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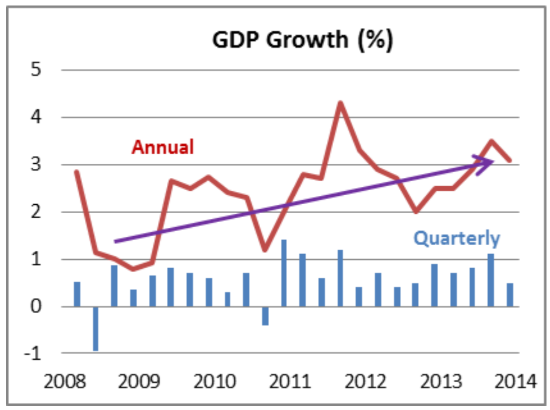
Australia: economic update - June quarter 2014



National accounts data for the June quarter show the Australian economy grew 0.5% in the June quarter, for **annual growth of 3.1%**. The accompanying graph shows Australia's volatile growth path since the financial crisis but annual growth barely slipped below 1% and an upward trend is evident across the five year period since.

June-quarter growth was less than half that of the March quarter but volatility, actual and statistical, in **resource exports** accounts for much of the drop. A big spike in resource exports in Q1 was due to a mild hurricane season in Northern Australia and a rundown in inventories, with these effects correcting in the second quarter.

Professional services, utilities, public sector administration and **agriculture** continued contraction evident over the past year. **Construction, health** and the rest of the **services sectors** saw continuing strength. **Manufacturing** had a strong quarter, expanding 2%. It may be that an extended period of contraction under a high currency might be bottoming out as firms make difficult adjustment.

Domestic demand grew a healthy 1.4% driven by rising housing construction and household spending, partially offset by falling public sector spending consistent with the government's budget consolidation programme. **Business investment** fell, mainly reflecting declines in mining investment and machinery and equipment purchase. Chronically low non-mining business investment is starting to pick up. Non-mining capital expenditure rose in Q2 and firms are upgrading their capital expenditure intentions over the next year. Surveys of **business confidence** and business conditions show their highest readings since 2010 (excluding a temporary spike around the September 2013 election and change of government) and augur well for rising economic activity in the non-mining economy.

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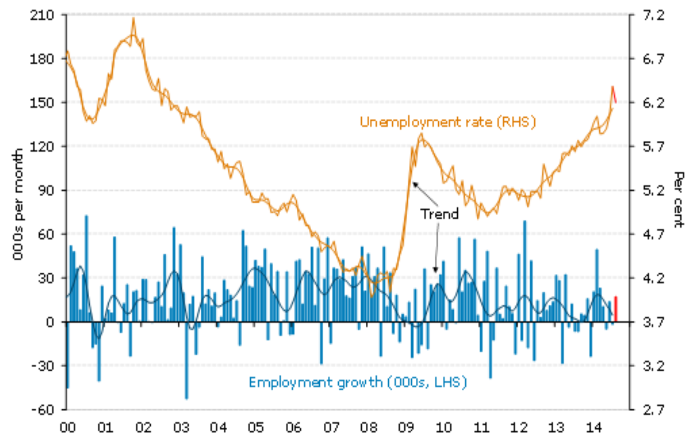
Unemployment has continued to rise up to mid 2014 with the jobless rate at 6.1% in August. Unemployment is now higher than the level it spiked to during the global financial crisis. The slowdown of 2013 continued to reflect in the lagging measures of unemployment, and continuing job shedding in the mining sector. This will go on but there are hopes the jobless rate is near its peak with forward indicators of job advertisements presaging higher rates of non-mining job creation.

Unemployment: Now higher than its financial crisis peak. *Source ANZ*



Labour **productivity** continues to improve after declining from the mid 2000s to 2012. The results are starting to show from businesses' focus on efficiency and cost control in a tighter economy, and the shift in the resources sector from labour intensive construction to capital intensive operations.

Australia's **terms of trade** fell another 4% last quarter, down 7% over the year as commodity prices, particularly for iron and coal, continue to fall. The trade terms are now 22% off their peak of 2011. This is having a negative impact not seen in the headline GDP figures. In real terms, i.e. discounting for inflation, the GDP numbers show an economy growing at healthy levels. But real GDP growth does not tell the whole story. **Nominal GDP growth**, the truer measure of actual incomes earned across the economy, is much weaker than average. **Income per capita** is lower over the past two years for the first time since the 1990s recession. The cause is sharply falling commodity prices in an economy where real growth has been driven by the resources sector. Australia might be selling higher and higher volumes of resource exports but it is earning less and less export income for each unit. The currency is not falling in response, as it historically has done, and so not cushioning the impact. This is hitting company profits (down 3.7% last quarter alone) and, with flow through to wages and the wider economy, keeping a lid on domestic demand. In turn, businesses are loath to invest and employ, hampering the required transition in growth from mining to the wider economy.

Official **interest rates** remain at a record low for Australia at 2.5%, and will likely stay steady into 2015 with the central bank making clear rates won't be going any lower to support growth. The governor says his work is done and that trying to reduce unemployment by "further inflating an already elevated level of house prices would seem an unwise route". **Inflation** is well contained

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at 2.8% by the central bank's underlying measures, supported by the high currency and low wages growth.

Australia is the first country to both implement and withdraw a **carbon price** and evidence emerging suggests the impacts on inflation and business costs have been overstated in both events. Based on Treasury modelling, the central bank has concluded that the tax impact on energy prices, the main channel of price transmission, contributed around 0.25 ppts to headline inflation, a third of that originally predicted. Commonwealth Bank analysis finds the other indirect effects were also overstated with major corporations not passing on the carbon tax to any great degree after its introduction. The central bank now estimates the carbon tax's removal would reduce CPI growth by 0.75% in 2014-15, mainly through reducing energy bills. But Comm Bank argues that again the impact is being overestimated because if the initial impact was less there must also be less to hand back.