Media release

18 May 2016

Strict Embargo 10:30am

Leading Index still weak

The six month annualised growth rate in the Westpac-Melbourne Institute Leading Index, which indicates the likely pace of economic activity three to nine months into the future, rose from –1.51% in March to –1.08% in April.

Westpac Chief Economist, Bill Evans commented, “The Index has now been in negative territory for the last 12 months and continues to point to below trend growth in the economy throughout 2016. With trend growth generally assessed as 2.75% for Australia the Index is sending a more negative signal than both Westpac and official forecasts.

“The Reserve Bank recently released its revised growth forecasts for 2016 and 2017 and retained the forecasts from its February Statement on Monetary Policy at 3% for through the year growth in both 2016 and 2017. On the other hand, the Government was a little more circumspect , broadly consistent with the signals from the Leading Index and forecasting year average growth in both 2015/16 and 2016/17 at 2.5%. Arguably, the recent sharp deterioration in the growth rate of the Leading Index (five consecutive months where the growth rate is more than 1 percentage point below trend) is likely to be pointing to a more serious below trend growth performance in 2016/17 than indicated even by the government.

"Westpac is more optimistic than the Government with forecasts of 2.9% (2015/16) and 2.7% (2016/17) although slightly less optimistic than the Reserve Bank with forecast growth rates of 2.8% (through the year) in both 2016 and 2017.

"To test what is driving the Leading Index to produce a more downbeat outlook than the official forecasters and Westpac it is helpful to consider the contributions to the growth rate from the various components of the Leading Index. International factors dominate with US industrial production (–0.46 percentage points) and Commodity Prices (RBA Index) (–0.31 percentage points) contributing 0.77 percentage points of the 1.08 percentage point deviation below trend.

"Perhaps the official forecasters and Westpac are underestimating the importance of these international influences on Australia's growth prospects.

"Another "test" of the signals from the Index is to track the contribution to the growth rate of the Index from its components over the course of the last six months. Over that period the growth rate of the Index fell from 0.5 percentage points below trend to 1.08 percentage points below trend.

"The main contributors to the fall in the growth rate were: aggregate monthly hours worked (–0.37 percentage points) Westpac MI Unemployment Expectations Index (–0.10 percentage points); Westpac MI Consumer Sentiment Expectations Index (–0.12 percentage points); US Industrial Production (–0.19 percentage points); yield spread (–0.7 percentage points); RBA commodity prices Index (–0.06 percentage points); and dwelling approvals (–0.04 percentage points). Partially offsetting this fall was a less negative contribution of 0.36 percentage points from the ASX 200.

“An overall conclusion from this analysis is that international factors have generally been the source of the underperformance of the Index but in recent months a deterioration in components associated with the labour market have contributed to further weakness.

“The Reserve Bank Board next meets on June 7. We were surprised that the Board decided to cut the cash rate by 0.25% at its meeting in May. We underestimated the degree to which the staff lowered its inflation forecasts in the wake of the March quarter Inflation Report. On the basis of that Report the Bank lowered its underlying inflation forecasts for 2016 and 2017 from 2.5% and 2.5% respectively to 1.5% and 2.0% even after allowing for the rate cut. Presented with those forecast changes the Board would have had little choice but to take some action.

“We expect that further action will be required at the August meeting once more information about the inflation outlook is available following the release of the June quarter Inflation Report. Indeed the Bank’s current forecasts for inflation take into account the May rate cut and market pricing which, at the time, assumed a further cut. With the 2017 forecast for underlying inflation barely reaching the bottom of the target zone (2–3%) it is likely that a follow up move will be required.

"However we do not expect that move as early as June. It will be prudent to test the current forecasts with the benefit of the June Inflation Report which will not be available until late July", Mr Evans said.

Issued by: Westpac Banking Corporation

Bill Evans	Dr. Tim Robinson
Chief Economist	Melbourne Institute
Westpac Banking Corporation	Ph: (61-3) 83442325
Ph: (61-2) 8254 8531	