21 July 2010

Leading Index: growth rate peaks

- **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 6.7% in May well above its long term trend of 3.0%. The annualised growth rate of the Coincident Index was 3.7%, also above its long term trend of 3.1%.**

This is the second consecutive month when the growth rate in the Index has slowed. In absolute terms the growth rate remains remarkably high but it appears that growth in the Index has peaked. Despite the slowing, the current growth rate of the Index is still indicative of a stronger outlook for growth in the near term than Westpac expects. We are currently expecting a growth pace through the second half of 2010 of around 3.5% annualised, slightly above trend which we assess as 3.25%.

The Leading Index is pointing to stronger growth than the "slightly above trend" pace we are forecasting.

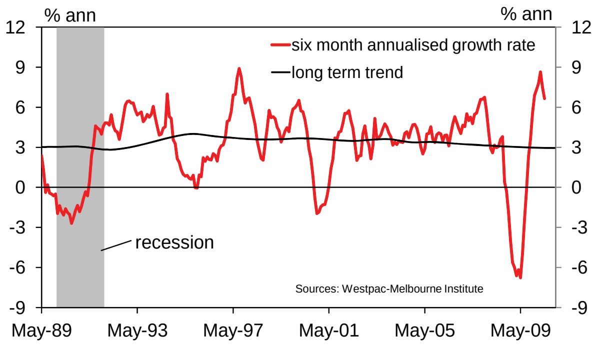
The anomaly probably lies with the global outlook. If we dissect the change in the growth rate of the Leading Index over the last 6 months to its individual components we note that domestic factors are a drag on the growth rate whereas positive offshore factors broadly offset these domestic forces. Over the last 6 months the growth rate in the Index has fallen slightly from 6.9% to 6.7%. International factors – commodity prices (2 ppt's) and US industrial production (1 ppt) added 3 ppt's to the growth rate. This was more than offset a bigger drag from domestic factors – dwelling approvals (–1.3 ppt's); overtime worked (–1.3 ppt's); and equity prices (–1.1 ppt's).

Other lesser contributors to the movement were corporate profits (0.7 ppt's); money supply (0.5 ppt's) and productivity (–0.7 ppt's).

From the March peak in the growth rate (8.6%) we have seen a 1.9 ppt fall. The key factors behind the growth slowdown have been: dwelling approvals; overtime worked and share prices.

The level of the Index rose by 0.4 points (0.15%). Two of the four monthly components of the Index rose in May (real money supply – 0.7% and US industrial production –1.3%) while there were savage falls in the share price index (down 7.8%) and dwelling approvals (down 6.6%).

Westpac-MI Leading Index



The level of the Coincident Index rose 1.1 points (0.4%). Consistent with the sustained high growth rate of the Leading Index the growth rate of the Coincident Index is now comfortably above its long run trend. That is consistent with the current momentum of the economy being above trend. Certainly Westpac is forecasting that the momentum of the economy in the second quarter is around a 3.5% pace compared to trend of 3.25%.

The Reserve Bank Board meets on August 3. The minutes of the July Board meeting which were released yesterday have highlighted the importance of the medium term outlook for inflation for the decision on rates. The board is expecting to see that underlying inflation will be reported to have fallen below 3% when the next inflation report is released on July 28. Our forecast is that the recent fall in inflation has stalled and underlying inflation remains at 3%. With the minutes and the Governor's speech in Sydney yesterday indicating that the Bank retains its upbeat view on medium term prospects for growth it remains likely that there will be a rate hike at the August meeting. Sharply adverse developments in the global economy or a more benign read on inflation will allow the Board to defer a rate hike until later in the year.

Bill Evans, Chief Economist