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Monthly Bulletin of Economic Trends: Review of the Australian Economy

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Review of the Australian Economy

- **Soft growth in the Australian economy persisted in the June quarter and despite the recent policy stimulus, growth is likely to remain low in the near term.**
- **The labour market remains a relatively positive component of the economy, despite the unemployment rate edging higher.**
- **Headline inflation increased in the June quarter, but there was little change in underlying inflation.**
- **The terms of trade strengthened further, but global growth prospects have weakened.**
- **Yields on Australian long Government bonds declined further, to be at a remarkedly low level by historical standards.**

Table 1: Outlook for Australia[1]

	Actual				Forecasts				Actual	Forecast
	2018	2018	2019	2019	2019	2019	2020	2020	Financial Year	
	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun	2018/19	2019/20
Economic Activity										
GDP	2.6	2.2	1.7	1.4	1.9	2.4	2.4	2.5	2.0	2.3
	(0.3)	(0.1)	(0.5)	(0.5)	(0.8)	(0.6)	(0.6)	(0.6)		
Household Consumption	2.6	2.0	1.8	1.4	1.5	1.6	1.8	2.0	1.9	1.7
	(0.3)	(0.4)	(0.3)	(0.4)	(0.4)	(0.5)	(0.5)	(0.6)		
Private Dwellings	7.0	3.2	-2.3	-9.1	-11.5	-11.2	-11.2	-8.9	-0.4	-10.7
	(0.1)	(-2.8)	(-2.2)	(-4.4)	(-2.5)	(-2.5)	(-2.3)	(-2.0)		
New Business Investment	-1.2	-0.8	-1.6	-1.6	0.4	0.8	2.0	4.0	-1.3	1.8
	(-1.6)	(0.4)	(0.0)	(-0.4)	(0.4)	(0.8)	(1.3)	(1.5)		
Domestic Final Demand	2.5	2.0	1.2	1.0	0.8	1.1	1.5	1.8	1.7	1.3
	(0.4)	(0.2)	(0.1)	(0.3)	(0.2)	(0.4)	(0.5)	(0.6)		
Imports of Goods & Services	2.0	1.2	-0.7	-2.8	-1.2	-1.0	-0.5	1.5	-0.1	-0.3
	(-1.5)	(0.1)	(-0.2)	(-1.3)	(0.2)	(0.3)	(0.4)	(0.6)		
Exports of Goods & Services	3.9	4.9	2.2	2.9	3.8	5.4	4.3	3.5	3.5	4.3
	(0.3)	(-0.7)	(1.9)	(1.4)	(1.2)	(0.8)	(0.8)	(0.7)		
Inflation & Financial Market										
Underlying inflation[2]	1.7	1.8	1.6	1.5	1.6	1.5	1.6	1.6	1.7	1.6
	(0.4)	(0.5)	(0.3)	(0.4)	(0.4)	(0.4)	(0.4)	(0.4)		
Headline Inflation	1.9	1.8	1.3	1.6	1.9	1.6	2.0	1.8	1.6	1.8
	(0.4)	(0.5)	(0.0)	(0.6)	(0.7)	(0.3)	(0.4)	(0.4)		
90-day Bill Rate[3]	2.0	2.0	1.9	1.5	1.0	0.9	0.9	0.9		
Trade Weighted Index[4]	62.6	62.0	60.9	60.2	59.1	58.9	58.9	58.9		
$A/$US rate (100)[4]	0.73	0.73	0.72	0.70	0.70	0.67	0.67	0.67		
Labour Market										
Unemployment Rate[4]	5.2	5.0	5.0	5.2	5.3	5.4	5.4	5.3	5.1	5.4
Employment Growth Rate[5]	2.4	2.3	2.2	2.5	2.5	2.2	1.9	1.7	2.4	2.1
	(0.6)	(0.6)	(0.6)	(0.6)	(0.6)	(0.4)	(0.3)	(0.4)		
Participation Rate[4]	65.5	65.6	65.7	66.0	66.2	66.3	66.3	66.3	65.7	66.3
Wage Price Index	2.3	2.3	2.3	2.3	2.2	2.2	2.2	2.1	2.3	2.2
	(0.6)	(0.5)	(0.5)	(0.6)	(0.5)	(0.5)	(0.5)	(0.5)		

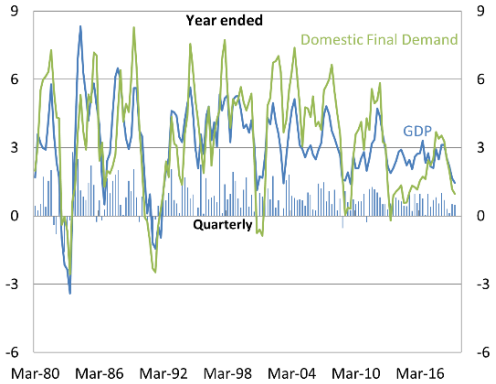
1: Actual in black and forecasts in blue; values in parentheses are quarterly growth rates. 2: As measured by the Reserve Bank's trimmed mean measure of inflation. 3: Average over last month in quarter. 4: Average of 3-months in the quarter. 5: Calculated from quarterly employment numbers that are averaged over the 3 months in the quarter.

Prepared by G. Lim and T. Robinson, Macro@MI. Data in this report were finalized on 25/09/2019.

Subdued growth in the Australian economy continues…

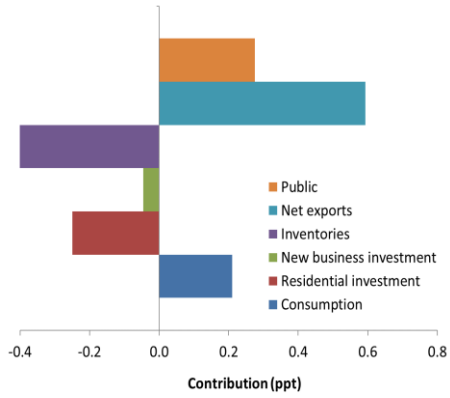
- The Australian economy grew by 0.5 per cent in the June quarter, a similar pace to the March quarter. Looking through the volatility, quarterly trend growth is 0.4 per cent. Over the year the economy grew by 1.4 per cent, its slowest rate since the financial crisis (Figure 1).
- A recent trend has been strong growth in Government consumption offsetting weak household consumption growth, and this was even more stark in the June quarter (Figure 2). Government final consumption expenditure increased by 2.7 per cent; this reflected higher spending by state and local governments, together with growth in National Disability Insurance Scheme (NDIS) spending.
- Household consumption growth ticked up in the June quarter, but remained weak at 0.4 per cent and only 1.4 per cent over the year. Household consumption is the largest component of the economy and so typically makes a substantial contribution to growth; in the June quarter it contributed only 0.2 per cent (Figure 2). This reflected factors such as low wages growth and falling house prices persisting, although there was a turn in sentiment in the housing market following the Federal election.
- The downturn in residential construction gained momentum in the June quarter. It fell by 6 per cent and the decline was broad based, with falls in the construction of both houses and attached dwellings.
- Lower non-residential construction weighed on new business investment, which fell by 0.4 per cent. Mining investment rose, whereas non-mining investment declined due to a fall in non-residential construction. The increase in mining investment is encouraging as for a long period after the mining boom, falling mining investment was a drag on overall growth.
- Inventories were run down, subtracting 0.5 percentage points from growth.
- Net exports were an important source of growth, contributing 0.6 percentage points. The positive aspect was that exports grew by 1.4 per cent, with growth in all categories except rural goods, which continue to be adversely affected by the drought. The negative aspect was that imports declined, reflecting weak growth in domestic demand.
- The 2018-19 final Australian Government budget outcome was an underlying cash deficit of $0.7 billion – essentially balanced. Payments were less than expected/forecasted in the 2019-20 Budget Statement, with lower-than-expected NDIS payments a contributing factor.
- Overall, the June quarter National Accounts were a continuation of recent trends with sluggish household consumption growth offset by public sector expenditure and net exports.

Figure 1: Growth
(chain volume, per cent)



Source: ABS

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

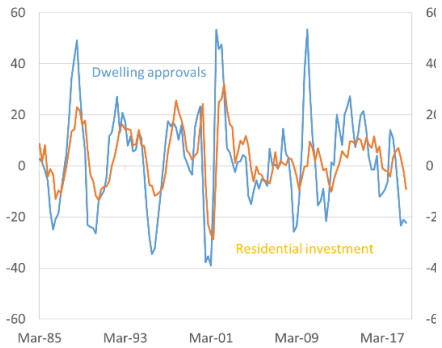


Source: ABS

Weak growth is likely to persist in the near term…

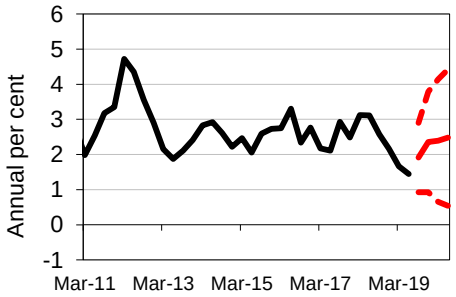
- Household Consumption: The RBA cut the cash rate in June and July, reaching a low 1 per cent. Despite this policy stimulus many of the timely indicators for household consumption growth have not signalled improvements. For example, the Westpac-Melbourne Institute Consumer Sentiment Index was 3 per cent lower in September than its pre-stimulus level in May. This softening primarily reflected weaker expectations, rather than current conditions. The retail sector, as measured by the NAB Business Survey, reported improved conditions in August, but the trend measures suggests it remains the weakest sector in the economy.
  - The one positive aspect for the consumption outlook is the strengthening in the housing market, particularly in Sydney and Melbourne. In addition to the interest rate cuts, the Australian Prudential Regulatory Authority (APRA) removed the requirement that lenders use a 7 per cent interest rate when assessing the ability of new mortgage applicants to service their loans.
  - Overall, we have made slight downward revisions to our already low consumption forecasts.
- *Residential investment:* building approvals, a leading indicator for residential investment, previously had been showing some tentative signs of stabilising, but this has ceased. Approvals for private dwellings other than houses, such as apartments, are more than 44 per cent lower than a year ago. Reflecting these declines in building approvals and the weak June quarter outcome we have lowered our forecasts for residential investment.
- *Business Investment:* The NAB Monthly Business Survey Business Conditions Index weakened in August and is at a below-average level. The more forward-looking confidence measure also fell and is below average. Business sentiment is another indicator and it is not showing the bounce one would have expected following the policy stimulus. Overall, our quarterly investment growth forecasts have been lowered, reflecting greater uncertainly about non-mining investment.
- *Trade:* Despite the ongoing trade tensions, we have revised up our near-term exports forecasts slightly. This reflects the June quarter outcome and more optimistic forecasts from the Department of Industry for both resources and energy exports, but also the depreciation. Our import forecasts have been revised slightly lower down due to the weak June quarter outcome and the softer near-term outlook for domestic final demand. Net exports are now expected to make a positive contribution until mid next year.
- *Overall growth prospects:* The Melbourne Institute expects below-trend growth to persist into 2020 (Figure 4).

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



Source: ABS

Figure 4: Growth Forecasts
(year-ended)

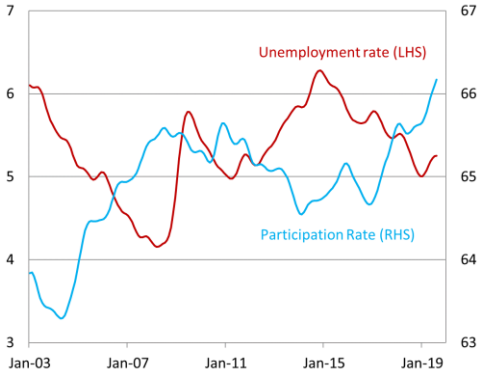


Source: ABS, Melbourne Institute

The labour market continues to be relatively positive …

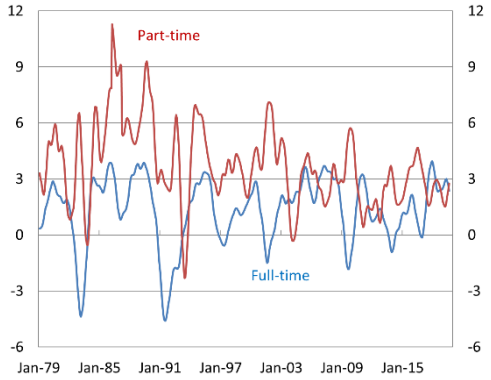
- The labour market continues to provide a more positive reading on the state of the economy than the activity indicators.
- The unemployment rate ticked up to 5.3 per cent in August (Figure 5). This increase occurred despite reasonable employment growth – monthly growth is currently around average - reflecting that labour force participation also moved higher (Figures 5 and 6). The trend participation rate is currently at its highest level on record. Essentially, it appears that growth in labour demand is failing to keep up with increases in supply.
- The employment-to-population ratio has continued to increase (Figure 7).
- A broader measure of slack in the labour market is the undertilisation rate, which includes those that are underemployed – working less hours than they desire – recently has increased by more than the unemployment rate. Nevertheless, the underutilisation rate is less than 0.2 percentage points higher than a year ago.
- Looking forward, the ANZ Job Advertisements Index recently has been volatile. Consequently, focussing on the trend measure, a softening in the outlook is evident. More encouragingly, the employment indicator in the NAB Monthly Business Index Survey has recently been broadly unchanged, although its current level is consistent with weaker employment growth.
- *Labour-market prospects:* It appears likely that the unemployment rate will increase slightly further in the near term, although considerable uncertainty surrounds the outlook. In particular, it is difficult to know how much further the participation rate will increase. In the medium term a gradual improvement in domestic demand growth, and a levelling out of the participation rate, is expected to result in the unemployment rate drifting lower (Figure 12).

Figure 5: Labour Market
(trend, per cent)



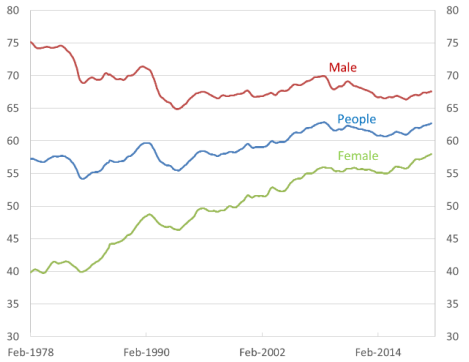
Source: ABS.

Figure 6: Employment Growth
(trend, year-ended, per cent)



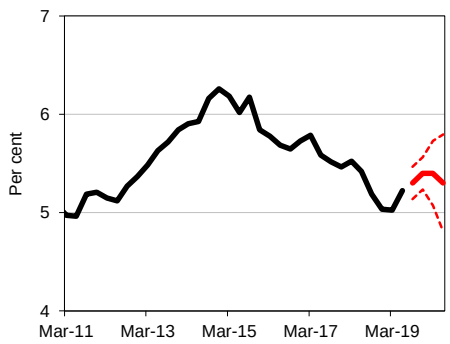
Source: ABS.

Figure 7: Employment to Population Ratio
(trend, per cent)



Source: ABS.

Figure 8: Unemployment rate
(per cent)

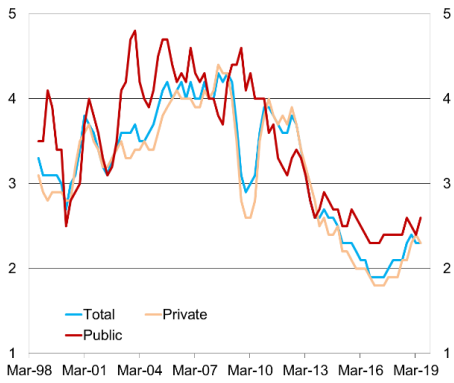


Source: ABS, Melbourne Institute.
The dashed lines are the 90% confidence bands.

Mixed signals on inflation prospects…

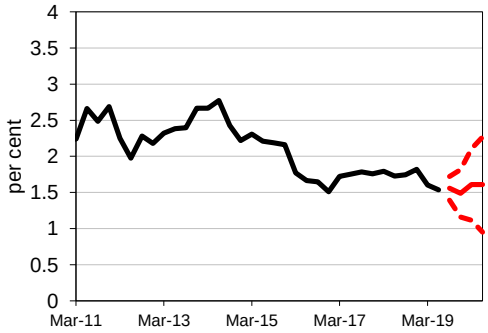
- The CPI rose 0.6 per cent in the June quarter (0.8 per cent seasonally adjusted), a step up from the March quarter outcome, with higher petrol prices an important factor. The CPI is 1.6 per cent higher over the year.
- The Reserve Bank focusses on measures of underlying, rather than headline, inflation. These are intended to give a better indication of the inflation which is likely to persist in the future. As such, they are less impacted by the higher petrol prices - the trimmed mean increased by 0.4 per cent in the June quarter, to be 1.6 per cent higher over the year.
- Private sector wages growth increased by 0.5 per cent in the June quarter, although the year-ended growth rate declined (Figure 9). Unit labour costs are productivity–adjusted wages and are an important determinant of inflation. Quarterly unit labour costs growth strengthened in the June quarter, to be 3.5 per cent higher over the year.
- Import prices are another important determinant of inflation, and these increased by 1 per cent in the June quarter. Recent drone attacks on Saudi Arabia have boosted international crude oil prices, which together with the depreciation in the A$ will boost import prices.
- Inflation expectation measures have continued to weaken. Consumer inflation expectations for a year ahead, as measured by the Melbourne Institute, fell to 3.1 per cent; this compares to an average of 4.4 per cent since 1995.
- *Inflation prospects:* In all, while there were a few positive signs in the June quarter, the medium-term prospects for inflation are little changed. The Melbourne Institute expects near term underlying inflation to remain below the bottom of the RBA's target band (Figure 10).
- *Monetary policy prospects:* The continued outlook for sluggish growth and low inflation makes a further interest rate cut likely in the near term. We believe, absent a major negative shock, the RBA is likely to take a cautious, gradual approach. Concerns about stimulating the housing market too much may limit the speed of policy easing. The RBA has recently taken to providing forward guidance that rates will remain low. The hope is that households will act now and increase consumption based on the expectations that future interest rates will remain low.
- Fiscal policy could also aid monetary policy in stimulating demand. The RBA Governor has repeatedly highlighted infrastructure spending; however, there may be capacity constraints. Major projects, e.g. building new highways, are only one type of infrastructure spending. Also, other fiscal responses are possible. For example, many commentators have noted that the current level of the Newstart allowance – Australia's unemployment social security payments – is very low.

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



Source: ABS.

Figure 10: Underlying CPI Inflation
(actual and forecast)

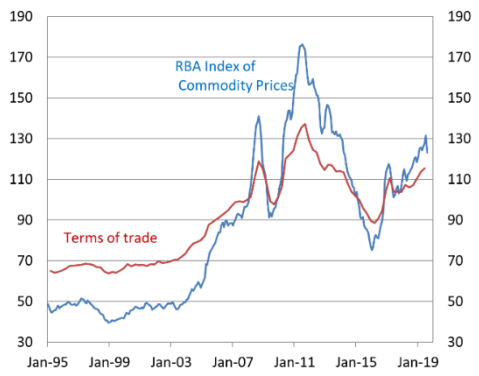


Source: ABS, Melbourne Institute
The dashed lines are the 90% confidence bands

The terms of trade improves further, but considerable uncertainty surrounds the global growth outlook

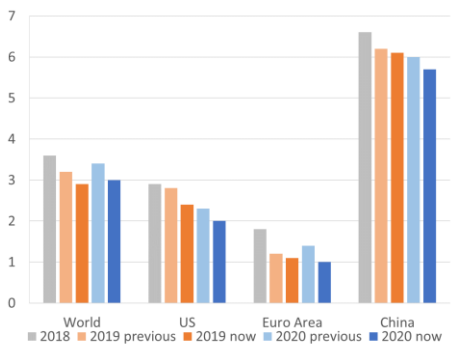
- The terms of trade - the ratio of export to import prices – increased by 1.4 per cent in the June quarter, to be nearly 9 per cent higher over the year. Australia's terms of trade are driven primarily by the prices of its commodity exports, particularly the bulk commodities – iron ore and coal. Supply issues in Brazil boosted the spot price of iron ore in the first half of the year. More recently, the RBA Index of Commodity Prices has fallen. Australia's terms of trade, therefore appears likely to fall in the near term.
- Falls in the terms of trade, if they eventuate, will weigh on income growth. Real net disposable income – a measure of living standards in a small economy – was boosted by the increase in the terms of trade in the June quarter, and grew by 1.4 per cent – considerably stronger than output – and was 4.4 per cent higher over the year.
- Turning to growth in the major overseas economies, in the US in the June quarter it slowed to 0.5 per cent, with lower business investment and exports as the two contributing factors. Some timely indicators for the US economy point to sluggish growth continuing. The trade war with China appears to be weighing considerably on US manufacturing. Employment growth has slowed, but the unemployment rate remains very low. Nowcasts of the pace of growth in the September quarter from the Atlanta Fed and the New York Fed suggest growth it is likely to be similar to the June quarter. The Federal Reserve eased monetary policy at both their July and August meetings.
- The Chinese economy grew by 1.6 per cent in the June quarter, taking year-ended growth to 6.2 per cent, down from 6.4 per cent in the previous quarter. Turning to the more timely data, in August year-ended growth in retail trade edged down, and there was a noticeable slowing in industrial production growth. Fixed asset investment growth over the year to August came in below market expectations. The People's Bank of China (PBOC) cut the reserve requirement ratio in September.
- The OECD in its September Interim Economic Outlook revised down its forecasts for the global economy in 2019 and 2020 (Figure 12). They noted these are the ``the weakest annual growth rates since the financial crisis, with downside risks continuing to mount."
- *Global growth outlook:* The global growth outlook has weakened further, although this has been accompanied by policy responses. A large degree of uncertainty, e.g. due to the trade war and Brexit, surrounds the near-term outlook. A depreciation in the exchange rate could occur if a geo-political shock were to eventuate, buffering the Australian economy.

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



Sources: RBA, ABS

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



Source: OECD
Note: Previous is the May Economic Outlook

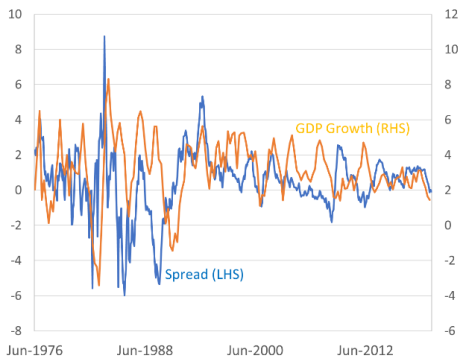
Australian Long Government yields are very low…

- Australian Government 10-year bond yields are now at a particularly low level by historical standards, even taking into account the shift down in the average inflation rate associated with the RBA adopting inflation targeting (Figure 13).
- In some countries, such as the US, long yields have fallen beneath their shorter counterparts, that is, the yield spread turned negative. This is taken to be an indicator of expectations of a recession.
- To understand this, one model of long yields is known as the Expectations hypothesis. This states that the long rate is the average of current and expected future short rates.
    - Consequently, long rates being lower than the current short rate is an indicator of expectations of short rates decreasing in the future. These could reflect a future monetary policy easing, driven by a weakening economy, such as a recession.
    - The Expectations hypothesis, however, empirically has proven to be an imperfect model. Persistent deviations from its predictions exist, known as term premia.
    - Australian yields often are considerably influenced by international developments.
- Presently Australian 10-year Government bond yields are lower than the cash rate. While this spread has some correlation with future growth, it is an imperfect indicator (Figure 14).
- Long yields are also important as they influence long-lived investment decisions. This influence, however, is muted by some firms resetting their hurdle rates – the required rate of return for an investment to earn in order for it to be undertaken – only infrequently.
- With the cash rate at a low level, the prospects of the RBA using unconventional monetary policy has been raised. One form this could take is the RBA purchasing bonds to lower long yields. While this may have a stimulatory effect, given their current low level it could be limited. Other forms of unconventional monetary policy do exist. Regardless, given the state of the federal budget and the economy, a fiscal response is desirable.

Figure 13: Australian Government 10-Year Yields
(Per cent)

Sources: RBA, calculations.

Figure 14: Yield Spread and Output Growth
(Per cent)



Sources: RBA, ABS, calculations.

Note: Spread is 10 year - effective cash rate

Table 2: Precision of the year-ended Forecasts for Australia

Precision of (year-end) Forecasts					
	2019 Sep	2019 Dec	2020 Mar	2020 Jun	Financial Year 2019/20
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		0.1	0.2	0.3	**0.3**
Headline Inflation		0.3	0.4	0.5	**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	0.1	0.2	**0.3**
Employment		0.1	0.2	0.4	**0.5**
Participation Rate		0.1	0.2	0.3	**0.3**
Wage Price Index	0.5	0.5	0.6	0.7	**0.4**

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