MELBOURNE INSTITUTE
Applied Economic & Social Research

Monthly Bulletin of Economic Trends: Review of the Australian Economy

March 2019

THE UNIVERSITY OF MELBOURNE

MELBOURNE INSTITUTE

Review of the Australian Economy

- **Growth in the Australian economy disappoints again, and leading indicators weaken** *Soft consumption growth and a fall in residential investment weighed on GDP growth. The public sector, however, continued to be an important source of growth.*
- **Low unemployment remains, and private sector wages growth improves slightly.**
- **Global growth prospects soften, but commodity prices strengthen.**
- **The Australian economy has entered a per capita recession, but what does that mean?**

Table 1: Outlook for Australia[1]

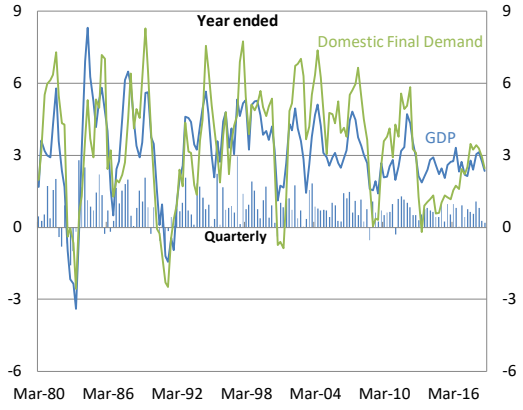
	Actual				Forecasts				Actual	Forecast
	2018	2018	2018	2018	2019	2019	2019	2019	Calender Year	
	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	2018	2019
Economic Activity										
GDP	3.1	3.1	2.7	2.3	1.8	1.6	1.9	2.3	2.8	1.9
	(1.1)	(0.8)	(0.3)	(0.2)	(0.6)	(0.6)	(0.5)	(0.5)		
Household Consumption	2.8	2.9	2.6	2.0	2.0	1.5	1.7	1.8	2.6	1.8
	(0.4)	(0.9)	(0.3)	(0.4)	(0.4)	(0.4)	(0.5)	(0.5)		
Private Dwellings	2.9	5.2	7.1	2.5	-1.7	-4.5	-5.9	-3.8	4.4	-4.0
	(3.4)	(2.2)	(0.5)	(-3.4)	(-0.8)	(-0.8)	(-1.0)	(-1.3)		
New Business Investment	4.6	3.9	-0.7	-0.2	-0.1	1.5	4.3	5.3	1.9	2.7
	(0.9)	(-0.4)	(-1.3)	(0.7)	(1.0)	(1.2)	(1.4)	(1.6)		
Domestic Final Demand	3.4	3.3	2.9	2.5	2.1	2.0	2.1	2.4	3.0	2.2
	(0.9)	(0.7)	(0.5)	(0.3)	(0.6)	(0.6)	(0.6)	(0.6)		
Imports of Goods & Services	6.2	6.7	2.4	1.5	1.0	1.4	3.5	4.4	4.1	2.5
	(1.8)	(0.6)	(-1.0)	(0.1)	(1.2)	(1.1)	(1.0)	(1.0)		
Exports of Goods & Services	6.5	4.9	4.0	4.7	1.8	1.7	2.5	3.9	5.0	2.5
	(4.1)	(1.3)	(-0.1)	(-0.7)	(1.2)	(1.2)	(0.8)	(0.6)		
Inflation & Financial Market										
Underlying inflation[2]	1.8	1.8	1.8	1.8	1.7	1.6	1.8	1.9	1.8	1.7
	(0.6)	(0.4)	(0.4)	(0.4)	(0.4)	(0.4)	(0.5)	(0.5)		
Headline Inflation	1.9	2.1	1.9	1.8	1.8	2.0	2.0	2.0	1.9	2.0
	(0.4)	(0.4)	(0.4)	(0.5)	(0.5)	(0.5)	(0.5)	(0.5)		
90-day Bill Rate[3]	1.8	2.0	2.0	2.0	2.0	2.0	2.0	2.0		
Trade Weighted Index[4]	64.2	62.5	62.6	62.0	60.8	60.6	60.6	60.6		
$A/$US rate (100)[4]	0.77	0.77	0.73	0.73	0.71	0.70	0.70	0.70		
Labour Market										
Unemployment Rate[4]	5.5	5.4	5.2	5.0	5.0	5.0	5.1	5.1	5.3	5.1
Employment Growth Rate[5]	3.4	2.7	2.4	2.3	2.1	2.0	1.7	1.5	2.7	1.8
	(0.7)	(0.4)	(0.6)	(0.6)	(0.5)	(0.3)	(0.3)	(0.4)		
Participation Rate[4]	65.7	65.6	65.6	65.6	65.7	65.6	65.5	65.4	65.6	65.6
Wage Price Index	2.1	2.1	2.3	2.3	2.2	2.3	2.3	2.3	2.2	2.3
	(0.5)	(0.5)	(0.6)	(0.5)	(0.5)	(0.6)	(0.6)	(0.6)		

1: Actual in black and forecasts in blue; values in parentheses are quarterly growth rates. 2: As measured by the Reserve Bank's trimmed mean measure of inflation. 3: Average over last month in quarter. 4: Average of 3-months in the quarter. 5: Calculated from quarterly employment numbers that are averaged over the 3 months in the quarter. *Prepared by G. Lim and T. Robinson, Macro@MI. Data in this report were finalized on 27/03/2019.*

Growth in the Australian economy disappoints again…

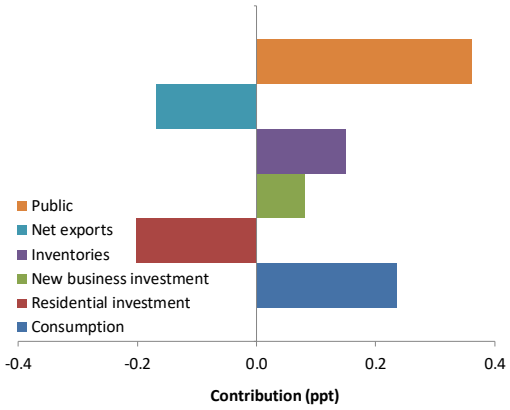
- The Australian economy grew by a below-trend 0.2 per cent in the December quarter. As this followed weak growth in the September quarter – 0.3 per cent – growth is only 2.3 per cent over the year (Figure 1).
- Public and household consumption and inventory accumulation were the main sources of growth in the quarter (Figure 2).
- Household consumption, while being one of the main sources of growth, increased by a below-trend 0.4 per cent in the quarter, to be 2 per cent higher over the year. Ongoing moderate growth in household disposable incomes, reflecting subdued wage increases, is likely to be a contributing factor, as well as negative wealth effects stemming from falling house prices. The household saving ratio ticked up.
- Government final consumption expenditure increased by 1.8 per cent and is a strong 5.6 per cent higher over the year. Benefits payments to households (e.g. disability related) underpinned the increase. It contributed 0.3 percentage points to output growth.
- New private business investment increased by 0.7 per cent. While mining investment fell, encouragingly non-mining business investment grew in the quarter.
- Total public investment grew modestly, as a fall in investment by public corporations was more than offset by an increase in general government investment due primarily to higher infrastructure spending by state and local governments.
- The downturn in the housing sector weighed on growth. Residential investment fell by 3.4 per cent and subtracted 0.2 percentage points.
- Domestic final demand growth was slightly stronger than overall growth.
- Exports fell by 0.7 per cent in the quarter, due to a fall in rural goods exports. Service exports rose marginally. Imports also increased slightly, and consequently net exports subtracted 0.2 percentage points.
- Overall, the December quarter National Accounts were weak, with output growth underpinned by the public sector.

Figure 1: Growth
(chain volume, per cent)



Source: ABS

Figure 2: Contributions to Quarterly Real GDP Growth (percentage point)



Source: ABS

Leading indicators weaken…

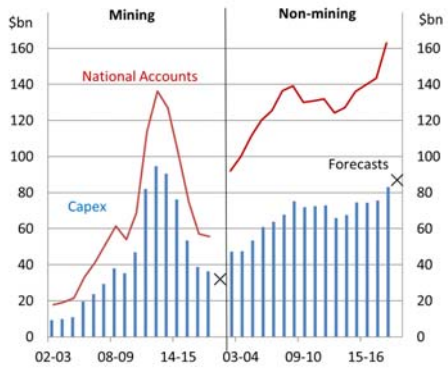
- *Consumption:* Consumer sentiment recently has weakened. In March the Westpac-Melbourne Institute Consumer Sentiment Index fell by 4.8 per cent, with the number of pessimists now slightly outweighing optimists.
    - Consumer sentiment remains well above recessionary levels. For example, in the severe recession of the early 1990s the index reached 64.6, whereas it currently is 98.8.
    - The fall in consumer sentiment in March was greater in the forward-looking components, although the Current Conditions Index also weakened.
    - Nominal retail trade rose only slightly in January, following a fall in December.
    - Total new vehicle sales (including commercial vehicles) was 9.3 per cent lower than a year ago according to the Federal Chamber of Automotive Industries.
    - Prospects for house prices are probably weighing on the consumption outlook, although wealth effects are generally thought to be small. In March the Westpac-Melbourne Institute House Price Expectations fell further and is more than 34 per cent lower than a year ago. On the flipside, the Time to Buy a Dwelling Index strengthened in March.
    - Prospects for the labour market are crucial for the consumption outlook and are described in the labour market section.
- *Residential investment:* Building approvals strengthened in January, although they are volatile and are more than 28 per cent lower over the year (albeit from a very high level). The decline has been concentrated in approvals for apartments etc., but houses have also fallen. Building approvals point to further falls in residential investment in the next six months (Figure 3).
    - The value of lending commitments (excluding refinancing) for owner occupiers and particularly investors also fell in January.
    - The minutes to the recent RBA monetary policy meeting noted that "…residential building approvals and information from the Bank's liaison program pointed to a marked slowing in dwelling investment in one to two year's time, unless pre-sales increased significantly in the following few quarters.
- *Business Investment:* The NAB Monthly Business Survey business conditions index has eased significantly compared to late last year. Business conditions are reported to be weakest in the retail sector. The survey's measure of capacity utilisation has eased to be marginally below average. The more forward-looking business confidence measure has likewise eased to a slightly below-average level.
    - A relatively more upbeat (although slightly dated) perspective is provided by the ABS Capital Expenditure (CAPEX) survey. This was the 5th estimate for 2018-19; while nominal mining investment is still anticipated to fall, this fall is expected to be smaller and the upswing in non-mining investment stronger (Figure 4).
    - Dampened small business lending and hence investment is another potential channel through which falls in house prices may adversely impact on the real economy. As noted in the Quarterly Statement by the Council of Financial Regulators, "…around half of loans to unincorporated enterprises are secured by residential policy" and "for many small businesses, personal and business finances are intermingled."

- *Exports:* Strong growth in resource exports in 2018-19, underpinned by increases in LNG exports, continues to be forecast by the Department of Industry. By the end of 2019 much of the increase in production of LNG is likely to have occurred. Dry conditions in the eastern states are expected by ABARES to result in rural exports falling in 2018-19, although ABARES notes that higher prices for some commodities are buffering the impact on farm incomes.
- *Overall growth prospects:* The Westpac-Melbourne Institute Leading Index has eased in recent months and now points to growth being below-trend in the next three to nine months (Figure 5).
    - The RBA are forecasting GDP growth to be below trend in mid 2019. Subsequently they anticipate a strengthening, with a pick-up in business investment and household consumption growth important contributing factors. Given the December quarter GDP outturn and recent data these forecasts look optimistic. From late 2019 onwards growth is forecast to be at trend or above.
    - The OECD in March revised down their year-average forecasts to 2.7 per cent in 2019 (down 0.2 ppts) and 2.5 per cent in 2020.
    - In all, the partial indicators for economic activity have softened further this year. Weak output growth is likely to persist in the near term, weighed down by subdued consumption growth and declines in residential investment. Our forecasts for these components have been lowered relative to last quarter. A pick-up in business investment remains likely, although the uncertainty surrounding the magnitude of this upswing has increased (Figure 6).

Figure 3: Dwelling Approvals and Residential Investment Growth
(year-ended, per cent)

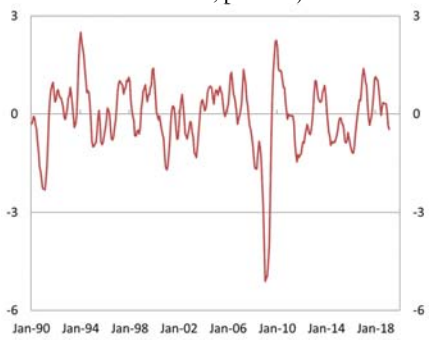
Source: ABS

Figure 4: Capital Expenditure Survey (Nominal)



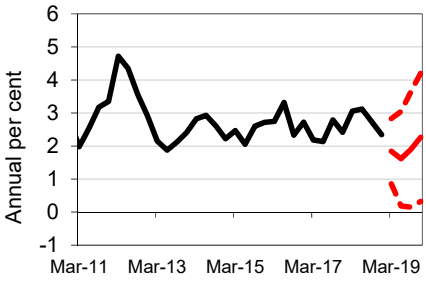
Source: ABS, Calculations

Figure 5: Westpac-Melbourne Institute Leading Index
(6-month annualised deviation from trend growth, smoothed, per cent)



Source: Melbourne Institute

Figure 6: Growth Forecasts
(year-ended)

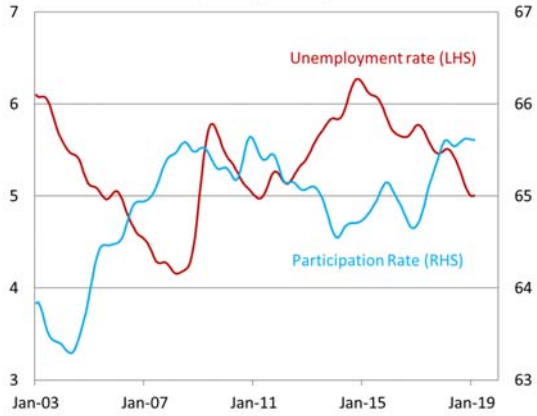


Source: ABS, Melbourne Institute

The labour market continues to perform well …

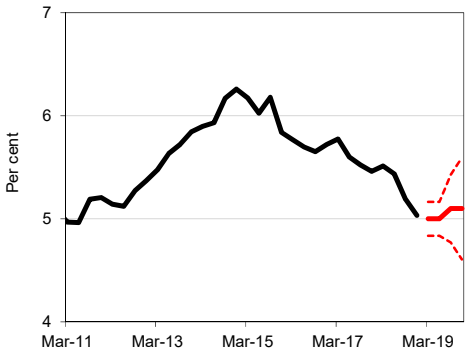
- The trend unemployment rate in February was unchanged in February at 5 per cent (Figure 7). This is 0.5 percentage points lower than a year ago. The seasonally adjusted rate improved slightly to be 4.9 per cent.
- Focussing on the trend data, the participation rate was unchanged at 65.6 per cent in February. An alternative measure of the participation rate, which is for those aged 15-64 years old, remained unchanged at 78.1 per cent. This measure partially abstracts from the impact of the aging of the population.
- The underemployment rate decreased slightly in February. At 8.1 per cent, it is 0.4 percentage points lower than a year ago.
- Employment increased by 20,600 people, with both full and part-time employment increasing. The majority of employment growth over the last year has been in full-time positions. The trend employment-to-population ratio, which is a good summary statistic of the state of the labour market, remained at a high level relative to recent years.
- Employment growth in recent months, however, has eased a little, with a slowing in full-time employment growth (on a 6-month annualised basis).
- Timely or forward-looking measures of the state of the labour market are mixed. The trend ANZ Job Advertisements Index fell by 0.7 per cent in February, to be 2.8 per cent lower over the year. The NAB Monthly Business Survey employment sub-index was unchanged in February at an above-average level. According to NAB its level is consistent with employment growth of around 19,000 people per month.
- The Reserve Bank has noted that a tension exists between the weakening real economy indicators and the current state of the labour market.
- *Labour-market prospects:* The Melbourne Institute expects in the near term the unemployment rate to remain around 5 per cent. There is a high degree of uncertainty about the medium-term prospects, reflecting the tension between the various indicators. Our central forecast is for the unemployment rate to be broadly unchanged (Figure 8). This is weaker than the RBA, who anticipate a further small improvement.

Figure 7: Labour Market
(trend, per cent)



Source: ABS.

Figure 8: Unemployment rate
(per cent)



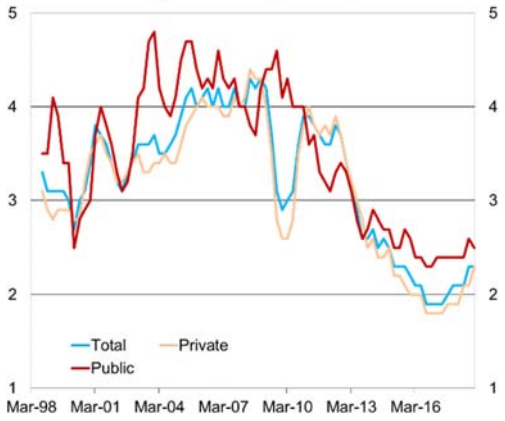
Source: ABS, Melbourne Institute.

The dashed lines are the 90% confidence bands.

…private-sector wages growth improves slightly

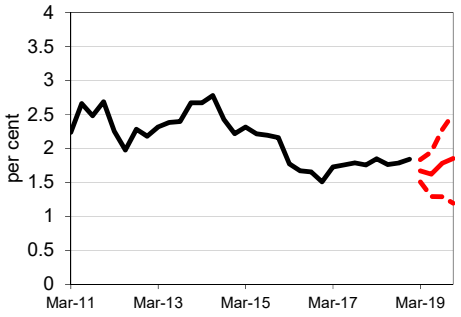
- Wages in the private sector increased by 0.6 per cent in the December quarter, taking growth over the year to 2.3 per cent, up from 1.9 per cent in mid 2017 (Figure 9). Public sector wages growth in in the December quarter was similar, but slightly higher over the year (2.5 per cent).
- Two key determinants of inflation are unit labour costs (productivity-adjusted wages) and import prices. Year-ended growth in both has strengthened in the last year, although unit labour costs growth remains subdued.
- Headline inflation increase by 0.5 per cent in the December quarter, with increases in tobacco prices (due to higher excise tax etc.) and domestic holiday and travel costs important contributing factors. In seasonally-adjusted terms the increase was a more modest 0.4 per cent.
- The RBA attempts to abstract from short term fluctuations in inflation by using underlying measures such as the trimmed mean. In the December quarter this also increased by 0.4 per cent, and is 1.8 per cent higher over the year. This is below the bottom of the RBA's target band.
- Measures of inflation expectations have been mixed. The break-even rate between nominal and real bond yields fell to a low 1.6 per cent in December. More recent measures have diverged; consumer expectations for one-year ahead ticked up in March, whereas union officials' expectations fell slightly.
- Monetary policy remains unchanged. The RBA, however, has shifted away from a tightening bias, describing the probabilities of scenarios requiring an interest rate increase or decrease in the future as "…more evenly balanced than they had been over the previous year."
- *Inflation prospects:* The Melbourne Institute expects underlying inflation in the near term to increase only modestly, gradually moving up to the bottom of the target band. (Figure 10).
- *Monetary policy prospects:* We have maintained the view that the most likely outcome is that the Reserve Bank holds interest rates unchanged. However, the chance of an interest rate cut has increased considerably given the weakening outlook for the real economy. In our opinion the main factor holding back a rate cut is the current good state of the labour market.

Figure 9: Wage Price Index
(year-ended, per cent)



Source: ABS.

Figure 10: Underlying CPI Inflation
(actual and forecast)

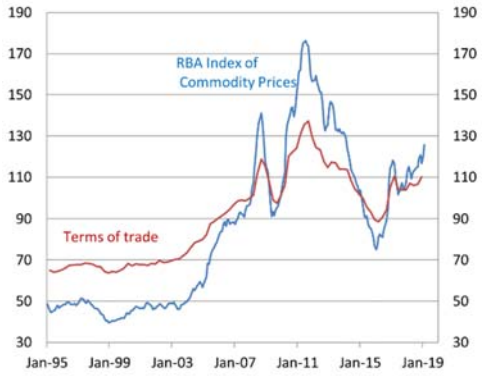


Source: ABS, Melbourne Institute
The dashed lines are the 90% confidence bands

The terms of trade improves, but external activity indicators moderate

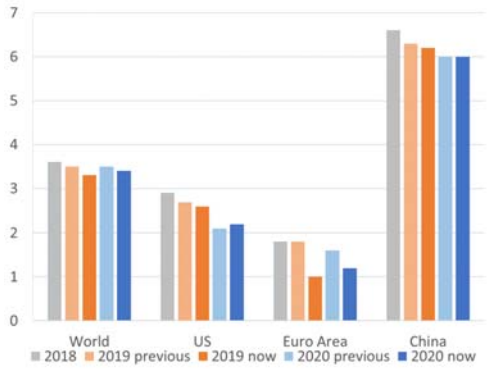
- The terms of trade increased by 3.1 per cent in the December quarter, to be 6 per cent higher over the year (Figure 11). Subsequently the RBA Index of Commodity Prices has increased further, boosted by higher export prices for the bulk commodities, although base metal and rural prices have also risen. and the RBA Index of Commodity Prices points to a further increase in the December quarter (Figure 11).
- The higher terms of trade will support the Federal budget position, which is highly sensitive to commodity prices (e.g. through company tax revenue).
- The UK's process of leaving the European Union (Brexit) has been fickle. Bank of England Monetary Policy Committee External Member Gertjan Vlieghe recently presented estimates that UK had lost around 2 per cent of GDP due to Brexit. He also demonstrated that the Brexit related uncertainty is likely to be holding back business investment, with this becoming more sizable as time passes without a resolution.
- The euro area (EA19) grew by 0.2 per cent in the December quarter, to be 1.1 per cent higher over the year (down from 2.4 per cent in the March quarter). The ECB in March issued new policy guidance, namely that the interest rate is likely to be "…at present levels at least through the end of 2019." New Targeted-Longer-Term Refinance Operations were also announced, which are meant to encourage bank lending.
- The United States economy grew by 0.7 per cent in the December quarter, down from the strong 0.9 per cent in the previous quarter. It is 3.1 per cent higher over the year. The Federal Reserve left the Federal Funds target range at 2.25 – 2.5 per cent at the March meeting. The increases included in the associated projections have been pared back considerably relative to those from December; the median projection is now for an increase in 2020.
- The Chinese economy grew by 1.5 per cent in the December quarter, 0.1 percentage points lower than in the September quarter. In year-ended terms growth was 6.4 per cent. The Chinese Government has announced a target growth rate of 6 to 6.5 per cent in 2019. A target unemployment rate of 5.5 per cent and business tax cuts were also announced.
- The OECD in its March Interim Economic Outlook once again revise down their forecasts for global growth (Figure 12). In 2019 growth of 3.3 per cent is now anticipated (previously 3.5 per cent) and 3.4 per cent in 2020 (was 3.5 per cent).
- *Global growth outlook:* In summary, output growth overseas appears to have slowed in recent months and the near-term prospects have also softened.

Figure 11: Terms of Trade
(March Quarter 2015 = 100)



Sources: RBA, ABS

Figure 12: OECD Growth Forecasts
(Year-on-Year, per cent)



Source: OECD.

Per capita recessions: what are they?

- Recently the combination of weak output growth and solid population increases has resulted in GDP per capita declining. This decline is undesirable as it implies a fall in living standards. This has raised discussion in the media that Australia is in a per capita recession.
- A recession is a prolonged period of declining economic activity. Identifying whether the economy is in recession essentially is identifying turning points in activity. In the United States this is done by a committee at the National Bureau of Economic Research analysing a broad range of economic data.
- A common approximation to the committee's decisions is that the economy enters a recession if there are two successive quarters of negative growth.
- Relatedly, an algorithm has been developed to identify turning points and cycle characteristics.[1] We apply this to GDP and GDP per capita (Table 2).
- Based on the two-quarter rule and the output of the algorithm Australia is currently is in a per capita recession, but not a conventional recession.
- *Per capita recessions: how do their characteristics compare?*
    - GDP per capita recessions occur more often. This can be seen in Table 2 as the duration of GDP per capita recessions are around half of those in GDP.
    - This occurs as the average rate of GDP per capita is considerably less than for GDP, reflecting population growth. The volatility of both series is similar, as population growth does not fluctuate much.
    - GDP per capita recessions tend to be slightly longer than conventional recessions, but to have a smaller average amplitude (Table 2).
    - Note, that these average amplitudes are percentages of different series. Alternatively, if one were to look at the at the average declines in GDP using the per capita recession dates it is a more modest 0.53 per cent (of GDP).
- In summary, GDP per capita recessions are much more frequent than conventional recessions. While undesirable as they represent falls in living standards, they are associated with smaller declines in overall economic activity. This is also evident in other indicators such as consumer sentiment, which have weakened recently but are not at recessionary levels.

Table 2: Cycle Characteristics

	GDP	GDP per capita
Moments		
Average quarterly growth rate	0.75	0.41
Standard deviation	0.87	0.88
Cycle Characteristics		
Average duration (quarters):		
- recessions	3.25	3.6
- expansions	33.6	16.11
Average amplitude (per cent):		
- recessions	2.15	1.84
- expansions	28.89	10.26
Average cumulative movement (per cent):		
- recessions	3.72	4.96
- expansions	831.35	115.09

Sample: 1973:Q3 – 2018:Q4

[1] Harding, Don & Pagan, Adrian, 2002. "Dissecting the cycle: a methodological investigation," Journal of Monetary Economics, Elsevier, vol. 49(2), pages 365-381, March.

Table 3: Precision of year-ended Forecasts for Australia

	Precision of (year-end) Forecasts				
	2019 Mar	2019 Jun	2019 Sep	2019 Dec	**Calender Year 2019**
Australia					
Economic Activity					
GDP	0.6	0.9	1.1	1.2	**0.7**
Consumption	0.5	0.8	1.0	1.1	**0.7**
Dwelling	2.3	2.4	2.5	2.8	**1.9**
Business Investment	5.2	6.0	6.7	7.5	**4.6**
Import	2.5	4.2	5.8	6.6	**3.7**
Export	2.6	3.4	4.0	4.4	**2.9**
Inflation & Financial Market					
Underlying Inflation		0.2	0.3	0.4	**0.3**
Headline Inflation		0.4	0.5	0.7	**0.6**
90 day bill		0.3	0.5	0.7	**0.6**
Trade Weighted Index		3.3	3.7	3.9	**2.3**
Labour Market					
Unemployment Rate		0.1	0.2	0.3	**0.3**
Employment		0.2	0.4	0.5	**0.5**
Participation Rate		0.2	0.3	0.4	**0.3**
Wage Price Index	0.4	0.5	0.6	0.7	**0.4**

For more information about the Melbourne Institute, see: http://melbourneinstitute.unimelb.edu.au/

For more information about Macro@MI and other Reports

see: http://melbourneinstitute.unimelb.edu.au/research-programs/macroeconomics

THE UNIVERSITY OF MELBOURNE

MELBOURNE INSTITUTE