

# Australian economy: Consumers spending again, buying a car & building a house

## Q2 GDP: 1.2%qtr, 3.3%yr

- The Australian economy expanded by a very healthy 1.2%qtr, 3.3%yr in the June quarter. That was a little above market expectations (0.9%qtr).
- This is a very significant result. The key challenge for the Australian economy has been whether we can emerge from a long period of below trend growth which has been essentially "propped up" by the government sector. In 2009, around half the economy's growth was due to an increase in government spending. If we add the indirect multiplier effects of the stimulus policies, the role of the government in "holding together" the economy during that period was dominant.
- For Australia, as the government withdraws its stimulus spending over the course of 2010 and 2011 (note that government investment spending declined by 0.2% in Q2 after rising by 44% over the previous year), we want to see a recovery in private sector spending to replace the government investment boost. We can be confident that mining investment will play a role, but it is only 4% of GDP. We need to see the household sector (around 55% of GDP) and services sector investment (around 10% of GDP) recovering. The most likely order of this recovery will be household spending followed by services investment as firms become more confident about future domestic sales.
- Recently the lacklustre retail sales data has cast a pall over prospects for this key dynamic to evolve. The recent recovery in the Westpac MI Consumer Sentiment Index provided some reason for optimism. Today's release of household spending data for Q2 provides even more grounds for optimism. Household consumption increased by 1.6% in the quarter. That compares with average reads of 0.05% in 2008, 0.7% in 2009 and 0.5% in 2010Q1.
- Much of the growth in household spending in Q2 was in categories we could describe as discretionary. Together motor vehicle sales (23%); transport - mainly air transport (10%); recreation (24%); and financial services (17%) contributed 74% of the growth in spending while they represent only 28% of total consumer spending. The emphasis on discretionary spending is encouraging evidence that we are moving into a period of stronger household spending than we have seen recently. With wage incomes rising by 2.9% in Q2, but being fully offset in the period by higher interest payments and falls in other non-wage incomes, this boost to household spending is encouraging evidence that households are emerging from the very cautious approach to spending we have seen in recent years.

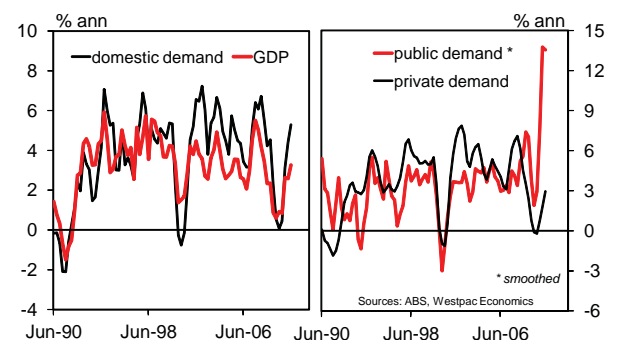
### GDP: Jun qtr 2009

	% qtr		% yr	
	Mar	Jun	Mar	Jun
Private consumption	0.5	1.6	2.9	3.2
Dwelling investment	-3.0	5.0	0.2	11.3
Business investment*	-2.7	-0.2	-2.0	0.0
Private final demand*	-0.5	1.4	1.8	3.0
Public spending*	5.1	1.2	13.8	13.5
Domestic demand	0.8	1.3	4.4	5.3
Stocks - private non-farm #	0.3	-0.6	0.9	0.7
- other #	0.1	-0.1	0.6	-0.2
GNE	1.1	0.6	5.9	5.8
Exports	-0.7	5.6	0.3	4.7
Imports	1.6	3.0	13.9	17.3
Net exports #	-0.5	0.4	-2.7	-2.5
Statistical discrepancy #	0.0	0.2	-0.7	-0.2
Non-farm GDP	-7.4	0.8	-1.5	3.4
GDP	0.7	1.2	2.6	3.3
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GDP deflator	1.9	2.4	2.0	6.6
Household deflator	0.9	0.3	2.7	2.7
Earnings per worker (non-farm)	0.8	2.7	0.0	3.8
Real household disp income	1.3	-0.2	0.3	-2.3

\*adjusted for asset sales, # ppt contribution to growth

Sources: ABS, Westpac Economics

### Australian economic conditions



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- **By contrast, there was no evidence of a recovery in non-mining business investment. Total private business investment contracted by -0.2% in the quarter, although recent business investment surveys point to a strong overall investment outlook for 2010/2011. The improved outlook for the household sector provides reason to feel more confident about this prospect.**
- **Note that, despite strong growth in wage incomes (+2.9%), overall disposable household incomes contracted. That was mainly because of interest rate increases during the quarter. Interest rates are certain to remain steady in the September quarter and, we believe, it would be sensible policy for rates to remain steady in the December quarter as well. That will provide a sound backdrop for the resurgence in household spending to be sustained through 2010. With investment by the services sector likely to gain some traction in the September and December quarter, stresses to capacity are likely to re-emerge in the first half of 2011. That will require a resumption of the RBA's tightening cycle.**

**Bill Evans, Chief Economist**

**Domestic demand (Andrew Hanlan)**

The Australian economy gained momentum in the June quarter, as evident from a pick-up in domestic demand and a burst of exports.

*Domestic demand* (1.3%qtr, 5.3%yr): There was a strengthening of domestic demand in the period, driven by a rebound in the private sector. That lifted annual domestic demand growth to over 5% for the first time since the start of 2008.

*Public demand* (1.2%qtr, 13.5%yr): The public sector continued to directly support economic conditions with an above 1% rise in public demand in the June quarter. However, that was not as brisk as the three previous quarters, when public demand growth averaged almost 4%. Public consumption (just over 70% of total public demand) expanded by 1.8%qtr, 6.3%yr in the June quarter – that's the fastest annual pace since 1996. This appears to be a catch-up phase following belt tightening during 2008/09.

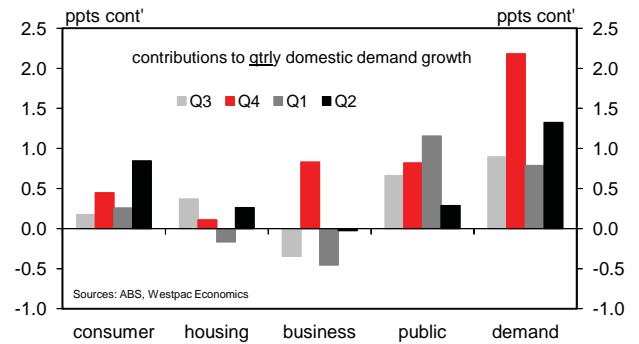
As expected, investment was flat in the quarter (-0.2%), consolidating at a very high level. The Federal Government's stimulus building program – \$14.7bn on schools and \$6.6bn on public housing – has provided a major boost, such that public investment is up 39% over the year.

*Private final demand* (1.4%qtr, 3.0%yr): The private sector gained momentum in the June quarter as upswings in housing and infrastructure emerged, plus a burst of consumer spending. Annual growth at 3.0% is the best result since 2008Q3.

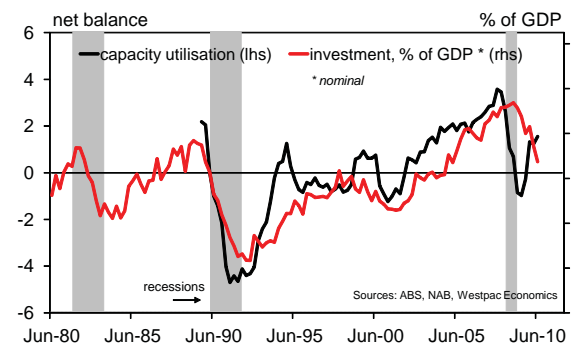
*Consumer spending* (1.6%qtr, 3.2%yr): Household spending was up a staggering 1.6% in the quarter. See below for more detailed discussion of the household sector.

*Housing construction* (5.0%qtr, 11.3%yr): The upswing in new dwelling construction got underway in the June quarter, with a rise of 12.5%. Demand for new housing picked up following the low interest rates in 2009 and government incentives for FHBs. There's further near-term upside, with dwelling starts up 27% in the three quarters to March. However, activity is likely to moderate during 2011, given the recent unwinding of stimulus. As for renovation work, that surprised with a 2.4% dip in the quarter, but is up almost 15% through the year.

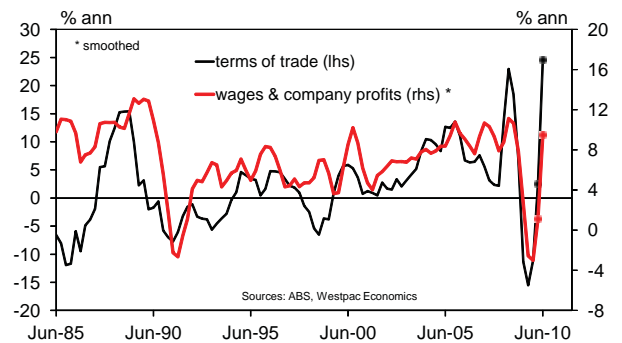
**Australia: the domestic growth mix**



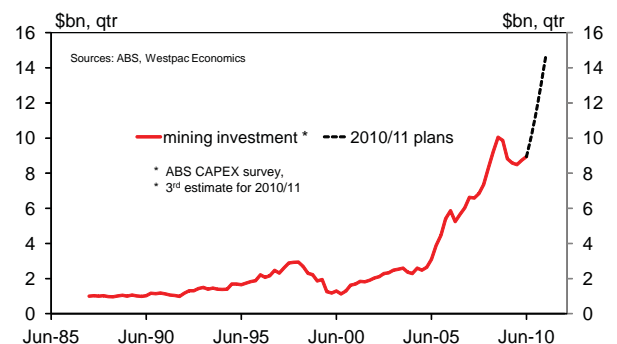
**Capacity utilisation up, investment to rise**



**Incomes boosted by terms-of-trade jump**



**Mining investment responding**



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**New business investment** (-0.2%qtr, 0.0%yr): Following a -2.7% in Q1, overall business investment stabilised in Q2. The upswing in infrastructure work got underway, +2.5%qtr after a -1.1% in Q1, boosted by the ramping up of work on the \$43bn Gorgon project. Spending on equipment eased further, -3.2% after a -7.2% in Q1. That reversed the 12.6% surge in Q4 in response to temporary tax breaks. Non-residential building activity increased by 1.5% and intellectual property products spending rose by 2.3%qtr, 9.0%yr.

The investment outlook appears to be favourable and will be a key driver of growth. The ABS CAPEX survey was very upbeat. Notably, miners are looking to lift investment sharply, upwards of 60% in 2010/11, in response to high global commodity prices. For the non-resource sector, capacity utilisation levels have rebounded to be a little above the historic average, profits are on the rise, interest rates are not overly high and the demand environment is positive.

**The States (Elliot Clarke)**

The state split of domestic demand highlights a surge in new dwelling construction in the eastern states and a strong pick up in infrastructure spending in WA.

**NSW** state demand accelerated to 1.3% in Q2, 5.7%yr. Consumption growth rebounded in Q2 to 1.5% after a modest decline in Q1. In contrast, business investment saw a further but more modest decline in Q2 (-0.6%) as infrastructure investment (-5.7%) and equipment investment (-2.1%) both declined; infrastructure investment remains a weak spot for the NSW economy, now down 22.1%yr. On a more positive note, housing investment rose 6.5% in Q2 and 13.5%yr, new dwelling construction the prime support, up 13.2% in Q2.

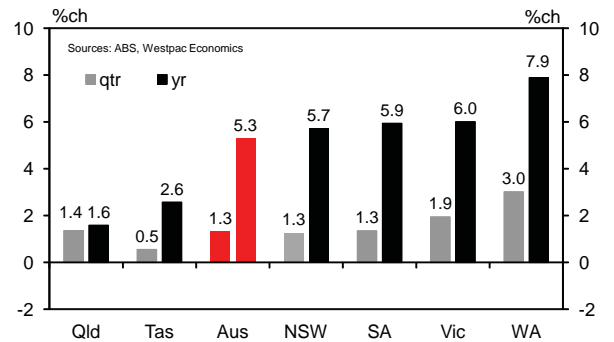
**Victoria's** state demand grew by a particularly strong 1.9% in Q2, more than twice that seen in Q1, to be up 6.0%yr. Consumption growth was very healthy at 2.0%. Housing investment was also strong at 7.9% in Q2, as new dwelling investment surged 15.3%. In contrast to much of the rest of the country, public demand growth also remained strong (4.0%; 15.0%yr), as public investment continued to surge, to now be up over 75%yr. Business investment subtracted from growth in Q2 as non-dwelling and equipment spending fell, despite a near 12% surge in infrastructure spending.

**Queensland** state demand rebounded strongly in Q2, up 1.4%. However, annual growth is just 1.6% - the weakest of the states. Business investment was the primary support for growth in Q2, up 12.3% after a 24% decline since Q4 '08 - this was the result of a much needed 36.4% surge in equipment investment. Housing investment was also supportive in the quarter, up 6.9%, thanks to a 12.8% increase in new dwelling investment. At 0.8%, consumption growth was softer than in most other states, but it was stronger than that seen through '09. Public demand was a drag on growth in Q2, owing to a 13% decline in public investment.

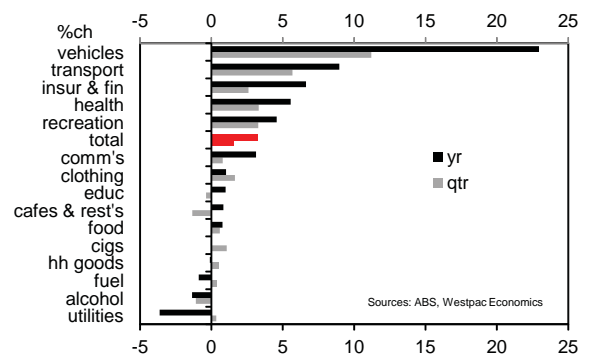
**South Australian** state demand maintained strong momentum in Q2 up 1.3%, 5.9%yr. Consumption was the primary support for growth again in Q2 at 1.8%. Public demand was also supportive in Q2, despite a decline in public investment. In contrast to the eastern states, growth in housing investment was modest at 1.7%; the breakdown also differed with alterations & additions growing faster than new dwelling investment.

**Western Australia** remained the leading light of the Australian economy in Q2 with state demand growth of 3.0% (7.9%yr). Business investment rose by 3.7% in Q2 as infrastructure spending surged 18.6% thanks to the Gorgon LNG project. Public demand growth was also strong at 5.7% thanks to a near 10% increase in public investment. Buoyed by the resource industry, consumption

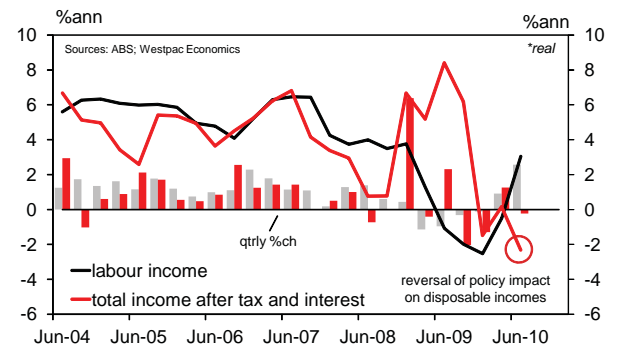
**State demand**



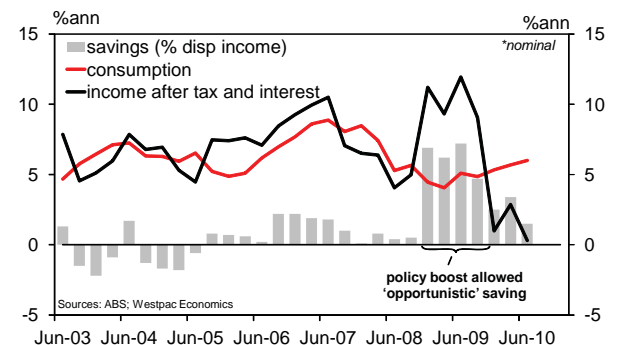
**Consumer spending by category**



**Household labour income growing again**



**Household income, spending and saving**



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growth remained well above the rest of the country in Q2 at 2.5%. Housing investment declined by 1.3% in Q2 as alterations & additions declined – new dwelling investment rose in Q2, but at a much more modest pace than in the east.

*Tasmanian* state demand growth was modest compared to the rest of the nation in Q2 (0.5%; 2.6%yr). Consumption growth was soft at 0.6% in Q2 and 1.0%yr; however business investment rose by 2% (though it is still down 12.8%yr). Public demand was also supportive, up 1.3% in Q2. Housing investment declined by 6.2% after a 8.5% increase in Q1 – new dwelling investment and alterations & additions both declined in Q2.

#### GDP: the expenditure estimate (AH)

The GDP(E) estimate increased by 1.0%qtr, 3.4%yr. As noted earlier, *domestic demand* was 1.3%qtr, 5.3%yr.

*Net exports* added 0.4ppts to Q2 GDP growth, a turnaround from a 0.5ppts subtraction in Q1. There was a burst of exports in the June quarter, with volumes up by 5.6% - easily outstripping a strong 3.0% rise in import volumes. While we expect exports to trend higher, growth at this pace is unlikely to be sustained.

*Inventories* were, by contrast, a drag on growth. Business inventory levels fell by 0.5%, subtracting –0.6ppts from growth. Total inventories subtracted –0.7ppts from quarterly growth. With this likely to be a temporary dip in inventories, given the strength of demand, we would expect a contribution from inventories in Q3.

#### Household sector (Matthew Hassan)

*Consumer spending* (1.6%qtr, 3.2%yr): it was 'all systems go' for consumers in the June quarter. The 1.6% rise was the strongest increase in spending since 2007, when the Australian consumer was in the midst of a fully-fledged boom.

The result was much stronger than expected. Although we knew retail spending had a solid quarter and vehicle purchases posted a 10%+ gain, these components were in line with Westpac's assumptions with the real upside surprise coming on the remaining categories, mainly services.

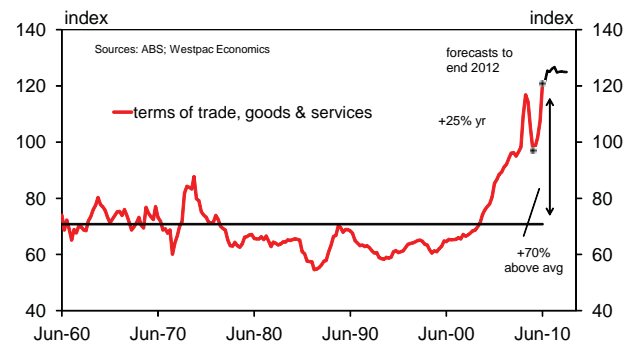
Other 'discretionary' items were particular standouts, including: transport services (+5.7%qtr led by surging air travel); recreation & culture (+3.3%qtr, the strongest rise since 2005Q1); health (+3.3%qtr led by spending in chemists); and insurance & financial services (+2.6%qtr after a 2.3%qtr rise in Q1, spending on insurance has been particularly strong).

The strong swing into discretionary items bears many of the hallmarks of a cyclical consumer upturn, especially given the absence of 'special' extenuating boosts to spending, i.e. fiscal payments, interest rate cuts, tax incentives etc.

Despite a strong spending result, Q2 was a mixed bag for household incomes. Total *wage income* posted a strong 2.9%qtr rise, the biggest quarterly gain since 2006 Q4 boosted by strong jobs growth. However, the big driver was a very strong rise in *average non-farm compensation per employee*, up 2.7%qtr. Incredibly, this is the biggest quarterly gain since 1988. It reflects both steady wages growth and a substantial increase in hours worked (up 1.1%qtr).

However, the boost to bottom line household cash flows was offset by weakness in non-labour income and a further rise in interest rates (interest payments up 7.7%qtr to be up 39.6%yr). The net result actually saw *real household disposable income* decline slightly by 0.2%qtr. However, the strength of labour income gains in Q2, and a pause in interest rate rises since May

#### Terms of trade: moves higher



suggests disposable incomes should show better gains in the second half of the year.

With disposable incomes basically flat and spending up 1.9%qtr in nominal terms, the 'gap' was funded by a sharp cutback in new saving. The household savings ratio dropped to 1.5% of disposable income in Q2, from 3.4% in Q1 and a peak of 7.2% in 2009 Q2. Consumer caution appears to have eased considerably in the first half of the year, although it remains to be seen whether this will be sustained going forward.

#### Incomes: (MH)

The GDP(I) estimate rose 1.4% in the quarter, a touch above the headline result, but at 3.1%yr, annual growth continues to lag the other two measures.

Australia's *terms of trade* jumped by 12.5% in Q2, lifting the annual rise to 24.5%. That's the strongest annual gain since June 1973! The terms of trade have now eclipsed their 2008 peak and are back at the highest level since the wool boom associated with start of the Korean War in 1951. Moreover, they are now 'just' 10% shy of that extraordinarily high and short-lived peak.

The surging terms of trade and buoyant domestic demand produced a big jump in profits with *non-financial corporations* registering a 10.7%qtr jump to be up 19.8%yr, *financial corporations* posted a smaller 2.9%qtr gain, but were still up 9.8%yr. Small businesses and farms had a weaker quarter though with *mixed income* down 0.6%qtr, though still 13.1% higher on an annual basis.

#### Production: an industry perspective (AH)

The GDP(P) estimate increased by 1.2%qtr, 3.3%yr.

*Non-farm GDP* increased by 1.2%qtr, 3.3%yr – the fastest annual pace since the end of 2007. The farm sector also expanded in the period, up 0.8%qtr, 3.4%yr.

On an industry basis, no surprise that the construction sector was a stand-out, increasing by 4.9%qtr, 9.4%yr. Mining output is increasing, encouraged by high prices, up 1.1%qtr, 6.6%yr. Sub-sectors within manufacturing are benefitting – metal products +5.0%qtr, 7.0%yr and non-metallic mineral products +4.8%qtr, 6.5%yr. Despite this, total manufacturing output managed a rise of just 0.5%qtr, but was up 5.6%yr.

Some strength is evident in business services, with "professional, scientific & technical services" increasing by 2.3%qtr, 5.7%yr and "information media & telecommunications" up 2.8%qtr, 4.7%yr. However, conditions were mixed in wholesale (-1.4%qtr), retail (+0.9%qtr) and accommodation & food services (0.4%qtr).

**Prices (AH)**

On the prices front, the *consumption deflator* increased by just 0.3% in the June quarter, holding annual growth at 2.7%. That was more muted than the Q2 CPI result of 0.6%qtr, 3.1%yr.

The *GNE deflator* (which is unaffected by the terms of trade) declined by 0.1% in the quarter, with prices for investment falling by 0.3% in the period. The annual rate edged up to 1.9% from 1.6%.

The *GDP implicit price deflator* was up 2.4%qtr, 6.6%yr, reflecting the impact of the rising terms of trade.

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