

Australian economy expands in Q1, but it is not all good news

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For ANZ Economics and Markets Research to be the most respected, sought-after and commercially valued source of economics and markets research and information on Australia, New Zealand, the Pacific and Asia.

Key Points

- Australia has so far managed to avoid a technical recession, with real GDP expanding by 0.4% in Q1 following a 0.6% contraction in Q4 2008.
- Households are responding positively to significant monetary and fiscal policy stimulus, with household consumption rising 0.6% in the quarter. However there was evidence of distress in the business sector in Q1, with production, investment and inventories all falling in the quarter.
- Unfortunately, higher consumer spending was not enough to prevent a contraction in domestic spending overall. Domestic demand contracted by 1.0% in Q1, driven by sharp falls in private business investment, dwelling investment and government investment. All states experienced a fall in demand with the exception of South Australia.
- Instead it was net exports which helped keep spending growth in positive territory (adding 2.2ppts to growth), largely due to a sharp drop in import volumes.
- Production in the economy was notably weak, falling by 0.9%, with the manufacturing sector falling sharply for a second consecutive quarter.
- Today's figures confirm that Australia has weathered the global financial storm much better than other advanced economies.
- However, we remain concerned that the economy may falter later in the year. The significant contribution from net export volumes cannot be sustained, and the economy is yet to experience the full impact on incomes from lower export prices, particularly for bulk commodities. In addition, there remain significant risks to household spending going forward as unemployment rises and the positive impact of cash handouts starts to wear off, particularly given that households have started to cut back on precautionary savings. The higher Aussie dollar and term interest rates also represent a significant tightening of financial conditions, and if sustained could reduce the benefit of lower official interest rates.

Figure 1: Key Figures

	Quarterly growth (%)		Yearly growth (%)
	Mar-09	Dec-08	Mar-09
Real GDP (A)	0.4	-0.6	0.4
Non-farm GDP	0.5	-0.8	0.0
Domestic demand	-1.0	0.0	0.5
Net exports	2.2	1.7	3.2
Real GDP (E)	1.1	0.4	1.8
Real GDP (P)	-0.9	-0.6	-0.6
Real GDP (I)	0.9	-1.5	-0.1
Nominal GDP (I)	-0.1	-1.1	5.0
GDP price deflator	-1.0	0.3	5.1
Terms of trade	-7.8	-2.9	5.8
Household savings ratio	1.8	6.9	-

Source: ABS

Australian economy expands in Q1...

Australia has so far managed to avoid a technical recession. Real GDP expanded by 0.4% in Q1 2009 following a 0.6% contraction in Q4 2008. This was stronger than the market had been expecting (+0.2%), but in line with our forecast (+0.4%). The yearly rate of growth actually eased to 0.4% from 0.8% (revised up from 0.3%).

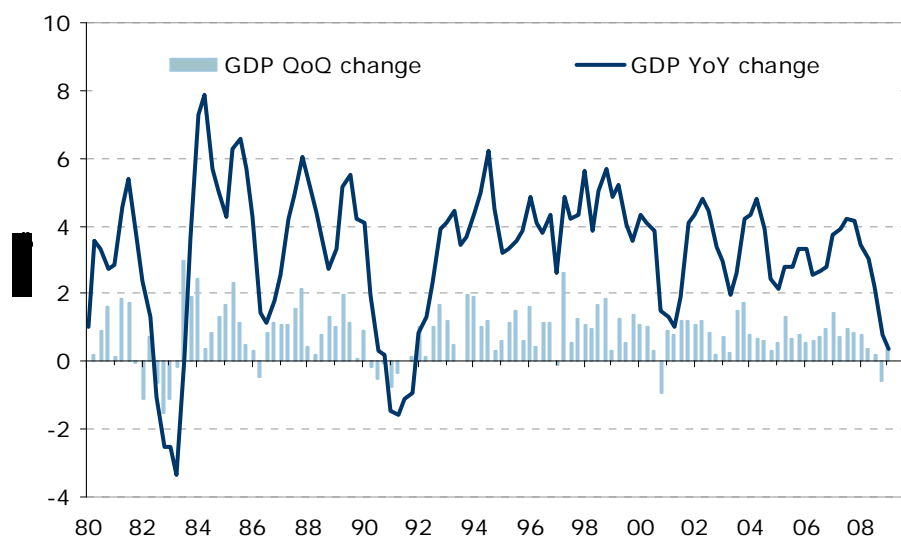
Today's data confirms that the domestic economy overall is responding positively to significant monetary and fiscal policy stimulus implemented since September last year. Households in particular are increasingly confident increasing spending and cutting back on precautionary savings. Household consumption rose by 0.6% in Q1 2009, the highest rate of growth in a year, and the household savings rate dropped sharply to 1.8% from 6.9%.

Unfortunately, higher consumer spending was not enough to prevent a contraction in domestic spending overall. Domestic demand contracted by 1.0% after being unchanged in Q4, driven by sharp falls in private business investment, dwelling investment and government investment. All states experienced a fall in demand with the exception of South Australia.

In fact it was international trade which kept growth on the positive side of the ledger. This in itself is not particularly encouraging as it was mostly driven by a collapse in imports (-7%), with consumption, capital and intermediate imports all down sharply, suggesting that firms were concerned about the economic outlook and unwilling to purchase capital equipment or replenish stock levels. A large cyclical bounce in rural export volumes also helped.

Overall, the expenditure measure of GDP expanded by 1.1% in Q1 (aggregate GDP is a composite of the expenditure, income and production measures of GDP). **But it is not expenditure in the economy which is experiencing the largest adjustment. Production in the economy fell a massive 0.9% in Q1** following a 0.6% contraction in Q4 2008. Indeed the production measure of GDP is down 1.8% in YoY terms. **Manufacturing output continued to bear the brunt of the downturn,** falling another 3.3% this quarter (now down 9% from a year ago). Agriculture and mining also saw their real output shrink in the quarter, as did property and business services, wholesale trade and transport. Stronger household spending managed to keep retail trade positive, but activity in hospitality and recreational services both fell in quarterly and annual terms.

Figure 2: Real GDP growth



Source: ABS and ANZ

Income in the economy was positive in real terms in Q1, however this largely reflects a fall in prices (with nominal GDP(I) falling by 0.1%) and strong growth in public sector and financial sector profits. Profits for non-financial corporations fell by 0.3% in Q1

and household disposable income dropped by 3.2% in nominal terms (-4.1% in real terms).

Price indicators in today's release generally pointed to weaker inflationary pressures going forward. This will provide further room for the RBA to cut interest rates later in the year should economic conditions deteriorate again (see below). In particular, while measures of productivity were mixed, real labour costs fell by 1.2% in Q1 with the national accounts measure of wages posting no growth in nominal terms after growing by an average 1.5% per quarter through 2008. Prices in the economy overall fell sharply in Q1 by 1.0%, driven largely by lower exports prices.

... but risks remain going forward

Today's positive result confirms that Australia has weathered the global financial storm much better than all other like economies, with GDP contracting in all other advanced economies in Q1 for which we have information available. **Unfortunately however, the composition of growth is not as reassuring. The business sector is clearly struggling, with investment, production and inventories all falling in the quarter.** So while the household sector (and the retail industry) are benefiting from policy stimulus, the business sector overall was not experiencing the same boost in Q1 and remained cautious in the current uncertain environment.

Looking forward however, the recent appreciation of the Aussie dollar and higher term interest rates represent a significant tightening of financial conditions in recent months and may soften the benefit the economy is receiving from lower official interest rates.

More broadly, we remain concerned that factors propping up growth this quarter cannot be sustained for a number of reasons:

- There remain significant risks to household expenditure later in the year as unemployment rises and as stimulus from cash handouts and lower interest rates wears off. Part of the acceleration in household consumption was driven by a fairly sharp fall in the household savings ratio, which is of concern for household finances and consumer spending should unemployment continue to rise from here.
- National income will receive a large hit in Q2 from lower bulk commodity prices and the massive contribution from net export volumes will not be continued; another sharp fall in imports is unlikely, rural exports cannot continue to rebound at the same rapid pace, and there are significant downside risks to hard commodity exports, particularly if China ceases stockpiling bulk commodities.

On the positive side, ambitious infrastructure plans should see government investment add to growth going forward, although this is unlikely to be enough to offset sharply lower business investment.

Today's figures are stronger than policy makers had been expecting, and support the view that the RBA will be on hold in coming months. Focus will now shift towards more timely economic indicators and evidence that this rebound can be sustained. There remain substantial challenges ahead for the domestic economy, and the RBA has clearly signalled that it is poised to cut rates further if necessary. As such, **we believe that the risks to policy rates later in the year remain to the downside.**

The expenditure detail

The figures on the **expenditure side of GDP** highlighted the diverging performance of different segments of the Australian economy:

- **Household consumption** expanded by 0.6% in the quarter, the strongest quarterly rate of growth since Q1 2008 and suggesting the household sector is responding to policy stimulus by increasing spending and decreasing savings. Indeed the household savings rate dropped sharply to 1.8% from 6.9% in Q4 2008. Spending was strong across most categories with the exception of vehicle purchases and spending on health and furnishings and household equipment. Spending on hotels, cafes and restaurants rose particularly sharply (+1.5%) after falling in the previous four quarters.
- **Net export volumes** were the major driver of GDP growth in the quarter, adding 2.2ppts. A rise in export volumes of 2.7% (largely due to higher rural exports) and

a 7% collapse in import volumes (driven by lower consumption, capital and intermediate goods) both contributed to growth.

- On the other hand, businesses were also very cautious in the quarter with **private investment** (ex transfers) contracting 6.3% in the quarter. Investment in machinery and equipment (-9.6%) fell particularly sharply, but investment in new building (-5.4%) and engineering construction (-4.4%) also posted large falls.
- The other sectors that declined in the December quarter were dwelling investment and public spending. **Dwelling investment** fell by 5.6% following a 2.6% drop in Q4. While rebounding housing finance and building approvals suggest the housing market is responding to lower interest rates and the FHOG boost, this is unlikely to support housing construction until late in 2009 and 2010.
- **Public spending** dropped by 0.3%, largely driven by a surprise 2.5% drop in government investment, with defence and non-defence capital spending both falling. Recently announced boosts to infrastructure spending are clearly yet to come on stream and may take some quarters yet. Government consumption (which mostly measures the public sector wage bill) was also subdued, growing by just 0.3% in the quarter.
- **Inventories** were neutral for growth in Q1 because inventories were run down at the same pace as in Q4. However, the fact that firms continued to run down stock levels quite aggressively suggests businesses remained concerned about the economic outlook. It also suggests some upside risk to GDP growth going forward, since production will have to pick up at some point to help replenish diminished stock levels.

Figure 3: Real expenditure components – March quarter 2009

	Quarterly growth (%)		Yearly growth (%)	Cont'n to quarterly growth (ppt)
	Mar-09	Dec-08	Mar-09	Mar-09
Household consumption	0.6	0.3	0.8	0.3
Dwelling investment	-5.6	-2.6	-5.7	-0.3
Business investment ¹	-6.3	0.5	0.3	-1.2
Public demand ¹	-0.2	-0.4	1.9	0.0
Domestic demand	-1.0	0.0	0.5	-1.1
Change in inventories	-	-	-	0.0
Gross national expenditure	-1.0	-1.3	-1.4	-1.1
Exports	2.7	-0.8	3.5	0.5
Imports	-7.0	-7.6	-10.3	1.6
Net exports	-	-	-	2.2
Real GDP (E)	1.1	0.4	1.8	-
Statistical discrepancy	-	-	-	-0.7
Real GDP (A)	0.4	-0.6	0.4	-

¹ Excluding transfers. Source: ABS and ANZ

Dr Alex Joiner
Economist

Income growth weak

The income measure of GDP rebounded strongly in real terms in Q1 to be up by 0.9% due to a negative deflator of 1.0%. However, in nominal terms the income measure was down 0.1%, after falling 1.1% in the previous quarter.

The national accounts measure of **profits**, the gross operating surplus (GOS), improved by 1.0% in the quarter. The profit share of total factor income rose marginally to 26.9% after a marked fall last quarter to remain at near historical highs.

Corporate GOS overall was up 0.4% in the quarter led by solid growth for the public non-financial corporations (up 4.3%). GOS for financial corporations was up a solid 3.7%, while private non-financial GOS fell 0.3% (note that company gross operating profits data on Monday fell by 7.2%). The decrease in GOS for private non-financial corporations was centred in the manufacturing sector which recorded sharp falls as did the mining and property & business services sectors. Retail trade was the standout performer with double-digit growth, clearly benefiting from lower interest rates and government handouts supporting consumption. The transition from the private to the public sector will be a key theme in the economy generally going forward and will be key in supporting growth in the back-half of this year.

The household sector also did not fare too well in income terms **with gross household disposable income falling** by 3.2% in the quarter. This was on the back of a 1.1% fall in the compensation of employees and weak employment figures in the quarter and was despite income payable on debt servicing falling sharply. This saw the wages share of factor income fall slightly to 52.9%. The weakness in household incomes did not seem to deter spending too much (household consumption rose 0.6%) and as such the savings ratio fell sharply to 1.8% from 6.9% the previous quarter. This raises concerns for spending in coming quarters as government handouts wane in influence and unemployment rises.

The nation also took a pay cut with **real gross domestic income (GDI)** contracting another 1.4% in the quarter as the downturn in the commodities cycle continues to weigh on the terms of trade.

Productivity mixed

Australia's productivity performance was mixed in Q1. GDP per hour worked increasing 1.6% on the back of a 1.2% fall in hours worked. The fall in hours worked is to be expected as employment falls and part-time employment becomes more prevalent. However, productivity in the market sector fell 0.6% despite a 0.9% fall in hours worked.

Industry performance

The key themes emerging from the performance of industries this quarter were:

- (1) Our export-oriented sectors are in difficulty, with quarterly falls in real output (gross value added) recorded in manufacturing, mining and agriculture, as well as the tourism-oriented sectors of hospitality and recreational services. Alone among the big exporting industries, education activity remained solid. The flow-on effect of declining activity in these sectors can be seen in the weak performance of wholesale trade and transport, both of which declined despite continuing growth among retailers.
- (2) The effect of plummeting business investment expenditure is already clearly evident in the construction industry and in property and business services (down 2.4% and 2.6% QoQ respectively). The effects of the global financial crisis are still being felt also, with the value of activity the finance and insurance sector falling another 0.5% to finish 0.1% down from a year ago.
- (3) Household and government consumption are clearly holding the fort, as can be seen in the relatively better performance of the giant retail, health and education sectors. Personal services and utilities also performed relatively well this quarter.

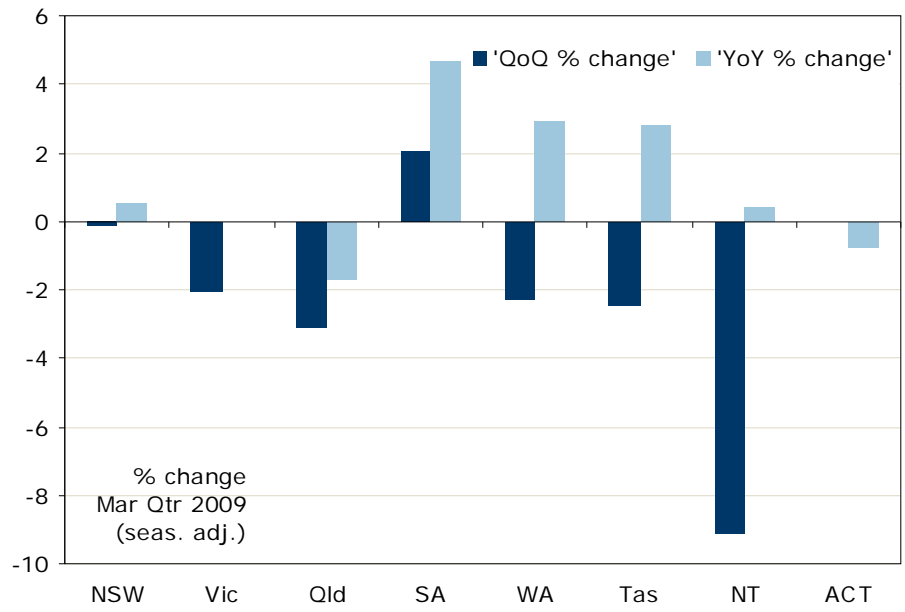
State by State

State final demand (which measures state consumption rather than production) fell in all states except South Australia in Q1 2009 (QoQ). South Australia also made the strongest showing in annual growth terms. This result was wholly driven by private fixed capital formation (i.e private sector investment), which was negative in all states except South Australia. Adding to this weak investment story, public fixed capital formation (i.e. public sector investment) was flat or negative this quarter in all states except WA, reflecting the slow speed at which the recently announced government infrastructure projects are coming onstream. Household consumption was flat or positive in all states, reflecting the widespread benefits of the government stimulus.

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Figure 3: State final demand



Source: ABS and ANZ



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