Australian economy: domestic demand shows growing momentum

Q3 GDP: 0.2%qtr, 0.5%yr

- The September quarter national accounts, while at 0.2%qtr printed slightly below our forecast growth rate of 0.4%, contained some encouraging positive surprises.

- Firstly, the upswing in the residential building cycle which we have anticipated all year is clearly underway. After contracting by 11% over the last year residential building increased by nearly 6% in the September quarter. We expect a further increase of around 20% over the next four quarters.

- The contraction in plant and equipment investment may now be stabilising. Although we saw a 2.9% fall in investment in the September quarter that was mainly due to the pull forward of investment into the June quarter in response to tax incentives. Taken over the two quarters plant and equipment investment is broadly flat. That compares with an 11% fall in the previous two quarters in response to early concerns about the global financial crisis.

- We were surprised to see household consumption growth hold up at 0.7% given that real retail sales contracted in the quarter. An unusually large fall in the consumption deflator assisted that result. However, going forward, we expect that given strong Consumer Sentiment and an improving labour market, consumption growth will pick up with the pace of growth doubling from 1.8% over the last year to 3.6% over the next year.

- A much lower than expected contribution to growth from inventories explained much of the undershooting in the headline number. The $7.7bn rundown in total inventories over the previous three quarters was halted with a modest $253mn (adding 0.8ppt’s to growth compared to our forecast of 1.9ppt’s) recovery in the September quarter.

  With inventory levels likely to be rebuilt at a faster pace in future quarters the inventory cycle will add to growth in the near-term.

- This September quarter appears to be the low point in this cycle. Momentum in domestic spending is apparent in these accounts and is likely to build through 2009Q4 and 2010. We expect to see annual domestic demand growth accelerate to around 4½% over the year ahead.

Bill Evans, Chief Economist

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**GDP: Sep qtr 2009**

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<th></th>
<th>% qtr</th>
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<th>% yr</th>
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<td></td>
<td>Jun</td>
<td>Sep</td>
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<tr>
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<td>5.7</td>
<td>7.0</td>
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*adjusted for asset sales, # ppt contribution to growth
Sources: ABS, Westpac Economics

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**Growth: Australia vs US**

Sources: ABS, Westpac Economics

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Domestic spending reasonably solid: boosted by government investment (Andrew Hanlan)

Domestic demand was more robust than expected. Not only was there the much anticipated jump in public investment, but household consumer spending increased by 0.7% - a major surprise given that real retail sales declined by 0.4% in the period.

**Domestic demand** (0.6%qtr, 0.1%yr): Demand expanded for the second consecutive quarter, reversing the drop of around 1% over the previous half year. The annual rise of just 0.1% was the weakest since 2000/01 (post introduction of the GST and post Olympics) and prior to that the early 1990s recession, when the low was -3.0%yr. With annual domestic demand growth set to rise from here this highlights that it has been a mild downturn.

**Public demand** (1.6%qtr, 1.8%yr): Public demand strengthened considerably over the last half year, with a 1.3% rise in Q2 and a 1.6% increase in Q3. That more than offset a temporary dip over the previous half year. The Federal Government’s stimulus package, with a focus on school building, public housing and to a lesser degree, road works, is now beginning to kick-in. Public investment rose almost 5% in the quarter and is set for further strong gains in the near-term.

**Private final demand** (0.3%qtr, -0.3%yr): Private demand increased a little in the quarter (after a 0.5% rise in Q2), as consumer spending and dwelling investment more than offset a decline in business investment. However, these two quarters of gains were not enough to fully offset the decline over the previous half year. Looking ahead, annual private demand growth is expected to turn positive in Q4. By way of comparison, the low point in the 1990s recession was much weaker at -3.5%yr in March 1991.

**Consumer spending** (0.7%qtr, 1.8%yr): The Q3 rise was a major upside surprise. The boost to disposable incomes from policy measures ended in July. Retail sales data also showed a –0.4% contraction in volumes in the quarter. Despite this, the national accounts showed a solid Q3 rise in line with the gain in Q2. Strength was concentrated in motor vehicle sales (+2.7%qtr) and services (+1.1%qtr) but even the retail goods components showed a slight gain (+0.1%qtr), with a much ‘smoother’ profile for spending through Q2-Q3 than suggested by surveyed retail sales.

The end to policy boosters and continued labour market weakness were a drag on household disposable incomes in Q3 but a big boost over the year. Real disposable income fell 1.1%qtr but was still up 7%yr, the strongest annual gain since 2004Q2. Real labour incomes fell 1.9% over the year. Labour incomes rose slightly, by 0.7%, in real terms in Q3 but 0.5pts of this was due to a boost to purchasing power from lower consumer prices.

The combination of a solid rise in spending and falling disposable income led to lower savings in Q3 although at 3.5% the savings rate remains high by historical standards.

**Housing construction** (5.8%qtr, -6.7%yr): Housing investment increased for the first time in a year. Super low interest rates, government incentives for first home buyers, pent-up demand for housing and a firming of labour market conditions all contributed to the turning of the housing market. This promises to be a very strong housing construction upturn, as evident from the housing finance data. New dwelling construction was up 4.4% in the quarter, while renovation work rose by 7.6%.

**New business investment** (-2.5%qtr, -6.1%yr): Business investment fell for the third time in the last four quarters. Additional tax incentives provided a temporary boost to investment in Q2, with a 1.1% rise in total business investment. In Q3 non-residential building work fell by 6.0%qtr, -18%yr with the segment hard

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hit by the credit crunch. Equipment spending declined by 2.9%, reversing the 2.3% rise in Q2. Infrastructure spending, supported by ongoing momentum in the mining sector, dipped by 2.3% but is still up 8% over the year.

The downturn in business investment is proving to be relatively mild compared to that experienced in a genuine recession. The resilience of consumer spending has limited the drop in capacity utilisation levels and the resurgence of China has contributed to the sharp recovery in business confidence.

The States (Matthew Hassan)

The state split of domestic demand continues to show a stark contrast between the resource states of Qld, WA and NT, where demand is contracting sharply, and the south-eastern states which have seen a milder slowdown and are showing signs of picking up.

**NSW** recorded a strong 1.3% rise in state final demand in Q3, with growth of 1% through the year. Continued robust rises in consumer demand (+0.8%qtr) and a turnaround in dwelling investment (+4.5%qtr) have combined with an uptick in business investment (+3.2%qtr) and a rise in public investment (+5.6%qtr).

**Victoria** slipped back in Q3 but this appears mostly due to lumpy investment spending with the recovery on a firm footing. State final demand was down 0.3%qtr, but this followed a 2.6%qtr rise in Q2 with demand still up 1.6%yr. Consumer spending is notably stronger in the state, running at 2.7%yr compared to the 1.8%yr national pace. Surging new dwelling investment (+4.0%qtr) and public investment (+11.0%qtr) helped offset a big decline in non-res building (–20.4%qtr) and a partial unwind of Q2’s spike in equipment spending (–9.7%qtr vs +14.8%qtr in Q2).

**Queensland**’s ‘difficult’ year is finally showing signs of improving. The state has seen by far the sharpest contraction in demand, down 2.9%yr, but managed a flat result in Q3, the first quarter without a decline since Q3 last year. Steady but unspectacular growth in consumer demand (+0.5%qtr) and a turnaround in dwelling investment (+6.1%qtr vs –11.1%qtr in Q2) offset another hefty fall in business investment (–8.1%qtr). That said, the consumer picture remains disappointing for a state with population growth of 2.6%yr.

**South Australia** continues to record the strongest growth of the states after experiencing the mildest downturn. State demand rose 1.9%qtr in Q3 and is up 2%yr. Another solid rise in consumer demand (+0.6%qtr), a bounce in dwelling investment (+8.2%qtr) and surging private infrastructure (+13%qtr, +38.1%yr) and equipment investment (+18.6%qtr) more than offset weakness in non-res building (–9.1%qtr).

**Western Australia** had a weak quarter but appears to be on the mend. Demand fell 1.3%qtr but this followed a 3.6%qtr rise, with demand flat over the year. The consumer recovery gained momentum (+0.7%qtr vs +0.2% average over previous three quarters) and dwelling investment bounced nicely (+6.7%qtr). The main drag in Q3 was from a 5.9% drop in business investment but this followed an 11% jump in Q2. The medium term outlook in this segment remains very positive thanks to Gorgon et al.

**Tasmania** had seen a pronounced weakening over the last six months. Demand slipped 0.1% in Q3 after falling 2.6% over the previous two quarters. Falling renovation activity (–9.4%yr) and a slump in business investment (–21.4%yr with double-digit declines across the board) have been the main source of weakness. Although soft, the Q3 data does suggest both segments are starting to turn. Meanwhile consumption (+0.5%qtr, +1.8%yr) and new dwelling investment (+3.3%qtr, +3.3%yr) have held up well.

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Economy wide (including farms) also rebounded, rising 2.6% qtr to be up 1.5% yr. This rise since 2008Q3. The slowdown continued to put pressure on real household disposable incomes. As mentioned earlier, domestic demand (0.6% qtr, 0.1% yr) increased moderately in the quarter. There were major and largely offsetting swings in inventories and net exports. Firms ran down inventories aggressively over the three quarters to June and, associated with this, cut back on imports over the half year to March. With a return of confidence and stronger demand conditions, firms are now importing again and rebuilding inventories.

Non-farm business inventories added 1.1ppts to quarterly growth as the level of inventories increased by 0.3% after a 2.2% fall in Q2. All up, inventory levels fell by 4.3% over the three quarters to Q2. Going forward, inventories are likely to make a small contribution to growth in the near-term.

Net exports subtracted 1.6ppts from Q3 growth. There was a burst of imports in the quarter, up 5.8%, after a sharp fall of 14% over the half year to Q1 and a virtually flat result in Q2. Import volumes are down about 8% over the year.

Export volumes dipped in Q3, down 2.3% to be flat for the year. That is a resilient outcome given the weakness of overall global demand. With the resurgence of the China export performance has exceeded expectations and the outlook is positive.

Incomes: patchy recovery at best (MH)

The GDP(I) estimate rose 0.4% qtr, above the headline result. This measure has been notably weaker over the last year, with growth only just lifting back into positive territory in Q3 (+0.7% yr vs –0.4% yr in Q2 and a low of –0.9% yr in 2008Q4).

Australia’s terms of trade stabilised in Q3, rising 1% qtr after dropping 16.7% over the previous three quarters. Despite the plunge, they remain 2.7% higher than their level two years ago.

The slowdown continued to put pressure on non-financial corporations in Q3 with profits down 0.6% qtr and 14.8% yr (though as with the terms of trade, well above their level of two years ago). Profits rose 2.7% for financial corporations, the first rise since 2008Q3. Mixed income (which covers small businesses including farms) also rebounded, rising 2.6% qtr to be up 1.5% yr.

Economy wide wage income edged 0.2% higher in Q3 but at 0.4% yr, through the year growth was the lowest since 1991, reflecting falling employment, hours worked and subdued wages growth. Average non-farm compensation per employee (the national accounts measure of average earnings closely watched by the RBA) rose 0.4% in Q3. However, back to back declines in Q1 and Q2 have dragged annual growth down to just 0.8% yr, indicating real wage declines.

As mentioned real household disposable incomes fell 1.1% in the quarter, reflecting the ‘let-down’ from fiscal policy boosters through the middle of the year and the subdued labour income picture.

Production: an industry perspective (AH)

The GDP(P) estimate reported a modest increase in the quarter, but remained negative over the year at 0.4% qtr, –0.5% yr. In contrast, annual growth on the Expenditure estimate is 1.1% and on the Income estimate is 0.7%.

Non-farm GDP increased by 0.3% qtr, 0.9% yr. The farm sector (which covers small businesses including farms) also performed strongly (2.3% qtr) as did transport (2.5%), with the jump in imports and inventory rebuilding a plus. Retail trade contracted (–0.7% qtr) consistent with the negative printed in the retail sales survey. Manufacturing activity edged higher for a second quarter (0.6%) after contracting significantly over the three previous quarters. Accommodation & food services declined for a second quarter (–1.4% qtr) with the high Aussie dollar a negative for international tourism and a plus for Aussies wanting to head overseas.

Prices (AH)

The consumption deflator was a surprise coming in at –0.5% qtr. Keep in mind that core CPI was 0.8% and headline CPI was 1.0% in the quarter, although the retail deflator was –0.3%. The consumption deflator was running at 0.6% for the last two quarters. We note the consumption deflator had only contracted twice in the last fifty years and by 0.1% on both occasions (2003Q2 and 2003Q3).

The GNE deflator (which is unaffected by the terms of trade) was –0.3% qtr, 0.5% yr.

The GDP implicit price deflator was 0.0% qtr, –2.9% yr. The GDP deflator fell sharply over the last half year (–3.6%) as the terms of trade retreated from a record high as commodity prices moderated. The terms of trade inched 1.0% higher in Q3 after dropping 17% over the three previous quarters, with the weakness concentrated in Q1 and Q2.

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