only slightly above trend. In its Statement on Monetary Policy which was released recently the Reserve Bank is more optimistic with expected growth rates of 3¾% – 4% in both years. Those forecasts are based on an assumption that rates move broadly in line with market expectations – implying little or no rate change. We expect another round of rate hikes through 2011 which will lower the likely growth profile. As discussed in the Reserve Bank Board's Minutes released yesterday, the Bank is relying on the direct and indirect effects of the mining boom to deliver above trend growth while housing and consumer spending are likely to be growing around trend. However another round of rate hikes is likely to lower domestic spending growth pushing it back to around the levels we envisage.

Since the growth rate in the Index peaked 3 months ago it has fallen from 9.1% to 6%. Corporate profits (0.4ppt's); commodity prices (0.5ppt's); real money supply (0.1ppt's) and US industrial production (0.1ppt's) were more supportive of growth. However, key domestic variables were all a bigger drag on growth. These included: the all ordinaries index (-1.1ppt's); dwelling approvals (-1.3ppt's); overtime worked (-1.2ppt's) and productivity (-0.7ppt's).

The level of the Leading Index fell by 0.1 points, the first outright decline since May 2009. Two of the four monthly components of the leading index rose in June and two fell. The real money supply and US industrial production rose 0.2% and 0.1% respectively. The all ordinaries index and dwelling approvals fell by 2.9% and 3.3% respectively.

Westpac-MI Leading Index



The growth rate in the Coincident Index is now clearly above trend. This is the second consecutive month that the growth rate is above trend pointing to a very solid growth performance for the economy in the June quarter. Indeed Westpac is currently forecasting GDP and domestic final demand to both register an annualised growth rate of 4.8% in the June quarter.

The Reserve Bank Board next meets on September 7. We are confident that the Bank will decide to keep rates on hold. The evidence from yesterday's minutes of the Board meeting on August 3 is clear that the Board is currently in a "wait and see" mode. Inflation has fallen into the Bank's target zone; there are clear signs of slowing consumer activity; and the global outlook remains uncertain. However we expect that a few more months of steady rates will begin to see a pickup in domestic spending that will encourage the Bank to maintain its above trend growth forecast for 2011. With that in mind and with, at best, inflation bottoming out in the top half of the target zone, we expect the Bank to resume its tightening cycle in the first quarter of 2011.

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