

Australian economy rebounds

Economic research note

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- The Australian economy grew by 1.2%/qtr in Q2 2011, above the consensus forecast of 1.0% and up from the natural disasters led -0.9% in Q1 2011. The annual pace of growth also rebounded, up to 1.4%/yr from 1.0%/yr in Q1 2011.
- Economic growth during the quarter was driven by household final consumption spending up 1.0%/qtr (contributing 0.5% points to growth), private sector capital spending also up 1.3%/qtr (+0.1% points contribution), while public sector capital spending fell 3.8%/qtr as stimulus spending wound down.
- The household savings rate fell to 10.5% from a flood payment impacted 11.7% in the previous quarter, still a high savings rate and indicating the cautious consumer remains despite some underlying signs of consumer demand.

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Australian economy rebounds:

The Australian economy rebounded in Q2 2011 by 1.2%/qtr after falling by a revised 0.9%/qtr (was -1.2%/qtr) in Q1 2011 post the natural disasters. The annual pace of growth also rebounded, to 1.4%/yr from 1.0%/yr in Q1. The pace of growth looks still looks unusually low following a very strong +1.4%/qtr in Q2 2010 and masks some of the underlying strength seen in today's data.

The mix of economic growth in the quarter was interesting with household final consumption spending up 1.0%/qtr (contributing 0.5% points to growth), contrary to expectations and read through from retail sales data. Private sector capital spending was up 1.3%/qtr (+0.1% points contribution), driven by a 4.9%/qtr increase in machinery and equipment, no surprise given mining and gas projects progressing over the quarter.

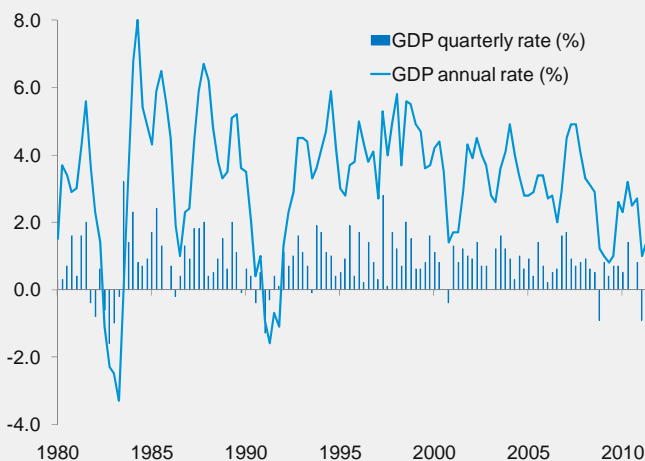
Public sector capital spending fell 3.8%/qtr as federal stimulus measures were unwound as expected. In addition, changes to inventories contributed to growth by a very large 0.8% points on the quarter.

These sources of growth were partially offset, however, by a -0.5% points contribution from net exports, with a 2.6%/qtr increase in exports and a 4.3%/qtr increase in imports. This compares to -2.2%/qtr fall in net exports in Q1 2011 due to natural disasters. The increase in imports suggests that the large pipeline of mining and gas capital expenditure has begun in earnest, but a substantial amount of capital goods to be imported given the strength in the Australian dollar. This was a theme also picked up on the recent company earnings season.

Importantly, Australia's terms of trade rose by a further 5.4%/qtr in Q2 2011 to a new record high. This gain in the terms of trade will provide further income flow into the economy in the quarters ahead and will continue to be a strong support for the economy.

Another theme evident in the release was the strength of the income side of the Australian economy. A broad measure of real disposable income (a measure of the economy that takes into account the terms of trade), rose by 2.6%/qtr. This gives an increase of 6.5% in real gross domestic income for the 2010/11 financial, the largest annual increase since 1987/88.

Australia quarterly and annual economic growth rates:



Source: ABS

Significantly, the national accounts also showed that the household savings rate retreated to 10.5% from a revised 11.7% in Q1 2011 (was 11.5%). This is at odds with recent thinking about ongoing household caution given global events, but a move higher in Q3 2011 cannot be ruled out in light of recent market volatility. The Q1 2011 savings measure was likely impacted by the savings of flood assistance packages which may have been unwound in Q2 2011

The fall in the savings rate came with a strong performance by the consumer. This is at odds with retail sales data over 2Q which showed ongoing weakness. It is important to remember that retail sales data only represents roughly 30% of all consumer spending. If we examine the national accounts data, it shows consumer demand rising 1% over the quarter in volume terms. This was driven by spending on transport services (+5.9%/qtr), recreation & culture (+3.1%/qtr) and hotels, cafes & restaurants (+3.0%). The consumer is willing to spend, but the composition and mechanism (though switching online) is changing.

From the RBA's perspective and for the financial markets more broadly, the Q2 11 GDP report is likely to be seen as the beginning of the recovery in economic growth post the natural disasters and before the large capital expenditure pipeline begins in earnest. This release also suggests that the economy can grow without the consumer recording above trend growth rates.

The savings rate at 10.5% shows consumers continuing to exercise caution, albeit at a lower rate than Q1 2011, boosted by flood payments in Queensland. This still high savings rate is no surprise given the global economic environment and expectations of higher official interest rates. Household consumption growth of 1%/qtr does show the importance of strong income growth in helping loosen consumers' wallets. Compensation per employee rose a strong 1.7%/qtr.

What does this mean for the RBA? In recent weeks the RBA has begun to communicate a level of comfort with leaving interest rates on hold.

Much of the discussion centres around the impact of global issues on uncertainty and confidence in Australia. In a speech just prior to the release of the GDP data, Governor Stevens noted "that recent global events "probably won't have much effect on the large-scale investment plans in the resources sector, but households and firms watching what is happening may continue their precautionary behaviour for longer than otherwise".

The RBA has also acknowledged that if this weaker demand eventuates it could dampen wages pressure and price setting behaviour and "curtail the upward trend in inflationary pressures that has, up to this point, appeared to be in prospect". There is obviously a counter argument to this, being low levels of productivity, the mining and gas boom and rising administrative process, particularly electricity.

In this uncertain environment it is likely to see the RBA leave interest rates on hold well into 2012. What recent speeches and today's GDP data does not do is ratify market expectations of an imminent and substantial easing of monetary policy in Australia.

Other highlights:

- On an industry basis, most sectors contributed positively to growth, except financial and insurance services, which detracted 0.1%pts.
- The strongest sectors were manufacturing and transport, both contributing 0.2%pts to GDP growth. The growth of manufacturing sector is contrary to expectations given the strength of the Australian dollar, but represents underlying demand in the Australian economy.
- On the expenditure side, inventories added 0.8% points to GDP, coming mainly from the manufacturing and mining industry.
- The terms of trade boom continued, reaching a new record of 122.6 from 116.3 in the previous quarter.
- Compensation of employees rose 1.7% in the quarter, to be up 7.5% for the year – which reflects a rise in average earnings of 1.2%. This suggests that proceeds from the higher terms-of-trade (up 5.4%/qtr) are flowing through into the broader economy.
- The profits share of income remains relatively high at 28.1% up in the quarter from 27.1%. Wages share fell slightly to 53.1%, from 53.7%, likely reflecting the large increase in company profits from the mining sector.
- Corporate profits rebounded sharply, up 10.1% for the quarter, with the mining sector a key contributor.
- Household consumption increased by 1%/qtr and the household saving ratio fell from 11.7% in the March quarter to 10.5% in the June quarter. The fall in the savings rate was a surprise, although Q1 2011 was likely impacted by flood assistance payments.
- On a state level, the strongest growth was in Queensland up 3.5% for the quarter, which mostly reflects the delayed recovery from the floods earlier in the year.
- South Australia was also surprisingly strong, up 2% for the quarter.

- This could reflect SA's close proximity to the resources sector and the development of Olympic Dam.
- Western Australia grew by 1.0%/qtr and the Northern territory grew by 1.1%/qtr. Tasmania and ACT both had negative growth, down -0.5%/qtr and -0.7%/qtr respectively.
- Victoria and New South Wales both experienced weaker growth than the key mining states, signs that a two-speed economy may still exist.

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