ECONOMICS WEEKLY

2 December 2016

AUSTRALIAN ECONOMIC DEVELOPMENTS

This week the Organisation for Economic Co-operation and Development (OECD) updated its global forecasts. For Australia, the OECD expects Australian GDP to pick up to 3% p.a. by 2018, following growth of 2.7% in 2016 and 2.6% in 2017. Mining investment is still tapering off, but the OECD expects household consumption, non-mining investment and exports to support growth. Wages and employment are expected to pick up, with unemployment expected to fall to around 5.3% by 2018. Inflation is expected to remain relatively weak, picking up to only 2.1% by 2018, from the current low CPI rate of 1.3% p.a. (see Table 1).

More controversially, the OECD said it expects Australia's Reserve Bank (the RBA) to start lifting the cash rate from late 2017, in response to perceived asset-pricing risks in Australia's housing market. The OECD also suggests a more expansionary fiscal policy (that is, government spending and investment) would be appropriate in Australia in response to slowing economic growth, given the relatively low level of Government debt (although this advice from the OECD is somewhat contradictory to Australia's widely-acknowledged operating budget deficit problem and the 'negative watch' ratings implemented recently by various credit ratings agencies). The OECD recommends more Australian Government investment in infrastructure (transport and telecommunications) and in workforce skills development, so as to boost national productivity.

Australian data this week confirmed the main risks to the Australian economic outlook at present: commodity prices; the Australian dollar; the local housing cycle and local business investment. More positively in November, Ai Group's **Australian PMI®** showed a stronger recovery in manufacturing after a weak patch in Q3. Forward indicators suggest more growth ahead and a broader base of growth across manufacturing sectors. Exports continue to provide a much-needed source of growth, as manufacturers benefit from the lower Australian dollar.

Risks to the Australian economy in 2017: commodities and FX

One of the key global risks to the Australian economy is always the commodity cycle and commodity prices. Higher commodity demand and prices (especially for iron ore and coal) add to Australia's national income, but they also tend to push up the Australian dollar, which makes other exports less competitive. This has been evident again through 2016, with strong rises in ore and especially coal prices. The RBA's bulk commodities index rose by 15.6% m/m in November, to be 61.9% higher than a year earlier. This helped push the Australian dollar above US0.76 by October (back to US0.74 in November), from around US0.70 cents a year earlier (see chart 1).

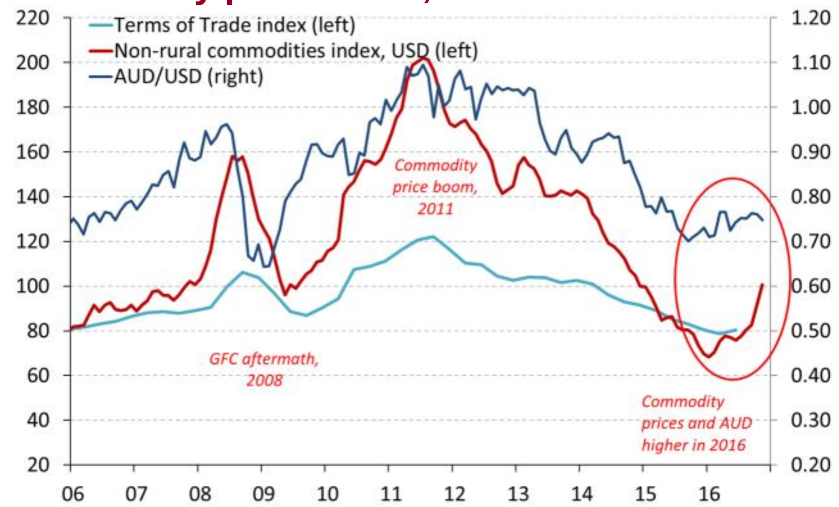
Table 1: Australian economy and OECD forecasts, November 2016

	2013	2014	2015	2016	2017	2018
	Current prices AUD billion	Percentage changes, volume (2013/2014 prices)				
GDP at market prices	1 555.6	2.7	2.4	2.7	2.6	3.1
Private consumption	855.7	2.8	2.8	2.7	2.6	3.0
Government consumption	280.2	0.6	2.9	3.7	1.7	2.0
Gross fixed capital formation	430.0	-1.9	-4.0	-0.2	-0.9	1.5
Final domestic demand	1 565.9	1.1	1.0	2.2	1.6	2.5
Stockbuilding[1]	0.1	0.0	0.0	-0.9	0.0	0.0
Total domestic demand	1 566.1	1.1	1.0	1.3	1.6	2.4
Exports of goods and services	318.9	6.7	5.8	7.1	7.0	7.1
Imports of goods and services	329.4	-1.7	1.5	-0.2	1.9	3.8
Net exports[1]	- 10.5	1.7	0.9	1.4	0.9	0.6
Memorandum items						
GDP deflator	_	0.1	-0.7	0.3	1.9	1.8
Consumer price index	_	2.5	1.5	1.3	1.8	2.1
Private consumption deflator	_	2.1	1.5	1.1	1.7	2.2
Unemployment rate	_	6.1	6.1	5.7	5.5	5.3
Household saving ratio, net[2]	_	9.5	8.4	8.0	7.8	7.4
General government financial balance[3]	_	-2.3	-1.8	-2.6	-2.0	-1.5
General government gross debt[3]	_	42.3	44.5	45.4	45.1	44.6
Current account balance[3]	_	-3.0	-4.8	-3.5	-2.5	-1.9

1. Contributions to changes in real GDP, actual amount in the first column.
2. As a percentage of disposable income.
3. As a percentage of GDP.

Source: OECD Economic Outlook 100 database.

Chart 1: RBA commodity price index, Australian dollar and terms of trade



Risks to the Australian economy in 2017: flat business investment

Within the Australian economy, the key risk to the outlook is flat business investment. Confirming the OECD's expectations of a slower year for Australia in 2017, business capital expenditure (CAPEX) dipped by a further 4% in Q3 2016, to be 13.7% lower than a year earlier. And after adjusting for typical realisations of investment (applying a 'realisation ratio'), the latest (fourth) estimate of CAPEX for 2016-17 implies a drop of around 19% in 2016-17 compared to 2015-16.

Total CAPEX undertaken in Q3 2016 fell by 4.0% in Q3 2016, to be down 13.7% p.a. (seasonally-adjusted and inflation-adjusted, see table 2). Most of Q3's CAPEX decline was in spending on buildings (-5.7% q/q and -24.3% p.a.) and spending by the mining industry (-7.2% q/q and -35.1% p.a), neither of which were unexpected. Mining CAPEX is now more than 60% below its 2012 boom-time peak. ANZ Economics calculates that as a share of the total Australian economy, this represents a fall in mining CAPEX from more than 9% of GDP in 2012 to around 3.5% in 2016. It is projected to fall further as the current set of major projects are completed (see table 3).

For the non-mining industries, a long-awaited pickup in CAPEX is proving elusive. Manufacturing CAPEX fell a further 4.9% q/q in Q3, while other non-mining industries' CAPEX fell 1.9% q/q, but were still up 6.4% up on a year earlier. Across the states, CAPEX fell in Q3 in all states except Victoria and Queensland. It was higher in Q3 than a year earlier in only NSW and Victoria.

Table 2: actual real CAPEX, by type, industry and state, Q3 2016

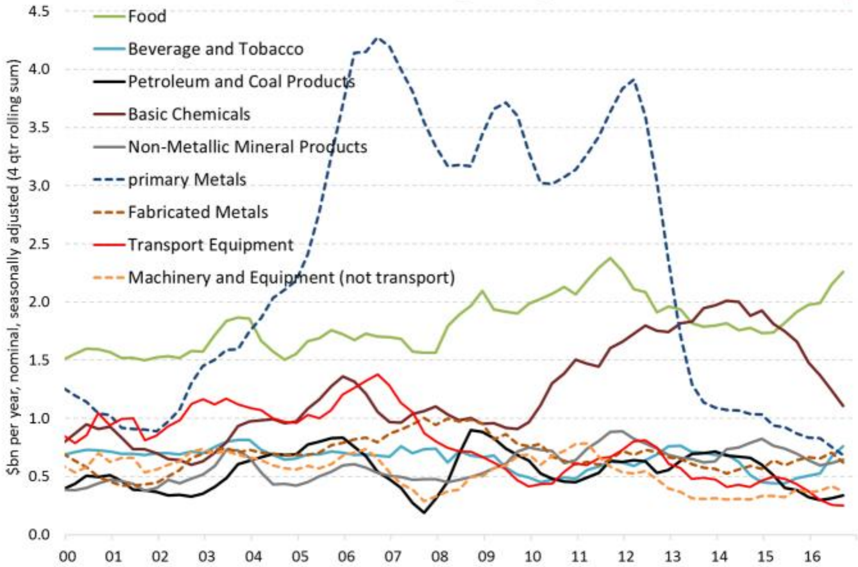
Seasonally adjusted real CAPEX	$mn per qtr	%q/q	%y/y	% of total
By type of asset:				
Buildings & structures	15,626	-5.7	-24.3	63.2
Equipment, plant & machinery	2,404	-1.9	4.6	36.7
By Industry:				
Mining	9,802	-7.2	-35.1	34.9
Manufacturing	2,035	-4.9	-6.3	7.4
Other selected (non-mining) industries	16,193	-1.9	6.4	57.7
All industries other than mining	**18,228**	***-2.3***	***4.8***	***65.1***
By state:				
NSW	7,173	-3.5	19.1	25.8
Vic	5,068	3.4	8.2	18.0
Qld	5,385	2.7	-16.2	19.3
SA	1,186	-4.8	-7.3	4.3
WA	7,562	-11.4	-37.7	26.9
Tas	220	-9.1	-6.8	0.8
NT	1,265	-10.0	-17.3	4.4
ACT	192	-8.1	-11.5	0.7
All CAPEX	**28,030**	**-4.0**	**-13.7**	**100.0**

Source: ABS, *CAPEX*, Sep 2016.

Digging into the more detailed data reveals some interesting CAPEX trends within manufacturing (nominal CAPEX, see chart 2). This highlights that the decline in manufacturing CAPEX in recent years has been driven mainly by sharp drops in three big sectors. Over the past two years there has been a sharp decline in CAPEX by the primary metals and basic chemicals sectors from recent peaks that were associated with resources-related capacity expansion. Primary metals has reduced its annual CAPEX from $3.9bn in 2012 to around $680mn in the year to Q3 2016. Similarly, basic chemicals CAPEX has dropped from $2bn in 2014 to $1.2bn in 2016. Unsurprisingly, CAPEX by transport equipment manufacturers – which includes the auto sector – has fallen from $1.3bn a decade ago to $800mn in 2012 to just $300mn in the year to Q3 2016.

The rising segments of manufacturing CAPEX correlate closely to the sectors that have been performing well in the Ai Group **Australian PMI** over the past year, namely food processing, beverages and building materials. Food processing is now Australia's single largest manufacturing sector and the largest source of manufacturing CAPEX ($2.2bn in the year to Q3 2016) and rising. Although the beverages sector's CAPEX is still relatively small, this sector spent more in the year to Q3 2016 ($760mn) than did the former CAPEX giant, primary metals ($680mn). Building materials manufacturers ('non-metallic minerals' in Chart 2 below) are also increasing their CAPEX in 2016 again, after a series of cuts in 2015.

Chart 2: annual nominal CAPEX by major manufacturing sectors



Source: ABS, *CAPEX*, Sep 2016.

This week's CAPEX data also provided the fourth estimate of business intentions for annual CAPEX in 2016-17. This fourth estimate of total CAPEX was a touch lower than the previous estimate (1.2% lower than the third estimate). And after adjustment for typical realisations of business investment (applying a 'realisation' ratio), this fourth estimate implies a drop in total CAPEX of around 19% in 2016-17 compared to the previous year (see table 3). This includes a further fall of 34% in annual mining CAPEX in 2016-17. Manufacturing CAPEX is expected to fall by a further 1%, its smallest annual fall since 2011 (when it increased CAPEX by 7%). All of the fall in manufacturing CAPEX is expected to be in spending on buildings, with spending on plant and equipment remaining stable or even increasing a touch. For other industries, CAPEX could fall by a similarly modest 1.5% p.a. in 2016-17, with most of this coming through in equipment.

Table 3: Actual and expected annual nominal CAPEX, by type and industry

Nominal annual CAPEX	2014-15 (actual)		2015-16 (actual)		2016-17 (estimate 4)*	
	$mn	% p.a.	$mn	% p.a.	$mn	% p.a.
Mining						
Buildings and structures	67,622	-16.5	47,560	-29.7	29,799	-37.3
Plant and equipment	8,495	-10.0	5,892	-30.6	5,413	-8.1
All mining	76,117	-15.8	53,452	-29.8	35,188	-34.2
Manufacturing						
Buildings and structures	2,483	-7.4	1,945	-21.7	1,877	-3.5
Plant and equipment	6,145	-6.2	6,562	6.8	6,597	0.5
All manufacturing	8,628	-6.5	8,507	- 1.4	8,419	-1.0
Other selected industries						
Buildings and structures	27,625	19.2	27,727	0.4	27,980	0.9
Plant and equipment	38,286	8.9	37,768	-1.4	35,989	-4.7
All 'other selected industries'	65,910	13.0	65,496	- .6	64,496	-1.5
All buildings and structures	97,729	-8.5	77,232	-21.0	58,533	-24.2
All plant and equipment	52,925	3.5	50,223	-5.1	46,829	-6.8
ALL CAPEX	**150,655**	**-4.6**	**127,455**	**-15.4**	**103,504**	**-18.8**

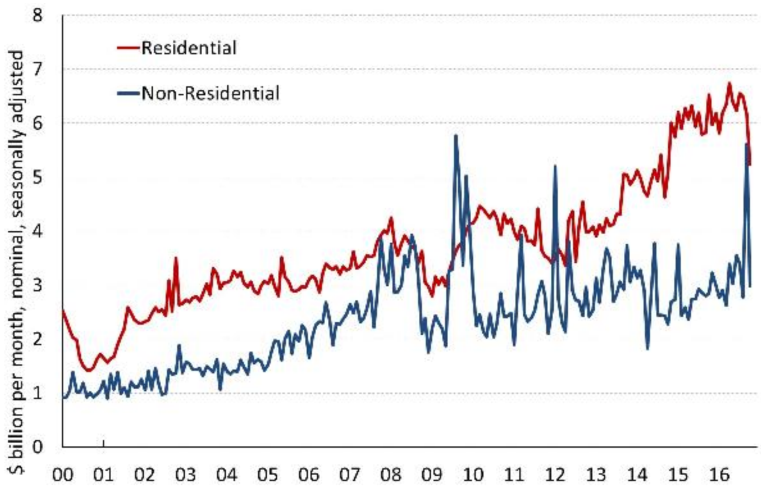
** five year average realisation ratio applied.*

Source: ABS, *CAPEX*, Sep 2016.

Risks to the Australian economy in 2017: the residential construction cycle

The latest ABS monthly building approvals data show the number of approvals fell by 12.6% (seasonally adjusted) in October, to be 24.9% lower than a year earlier. Much of this decline was in the number of approvals for residential approvals other than detached houses (including apartments, flats and units), which fell 24.8% m/m to be 42.6% lower over the year. October marks the third monthly decline in a row for non-house residential approvals. House approvals are also falling, but not nearly as fast, with a 2.5% decline during the month to be 4.5% down over the year to October.

Chart 3: Value of building approvals per month



Source: ABS

In value terms, approvals fell by 30.3% in October to be 12.4% lower than a year earlier (see chart 3). The value of residential approvals fell by 15.2% m/m and 19.9% p.a., including a fall of -18.4% m/m and -22.7% p.a in the value of new home construction. In contrast, the value of home renovation activity (a smaller but valuable segment) increased by 15.2% m/m and 5.9% p.a. The value of non-residential approvals fell by 46.9% m/m but remained up 4.7% from a year earlier.

Similarly, in HIA's latest New Home Sales report, total sales declined 8.5% in October. Detached home sales were down by 8.2% and multi-unit sales declined by 9.2% in the month. House building approvals and sales tend to 'lead' building activity by 12 to 18 months, so these further declines confirm that construction activity is peaking now and is likely to fall lower during 2017.

Manufacturing recovery strengthens in November

Ai Group's **Australian PMI®** increased by 3.3 points to 54.2 in November, with a stronger and more broad-based expansion across the manufacturing sector after relatively stable conditions in recent months (readings above 50 indicate expansion in activity, with the distance from 50 indicating the strength of the increase).

Key activity indexes of production, sales, exports, employment and new orders all expanded in November. A strong lift in new orders (up 4.8 points to 59.5) and solid growth in sales (down 1.5 points to 53.5) is encouraging. Exports (down 0.1 point to 55.9) continue to provide a good source of growth. Input prices eased in November but remained elevated (down 3.8 points to 62.5), while the selling prices sub-index moved back into expansion (up 3.6 points to 51.5 points).

Across the manufacturing sub-sectors, three of the eight manufacturing sub-sectors expanded in November. These were the large food and beverages sector (up 6.1 points to 56.5); petroleum & chemical products (up 1.7 points to 57.1); and machinery & equipment (up 0.8 points to 54.9).

Comments from manufacturers in November indicated a general lift in demand and confidence, with the relatively lower dollar and increased exports continuing to provide support to many manufacturers. Weather conditions appear to be affecting some manufacturers, directly and through increased raw material prices. Concerns about a slowing economy (locally and globally) and a volatile exchange rate are weighing on activity, while sourcing appropriately skilled labour and rising input costs (inducing energy prices) are presenting problems for some manufacturers.

Read the Ai Group's full report on the **Australian PMI** here:

www.aigroup.com.au/policy-and-research/economics/economicindicators/

*Ai Group economics this week released a set of Factsheets on **the economic performance of each Australian state in 2015-16**, based on the ABS 'State Accounts'. They are available here:*

https://www.aigroup.com.au/policy-and-research/economics/economicsfactsheets/

This week's data and events, 28 November – 2 December 2016

Day	Date	Data/event	Data period	Previous release
Wed	30 Nov	RBA private sector credit	Oct (M)	Sep: +0.4% m/m; +5.4% p.a.
		HIA new home sales	Oct(M)	-8.5% m/m
		ABS building approvals	Oct (M)	Sep: -8.7% m/m; -6.4% p.a.
Thu	**1 Dec**	**Ai Group Australian PMI®**	**Nov (M)**	**54.2 points**
		ABS capital expenditure	Sep (Q)	Sep: -4.0% q/q; -13.7% p.a.
		ABS industrial disputes	Sep (Q)	Sep: 93 disputes (+33) involving 26,300 employees (+5,800)
		RBA index of commodity prices	Nov (M)	Commodity price index (SDR): +10.2% m/m; +32.1% p.a.
Fri	2 Dec	ABS retail trade	Oct (M)	Sep: +0.6% m/m

M = monthly. Q = quarterly. H = half-yearly. A = annual. All data are seasonally adjusted unless otherwise noted.

Next week's data and events, 5 December – 9 December 2016

Day	Date	Data/event	Data period due for release	Previous release
Mon	5 Dec	ABS business indicators	Sep (Q)	Jun: corp. profits +6.9% q/q
		Ai Group Australian PSI®	**Nov (M)**	**50.5 points**
Tue	6 Dec	ABS balance of payments	Sep (Q)	Jun: current account -$15.5bn
		RBA interest rate decision	**Dec (M)**	**Cash rate: 1.50%**
Wed	**7 Dec**	**ABS national accounts (GDP)**	**Sep (Q)**	**Jun: GDP+0.5%q/q; +3.3%p.a.**
		Ai Group Australian PCI®	**Nov (M)**	**45.9 points**
Thu	8 Dec	ABS international trade	Oct (M)	Sep: Exports $27.3bn; Imports $28.5bn
		NAB monthly business survey	Nov (M)	Sep: Conditions+6; Confidence+4
Fri	9 Dec	ABS housing finance	Oct (M)	Sep: +2.3% m/m

M = monthly. Q = quarterly. H = half-yearly. A = annual. All data are seasonally adjusted unless otherwise noted.

Australian economy: latest full-year estimates and government forecasts

RBA (Nov 2016)	**2014-15 actual**	**2015-16 actual**	**2015-16 f**	**2016-17 f**	**2017-18 f**	**2018-19 p**	**2019-20 p**
GDP, % change p.a.	2.2	3.3	2.5-3.5	2.5-3.5	2.5-3.5	-	
Inflation (CPI), % change p.a.	1.5	1.0	1.5	1.5-2.5	1.5-2.5	-	
Treasury (May 2016)							
GDP, % change p.a.	2.2	3.3	2.5	2.5	3.0	3.0	3.0
Household consumption, % p.a.	2.7	2.9	3.0	3.0	3.0		
Dwelling investment, % p.a.	7.9	8.3	8.0	2.0	1.0		
Business investment, % p.a.	-6.2	-14.7	-11.0	-5.0	0.0		
Employment growth, % p.a.	1.6	1.9	2.0	1.75	1.75	1.25	1.5
Unemployment rate, %	6.1	5.8	5.75	5.5	5.5	5.5	5.5
Terms of trade, % change p.a.	-10.3	-5.4	-8.75	1.25	0.0		
Inflation (CPI), % change p.a.	1.5	1.0	1.25	2.0	2.25	2.5	2.5
Wages (WPI), % change p.a.	2.3	2.1	2.25	2.5	2.75	3.25	3.5

Sources: ABS various data; RBA *Statement on Monetary Policy*; and Australian Treasury, *Federal Budget 2016-17*. f = forecast. p = projection.

Australian economy: latest indicators

Economy				**FX and commodity prices (as of Friday)**		
RBA official cash rate, %	Nov (M)	1.50	-	AUD/USD exchange rate	US$0.7414	▼
Real GDP, % change p.a.	Jun (Q)	3.3%	▲	Oil price (WTI light crude, USD/BBL)	US$51.10	▲
Headline CPI, % change p.a.	Sep (Q)	1.3%	▲	Gold price (USD/OZ)	US$1,171.66	▼
Unemployment rate, % trend	Oct (M)	5.6%	▼	Copper price (USD/tonne, LME spot)	US$5,739.00	▲

Australian Industry Group monthly indexes		
Australian PMI®	Nov (M)	54.2 ▲
Australian PSI®	Oct (M)	50.5 ▲
Australian PCI®	Oct (M)	45.9 ▼

M = monthly. Q = quarterly. All data are seasonally adjusted unless otherwise noted.
Arrows represent direction of movement relative to last week for prices, and last observation for growth rates and indexes.
Sources: ABS various data; Ai Group; Australian Financial Review market prices (as of Fri); London Metals Exchange market prices (as of Fri).

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