Ai GROUP | ECONOMICS WEEKLY

9 December 2016

AUSTRALIAN ECONOMIC DEVELOPMENTS

This week the RBA kept the cash rate unchanged at a record low of 1.50%. The accompanying statement from RBA Governor Lowe (released on Tuesday, a day before the *National Accounts*) noted some positive trends in November such as higher commodity prices (which are boosting national incomes) and stronger business sentiment. However, national growth in output, prices, exports, investment and employment are subdued at best. As always, there are significant global and local risks to the outlook. For 2017, the RBA is especially concerned about the prospect of a higher Australian dollar and the continuation of 'brisk' house price rises in some locations.

The biggest economics news this week was the ABS *National Accounts* for the September quarter (Q3) of 2016. This showed that real Australian GDP *shrank* by 0.5% in Q3, with annual growth slowing to just 1.8% p.a., from a (downwardly revised) 3.1% p.a. in Q2. This was the first negative quarter of real output growth since Q1 2011 (due to the Queensland floods) and the largest quarterly fall since Q4 2008 (due to the GFC). This outcome is disappointing but not unexpected. It was the result of a confluence of negative factors including: the ongoing retreat from the mining investment boom; a decline in residential construction activity from recent peaks (and possibly disrupted by unseasonable spring weather); a sharp reversal in public sector investment; slowing household consumption growth and a negative contribution from net exports.

On the positive side, a further recovery in the terms of trade in Q3 (due to stronger commodity prices) saw a lift in national income following the 'income recession' of recent years. Other positives were stronger growth across some services industries and most manufacturing sectors.

Another positive this week was the ABS estimates of multifactor productivity (MFP) for 2015-16. These data show that MFP (on an 'hours worked' basis) improved by 0.9% in 2015-16 across the 16 'market sectors' included in these estimates. This was the fifth consecutive year of mildly positive improvements in Australian MFP. On a 'quality adjusted hours worked' basis, MFP grew by a less impressive 0.6% in 2015-16. The ABS notes that this growth in quality adjusted MFP "reflects a positive contribution from changes to labour composition, due to [improved] educational attainment and work experience".

Monthly activity data for November (released this week) suggest growth in Q4 is likely to be better than in Q3, particularly in the big services industries. Although the Ai Group **Australian PCI®** confirmed (again) that the housing construction cycle is already turning down, the **Australian PSI®** showed that conditions in some of the larger services sectors improved in November, after a weak period in August and September (also evident in the Q3 GDP data).

Australian demand, investment and exports stumble in Q3 2016

Australian real GDP (inflation-adjusted and seasonally adjusted) fell by 0.5% in Q3 2016, the first quarterly fall since Q1 2011. This result was disappointing but not unexpected; many of the activity indicators for this period had also shown an unwelcome dip during Q3, including Ai Group's **Australian PMI®** and **Australian PSI®** (both of which contracted in August and September but have since recovered in October and November), the NAB survey of business conditions, the ABS capital expenditure survey and the ABS estimates of construction work done.

In nominal terms, GDP grew by 0.5% q/q and 3.0% p.a. in Q3. This was slower than in Q2 (3.3% p.a.) but a significant improvement on the sub-2% growth in nominal GDP through 2014 and 2015.

Table 1: Australian GDP key aggregates, Q3 2016

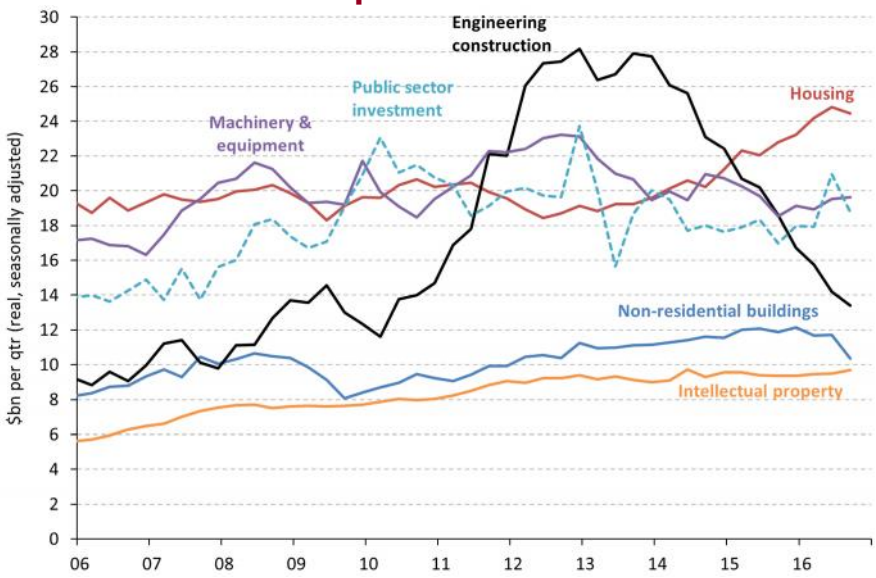
GDP, seasonally adjusted, inflation adjusted	*% q/q*	*% p.a.*	*q/q ppt contribution*
Components of expenditure			
Household consumption	0.4	2.5	0.3
General government consumption	-0.2	3.9	0.0
Total investment	-2.7	-2.5	-0.7
Dwelling investment	-1.4	7.2	-0.1
Private Business investment	0.1	-9.7	0.0
New building	*-11.5*	*-12.6*	*-0.3*
New engineering construction	*-5.6*	*-28.0*	*-0.2*
New machinery and equipment	*0.6*	*6.0*	*0.0*
Intellectual property investment	*2.0*	*3.7*	*0.0*
Public (government) investment	-10.4	10.7	-0.5
Domestic final demand	**-0.5**	**1.5**	**-0.5**
Change in inventories	na	na	0.1
Exports	0.3	6.0	0.1
Imports	1.3	2.3	-0.3
Net exports			**-0.2**
Terms of trade	4.4	1.4	
Real gross domestic income	0.4	2.0	
Real net national disposable income	0.8	3.2	
Real GDP	**-0.5**	**1.8**	**-0.5**
Nominal GDP	**0.5**	**3.0**	
Compensation of employees (wages & incomes)	1.3	3.1	
Private profits - total	1.0	0.7	
Private profits financial corporations	*1.6*	*5.5*	
Private profits non-financial corporations	*1.2*	*-1.0*	

Source: ABS, *National Accounts*, Sep 2016.

On the expenditure side of the *National Accounts*, the reasons behind this unwelcome dip in real GDP were a broad-based combination of the following (see table 1 and chart 1):

- Engineering investment fell another 5.6% q/q and 28% over the year, as the mining investment boom continues to wind down from its peak in 2013;
- housing investment fell by 1.4% q/q (but remained 7.2% up from a year earlier) as the current house construction cycle begins to move down from a peak some time in Q2 2016 (and as building activity was disrupted or postponed due to inclement weather);
- government investment fell by 10.4% q/q after rising by a similar amount in Q2, as a few large projects by various state governments were completed;
- Government consumption (that is, government spending on goods and services) shrank by 0.2% q/q after growing strongly in previous quarters. This was the first such quarterly decline in spending by Australian governments (federal, state and local) since June 2014;
- household consumption growth slowed to just 0.4% q/q (its slowest since June 2013) after growing at an average quarterly pace of 0.7% q/q over the preceding three years; and
- exports did not save GDP this quarter, as has been the case in other recent quarters. In fact, imports grew more strongly than did exports in Q3 and so net exports detracted 0.2 percentage points from growth. Within the exports total, exports of all goods (including agricultural, resources and manufactured goods) fell by 0.3% q/q while exports of services (mainly tourism and education) rose by 2.4% q/q, mirroring the recent increases in tourist and student arrivals.

Chart 1: Components of investment

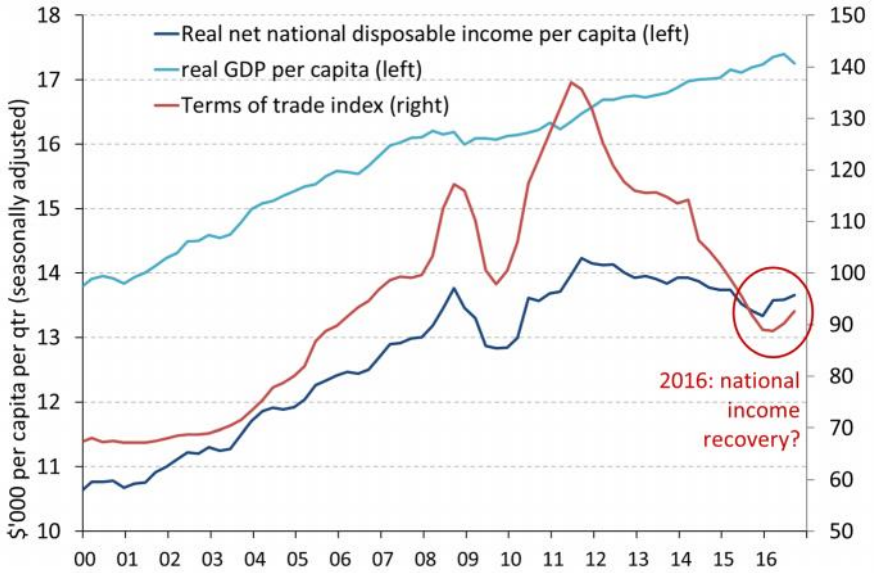


Source: ABS, *National Accounts*, Sep 2016.

National income growth firms in Q3 2016

A more positive (and somewhat contradictory) story is evident in the incomes data of the *National Accounts*. This improvement is primarily due to a further recovery in commodity prices and hence in the terms of trade, which was up a further 4.4% q/q from its recent low in Q1 2016. This has effectively ended the decline in national income (the 'income recession') that was evident from 2011-2015 (see chart 2). Real net national disposable income (the ABS' best measure of national spending capacity) grew by 0.8% q/q, its third quarter of recovery after declining since 2011.

Chart 2: terms of trade, GDP and net national disposable income per capita

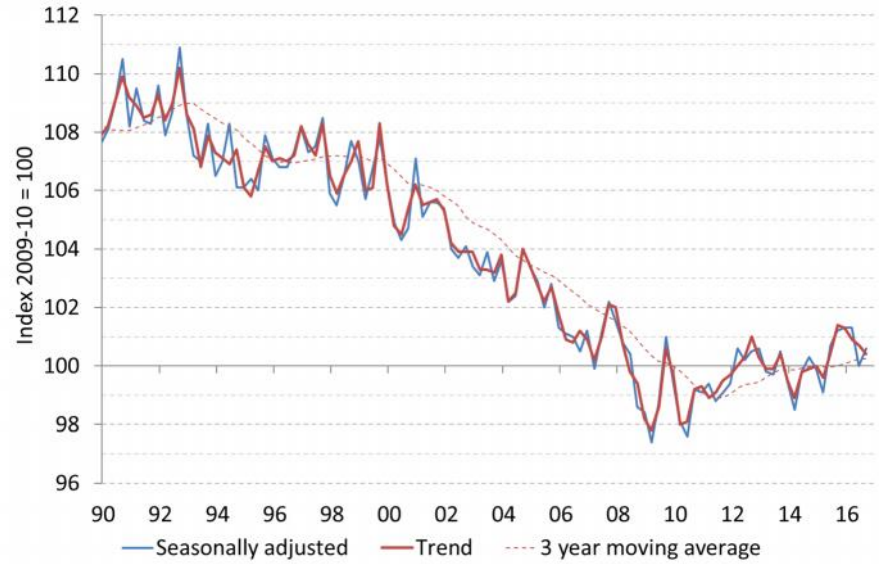


Source: ABS, *National Accounts*, Sep 2016.

Looking at the distribution of income, nominal wage and salary income for employees grew more strongly in Q3, up 1.3% q/q and 3.1% p.a. This was the strongest quarterly increase in wage and salary income since Q4 2013. Incidentally, even through the 'income recession' period of 2011-15, nominal wage and salary income grew in every quarter except Q3 2012 (-0.3%q/q), because all of this income drop occurred in the profits rather than on the wages side of incomes. Wage and salary income lifted to 54.5% as a share of total factor income in Q3 2016, from a recent low of 51.5% in Q1 2009.

Reflecting this increase in wages in the same quarter that national output fell, nominal unit labour costs for the non-farm economy jumped up by 1.9% q/q in Q3 (seasonally adjusted), after moderating in the previous three quarters. In real (inflation-adjusted terms), non-farm unit labour costs rose by 0.6% q/q in Q3, but remained 0.6% lower than a year earlier (see chart 3). In trend terms, real unit labour costs are falling, but remain elevated compared to the lows of 2008 - 10.

Chart 3: Real non-farm unit labour costs, index



Source: ABS, *National Accounts*, Sep 2016.

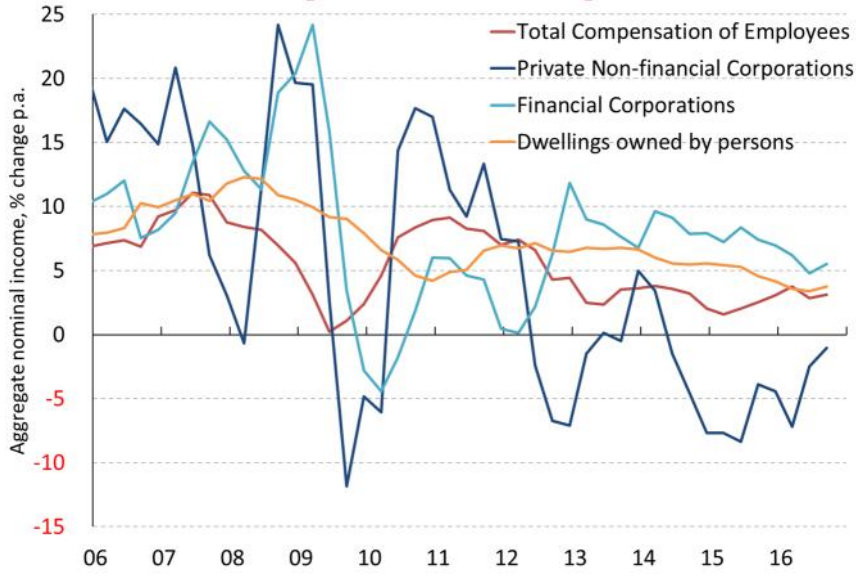
Profits for private non-financial corporations also seem to have recovered in aggregate, with a second quarter of recovery in Q3 2016, following eight consecutive quarters of flat or declining nominal profits (see chart 3). This has seen their share of total factor income stabilise at 17% in Q2 and Q3 2016, after declining from a recent peak of 22.7% in Q3 2011. Much of this longer-term profit trend has been tied to rising and falling resources prices and the fortunes of the mining companies. Profits across most of the non-mining private sector look to have stabilised in 2016, but few sectors are achieving strong profits growth due to the weak demand environment.

This ongoing weakness in company profits and profitability helps to explain the lack of growth in non-mining business investment, since low returns (in the form of weak profits) tend to make new business investments and expansions harder to fund and to justify.

Profits for financial corporations (banks and superannuation funds) continue to grow more strongly than for other corporates, up another 1.6% q/q and 5.5% p.a. in Q3 (see chart 4). Financial corporations have had only one quarter of decline in profits (Q1 2013) since 2011. The share of total factor income going to financial corporations rose to 6.1% in 2016 from 4.7% a decade ago (and just 1% in the 1970s and 1980s). This reflects the steady growth in output and activity from financial services over the decades, growing from 4% of GDP in 1980 to 9% today.

The share of total factor income attributed to ‘dwellings owned by persons’ has also risen steadily, reaching record high of 9.2% of total factor income in Q3 2016, from 7.5% a decade earlier and 6% back in 1980. This long-term rise probably reflects the steady increase in property investment and rental incomes paid to Australian households and individuals over this period.

Chart 4: nominal incomes growth from wages, profits and dwellings



Source: ABS, *National Accounts*, Sep 2016.

Finance and other services surge ahead

The value-added output or 'chain volume' production estimates published in the *National Accounts* for each industry were re-based in Q3 2016, so as to take into account the latest information on industry pricing, inputs and output volumes. This has affected the estimated 'base level' (i.e. size) of the output for some industries, but not their estimated growth rates. This has had the biggest impact on the mining and construction industries, due to large price movements in recent years. As a result, mining is now estimated to be Australia's fourth largest industry in output terms (previously estimated to be the second largest) while construction and healthcare have moved to second and third largest (previously third and fourth largest) place, based on their revised 'value added' output size (that is, all of their outputs minus all of their inputs, which provides an estimate of the value each industry adds to the economy).

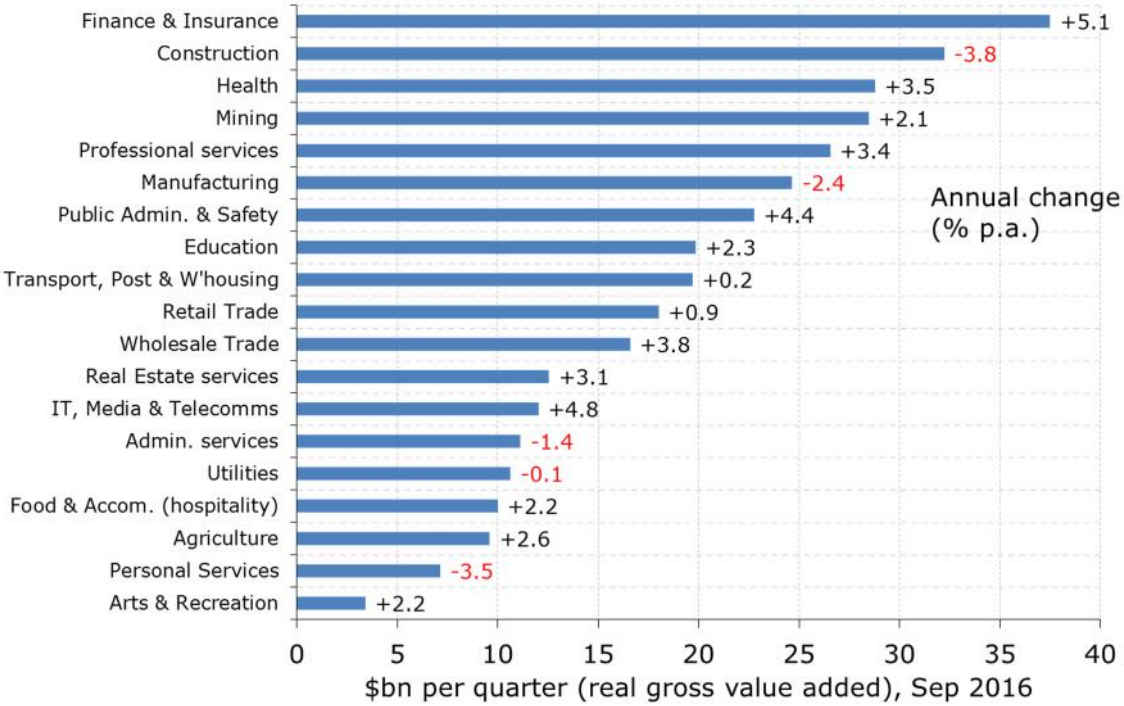
Abstracting from these significant data revisions, all of the growth was located in the services sectors in Q3 2016. Output from all the industrials (mining, manufacturing, utilities, construction) shrank in the quarter. Among the services sectors, the strongest growth in Q3 was in:

- IT, media and telecommunications, up 1.6% q/q and 4.8% p.a.;
- Finance, insurance and superannuation services, up 0.7% q/q and 5.1% p.a.;
- Wholesale trade, up 0.8% q/q and 3.8% p.a.;
- Health and welfare services, up 0.6% q/q and 3.5% p.a.; and
- Professional services, up 0.6% q/q and 3.4% p.a. (see chart 5).

Among these growth sectors, wholesale trade, IT and professional services are recovering from recent periods of shrinkage, while health and financial services are consistently growing larger.

Weaker consumption growth in Q3 may have contributed to a fall in retail trade output in Q3. It was down 0.8%q/q and just 0.9% larger than a year earlier.

Chart 5: Industry value-added output and growth, Q3 2016



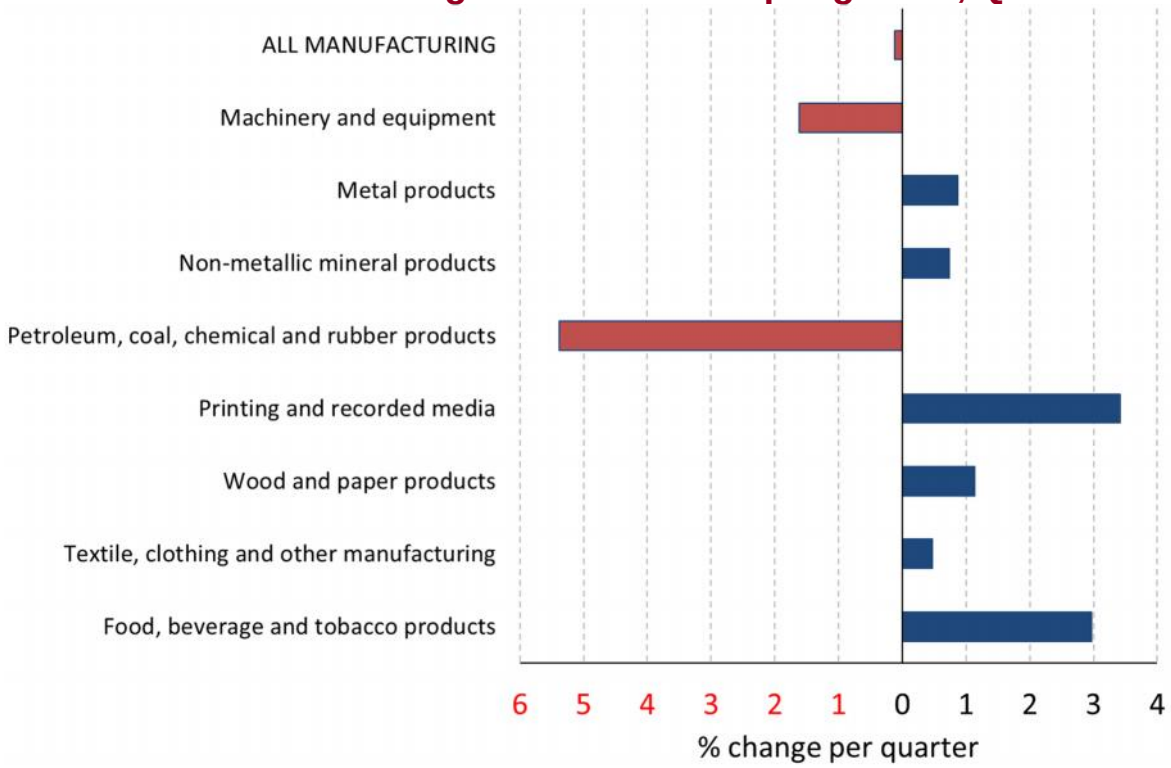
Source: ABS, *National Accounts*, Sep 2016.

In line with this year's **Australian PMI®** trends, the national accounts show that total manufacturing output expanded by 0.5% q/q in Q2 (following seven consecutive quarters of decline) but then contracted by 0.1% q/q again in Q3. The more detailed data reveals that Q3's decline occurred in just two manufacturing sectors (see Chart 6):

- machinery and equipment manufacturing, which includes automotive manufacturers who are in the midst of a planned industry-wide exit from Australia; and
- petroleum, coal, chemical and rubber products, which includes everything from basic chemicals to coatings, cosmetics, detergents and advanced pharmaceuticals.

All other segments of manufacturing showed output growth in the *National Accounts* in Q3, with especially strong growth in food and beverages production (up 3.0% q/q and 5.4% p.a. and accounting for 27% of all manufactured output). The tiny printing and recorded media sector grew by 3.4% q/q and 12.1% p.a., bucking a long period of structural and technological decline.

Chart 6: Manufacturing value-added output growth, Q3 2016



Source: ABS, *National Accounts*, Sep 2016.

Mixed messages across the states

Across the states, state final demand was weak or contracted in Q3. The strongest growth rates were in NSW, Queensland and South Australia (see table 2 and chart 6). State final demand growth contacted in Victoria in Q3 but was relatively strong over the year, due to better quarters earlier in 2016. Western Australia's state final demand growth plunged 3.8% in the quarter (-9.5% p.a.), its worst single quarter since Q3 1989.

Growth in NSW is proving to be more resilient in Q3, thanks to growth in private investment, with this sector providing the only source of growth in the quarter. Victoria's economy is looking more fragile with declines in government investment and government spending weighing on growth in the quarter, and household consumption and private investment growth not enough to counterbalance the tightening in government spending and investment.

Queensland and South Australia sustained weak growth in state final demand due to some growth in household consumption, while Western Australia suffered a large quarterly decline mainly due to falling private investment due to the completion of large mining projects.

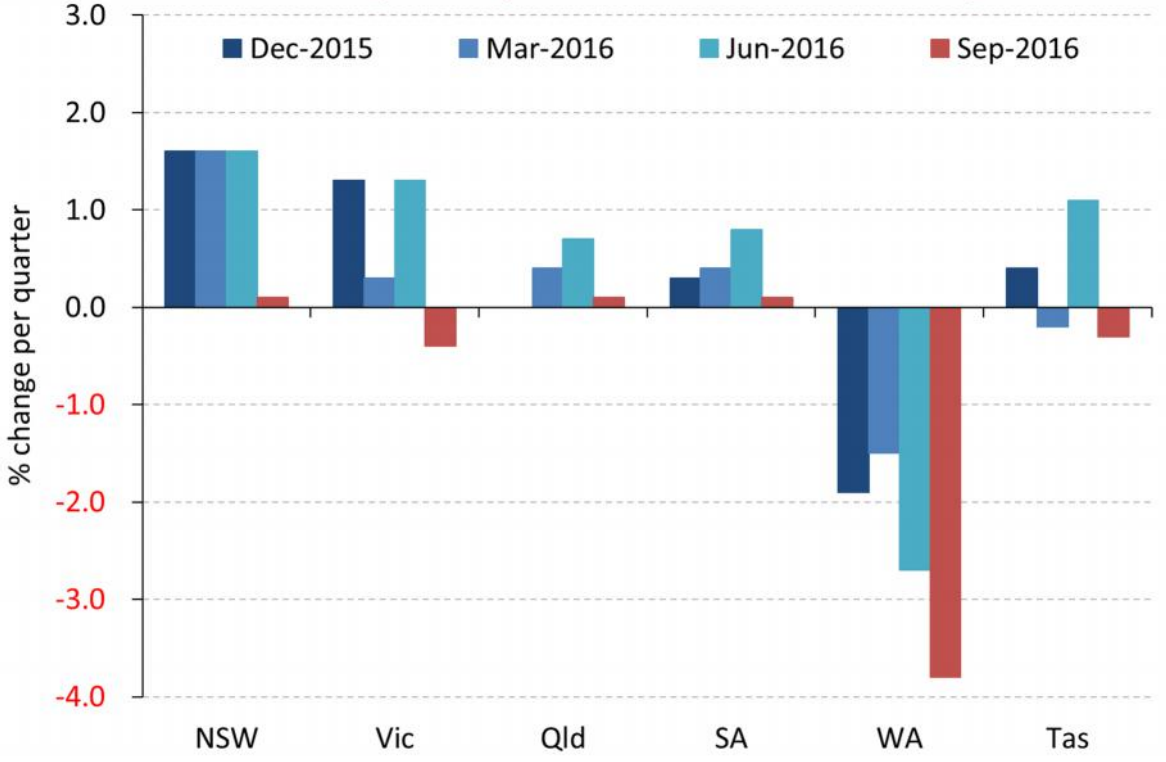
Household consumption growth across the states appears to be holding up, although tightening government spending and investment is sending growth backwards across most states. This also highlights where the heavy declines in mining investment are hitting hardest, with Western Australia's plummeting growth largely due to declining mining investment in that state.

Table 2: state final demand, Q3 2016

seasonally adjusted, real			Government consumption	Household consumption	Government investment	Private investment
	% q/q	*% p.a.*	% Contribution in Q3			
NSW	**0.1**	**5.0**	0.0	0.0	-0.0	0.1
Victoria	**-0.4**	**2.5**	-0.1	0.2	-0.9	0.4
Queensland	**0.1**	**1.2**	-0.1	0.6	-0.8	0.4
South Australia	**0.1**	**1.6**	-0.0	0.4	-0.0	-0.2
Western Australia	**-3.8**	**-9.5**	0.1	0.4	-0.9	-3.3
Tasmania	**-0.3**	**1.1**	-0.2	0.3	-0.6	0.1
NT	**4.7**	**1.5**	0.7	-0.0	0.9	3.2
ACT	**-1.3**	**6.4**	-0.7	0.1	-0.9	0.2
Australia (domestic final demand)	**-0.5**	**1.5**	-0.0	0.3	-0.5	-0.2

Source: ABS, *National Accounts*, Sep 2016

Chart 7: quarterly change in state final demand, by state



Source: ABS, *National Accounts*, Sep 2016

Services recover but construction cycle heads lower in November

Ai Group's **Australian PSI®** inched higher to 51.1 points in November (results above 50 points indicate expansion, with higher numbers indicating a stronger rate of expansion). This follows a sluggish period for the sector in the past several months.

Driving the mild expansion were increases in new orders, employment and deliveries in November. Inventory levels continued contracting and sales fell into contraction for the month. Across the sub-sectors, performance continues to be quite mixed. Personal & recreational services and the very large health & community services continued growing solidly, while the finance & insurance and property & business services sub-sectors picked up in the month. With selling prices growth lagging growth in input costs, margin pressures are intensifying for services businesses. For some businesses, this is the result of structural and technological changes within their industries.

Some respondents to the **Australian PSI®** noted that the US Federal election was a dampening influence on Australian business confidence in November. For others, competition from imports continued to constrain business while the flow-through from conditions in agriculture is having mixed outcomes, with positive effects from the increased value of cattle and negative effects from depressed dairy prices. Extreme weather events might also have affected demand for some types of consumer-oriented services in November.

In construction, the **Australian PCI®** continued to decline in November at 46.6 points, although at a slightly slower rate of decline than previously. Less pronounced reductions in new orders and deliveries from suppliers were evident, however activity fell at a steeper rate and employment returned to contraction with businesses attributing this to overall sluggish demand conditions.

All four sectors contracted in November. Apartment building declining for a third consecutive month, and house building recording a fourth month of contraction. The residential construction sector appears to softening from more robust mid-year activity levels. Engineering construction fell further into negative territory in November, recording its lowest activity reading (and therefore sharpest rate of contraction) in 13 months, while commercial construction fell for a fourth month.

Residential builders reported an easing in customer enquiries and lower sales in November. However, activity continued to receive solid support from on-going projects while investor activity was seen as remaining relatively firm in the month. There were some reports of a lift in project commencements in the commercial construction sector, although it was generally noted that conditions were patchy across states and major building categories. Engineering construction businesses reported a further winding back in mining-related investment which outweighed strengthening demand from new infrastructure work.

Read the Ai Group's full reports on the **Australian PSI** and **Australian PCI** here:

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

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

Day	Date	Data/event	Data period	Previous release
Mon	5 Dec	ABS business indicators	Sep (Q)	corp. profits -0.3% q/q
		ABS multifactor productivity	2015-16 (A)	market sector multifactor productivity, hours worked basis: +0.9% in 2015-16
		Ai Group Australian PSI®	**Nov (M)**	**51.1 points**
Tue	6 Dec	ABS balance of payments	Sep (Q)	current account -$11.4bn
		RBA interest rate decision	**Dec (M)**	**Cash rate: 1.50%**
Wed	**7 Dec**	**ABS national accounts (GDP)**	**Sep (Q)**	**GDP-0.5%q/q; +1.8%p.a.**
		Ai Group Australian PCI®	**Nov (M)**	**46.6 points**
Thu	8 Dec	ABS international trade	Oct (M)	exports $27.6bn; imports $29.2bn
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.

Next week's data and events, 12 December – 16 December 2016

Day	Date	Data/event	Data period due for release	Previous release
Mon	12 Dec	ABS lending finance	Oct (M)	Sep: personal -0.3% m/m; commercial +2.7% p.a.
Tue	13 Dec	ABS residential property price indexes	Sep (Q)	Jun: weighted avg +2.0% q/q; +4.1% p.a.
		NAB monthly business survey	Nov (M)	Oct: conditions: +6 confidence: +4
Wed	14 Dec	ABS sales of new motor vehicles	Oct (M)	Sep: -2.4% m/m; +1.2% p.a.
		Westpac-MI consumer confidence index	Dec (M)	Nov: 101.3
Thu	15 Dec	ABS labour force Australia	Nov (M)	Oct: employment +0.9% p.a. unemployment rate 5.6% (trend)
		NAB monthly business survey	Nov (M)	Sep: Conditions+6; Confidence+4

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$0.7452	▲
Real GDP, % change p.a.	Sep (Q)	1.8%	▼	Oil price (WTI light crude, USD/BBL)	US$50.90	▼
Headline CPI, % change p.a.	Sep (Q)	1.3%	▲	Gold price (USD/OZ)	US$1,117.66	▼
Unemployment rate, % trend	Oct (M)	5.6%	▼	Copper price (USD/tonne, LME spot)	US$5,903.00	▲

Australian Industry Group monthly indexes		
Australian PMI®	Nov (M)	54.2 ▲
Australian PSI®	Nov (M)	51.5 ▲
Australian PCI®	Nov (M)	46.6 ▲

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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