Ai GROUP | ECONOMICS WEEKLY

7 December 2018

This is our final Economics Weekly for 2018. This publication will resume on Friday 1 Feb 2019.

AUSTRALIAN ECONOMIC DEVELOPMENTS

This week the Reserve Bank of Australia (RBA) left the cash rate on hold at a record low of 1.50%, where it has been since August 2016. The RBA's accompanying statement remained generally upbeat about Australia's outlook. In particular, the RBA noted that the Australian economy is "performing well" and that "*the stronger labour market has led to some pick-up in wages growth… improvement in the economy should see some further lift in wages growth over time*."

Ai Group's monthly business surveys (the Australian PMI®, PSI® and PCI®) showed mixed results in November (released this week). The recovery in the Australian manufacturing sector slowed in November, with the Australian PMI® continuing to indicate expanding conditions but falling to its lowest level this year. In the services industries, the pace of expansion bounced higher in November after easing in recent months, as sales and new orders both accelerated. Businesses will be hoping this November bounce becomes more than just some early holiday-season spending and is sustained over coming months. The construction sector contracted for a third consecutive month in November, after strong activity levels in early 2018. In November, a further lift in infrastructure activity was not able to offset steep falls in the residential construction sectors. To view Ai Group's Performance Indices please click here.

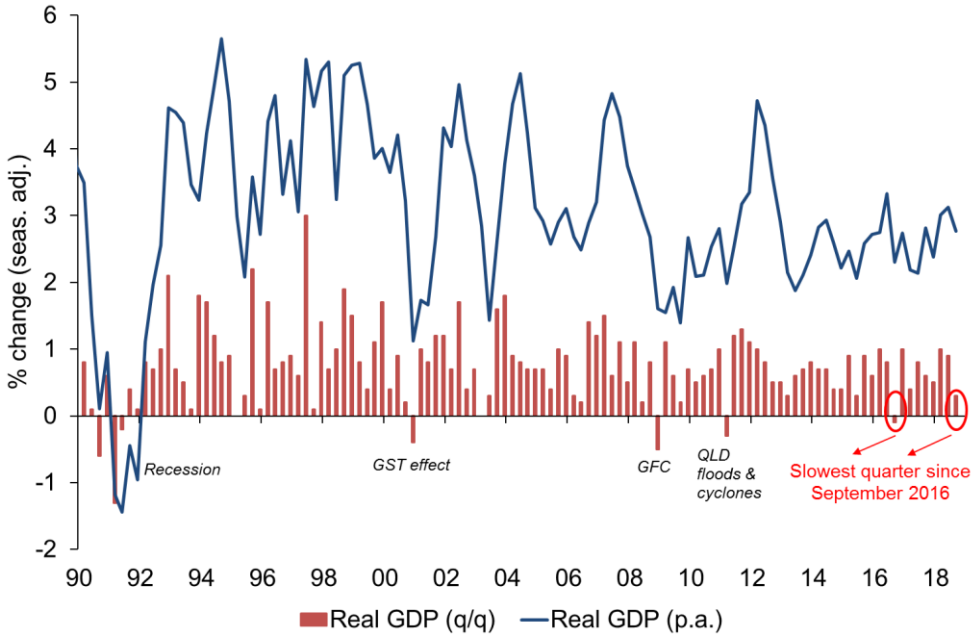
In the latest Australian Industry Group/Australian Constructors Association Construction Outlook survey, the nation's largest non-residential construction companies are expecting their work in major infrastructure projects to keep growing through to mid-2020. However, the pace of growth is expected to moderate as total infrastructure investment moves closer to peak levels. The outlook also points to large falls in revenue from multi-apartment work. Further detail is available online here.

The *National Accounts* released this week by the ABS confirm that the economy slowed in the September quarter (Q3) of 2018. This is consistent with Ai Group's monthly performance indicators since at least the middle of 2018. Australia's real output volumes (real GDP) grew by 0.3% q/q and 2.8% p.a. in the September quarter (Q3) of 2018, which was the slowest quarterly growth rate since Q3 2016. Growth in Q3 2018 was supported by government spending and net exports. Consumption growth slowed and business investment fell.

GDP growth slows in Q3 2018

The ABS *National Accounts* (released this week) indicate that Australia's real GDP grew by 0.3% q/q in Q3 of 2018. Annual growth edged down to 2.8% y/y from a downwardly revised 3.1% p.a. in Q2 2018 (previously reported as 3.4% p.a.). The ABS revised these figures using updated data from the 2016-17 financial year. The good news from these revised data is that the economy was growing faster in 2016-17 than was previously estimated but the bad news is that growth has been slower than previously estimated through 2018 to date.

Chart 1: Real GDP growth, annual and quarterly rates, to Q3 2018



Source: ABS, *National Accounts,* Sep 2018.

On the expenditure (demand) side of the *National Accounts*, growth in Q3 2018 was mainly driven by net exports and government spending (see table 1). Unfortunately, net exports rose due to lower imports rather than significantly higher exports in Q3. Imports of goods and services fell by 1.5% in Q3, while exports rose by just 0.1% q/q. Services exports rose by 4.5% q/q but this was offset by a decline in goods exports.

Since 2015, government consumption has consistently grown faster than household consumption (see chart 2). Government consumption increased by 0.5% q/q and 4.8% p.a. in Q3. Commonwealth Government spending has been growing strongly in recent years due to increased spending on health, aged care and disability services, including the roll-out of the NDIS (see table 1 and chart 2). In contrast, household consumption growth slowed to 0.3% q/q in Q3 after rising to 0.9% q/q in Q2 2018. This has a large effect on headline GDP because household consumption accounts for about 57% of GDP (on the expenditure side). On an annual basis, household consumption growth slowed to 2.5% p.a. in Q3, with weaker spending most evident in fuel consumption (petrol), car sales and cigarettes. Indeed, the value of new car sales fell by 2.1% p.a., the worst slump since the GFC. Consumer spending grew for insurance and other financial

services, food and transport services. It appears that at least some of this quarter's consumption was financed by households reducing the amount they are saving; the household saving ratio (the proportion of income saved) fell to 2.8% of income, which is its lowest rate since Q4 2007.

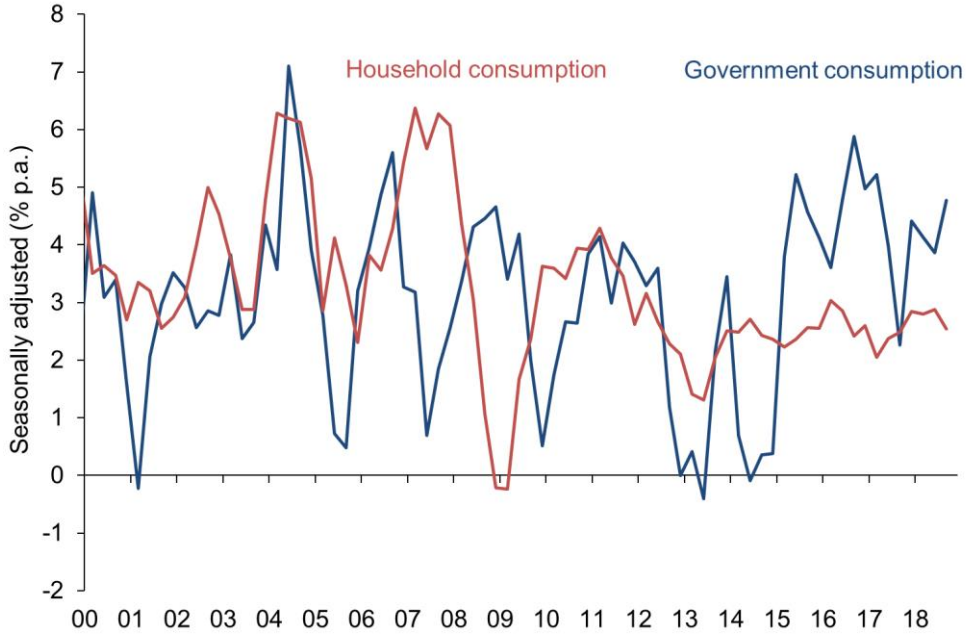
Regarding investment spending, public sector investment contributed to GDP in Q3 but was largely offset by weaker business investment (see table 1 and chart 3). Spending on new buildings fell, as did spending on new engineering construction as the last two mega-LNG plants (Ichthys and Prelude) near completion. Most positively for future productivity gains, intellectual property investment by Australian business is rising again after falling between 2012 and 2016 (see chart 3). In Q3, intellectual property investment rose by 0.9% q/q and is up 6.5% p.a., to $9.9 billion.

Dwelling (residential) investment rose by 1.0% q/q and 7.1% p.a., with renovation activity supporting growth in Q3. In contrast, new housing construction fell by 0.8% in the quarter. It now appears that new housing construction may have peaked, after the number of dwellings under construction in Australia reached a record high in early 2018, at about 225,000 new dwellings. This would be consistent with the recent easing in building approvals from record levels in 2018, which is now flowing through to fewer commencements.

Table 1: Key components of GDP, Q3 2018

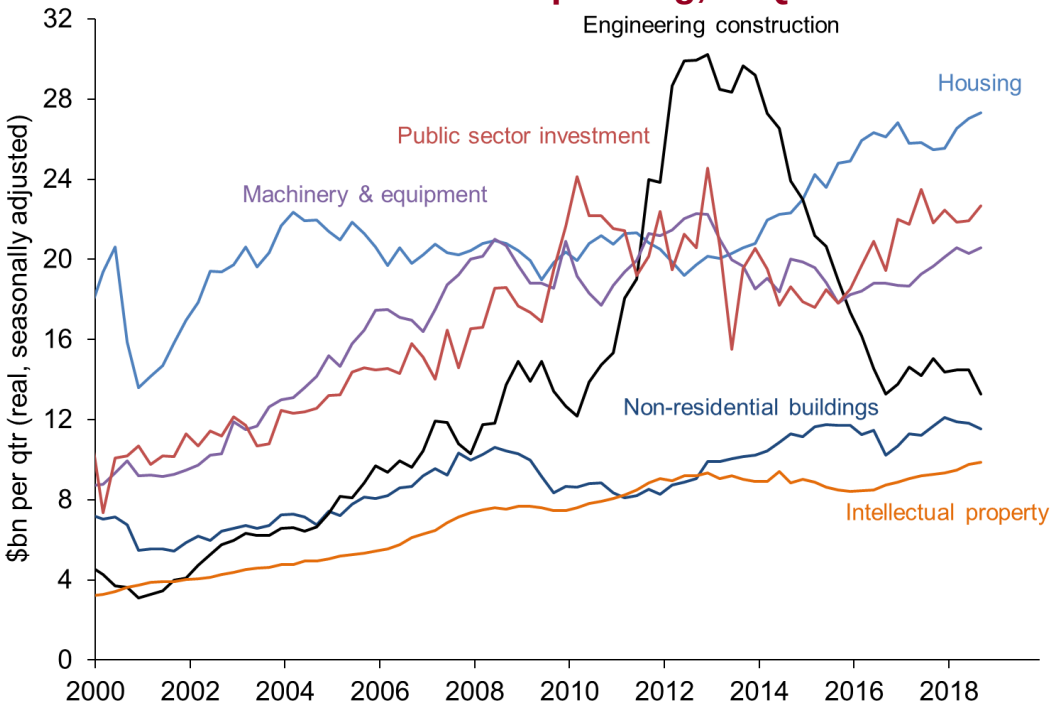
seasonally adjusted	**% q/q**	**% p.a.**	**ppt, contribution to growth**
Real GDP	0.3	2.8	**0.3**
Household consumption	0.3	2.5	0.2
General government consumption	0.5	4.8	0.1
Total investment	0.1	1.3	0.0
Dwelling investment	1.0	7.1	0.1
Private business investment	-1.2	-1.2	-0.1
New building	-2.4	-1.2	-0.1
New engineering construction	-8.2	-11.8	-0.3
New machinery and equipment	1.5	4.7	0.1
Intellectual property investment	0.9	6.5	0.0
Public (government) investment	3.4	3.8	0.2
Domestic final demand	0.3	2.7	0.3
Change in inventories	na	na	-0.3
Exports	0.1	4.1	0.0
Imports	-1.5	1.5	0.3
Net exports			**0.1**
Terms of trade	0.8	2.7	
Real gross domestic income	0.4	3.4	
Real net national disposable income	0.1	2.9	
Real GDP per capita	-0.1	1.2	
Nominal GDP	1.0	5.2	
Compensation of employees (wages & incomes)	1.0	4.3	
Private profits - total	1.7	7.1	
Private profits financial corporations	1.7	5.8	
Private profits non-financial corporations	2.0	7.5	

Chart 2: Household and government consumption growth



Source: ABS, *National Accounts,* Sep 2018.

Chart 3: Investment spending, to Q3 2018



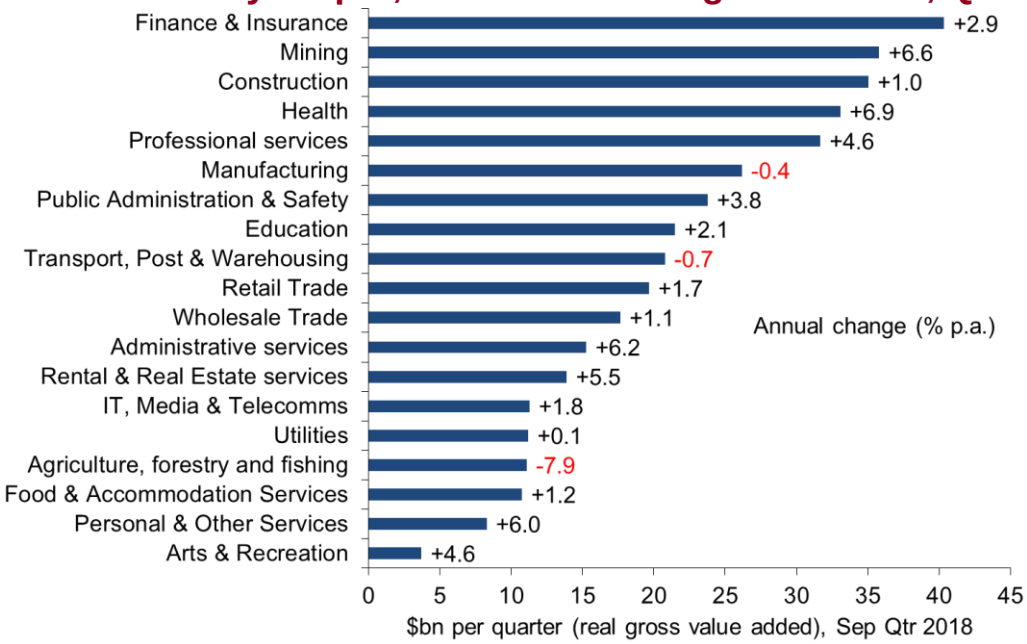
Source: ABS, *National Accounts,* Sep 2018.

Output falls across industrial sectors

On the production (output) side of the *National Accounts*, industry output[1] grew in 12 of the 19 major industries during Q3 2018. 16 of the 19 major industries grew over the year to Q3 (see chart 4). In Q3, growth was concentrated in healthcare (largely due to growth in the NDIS and other public sector programs) and in the services industries that are linked to current infrastructure projects. Output fell in Q3 across all of the industrial-related sectors including construction, manufacturing, mining, utilities, agriculture, transport and telecommunications.

Agricultural output was clearly affected by drought. It fell by 1.6% in the September quarter and 7.9% over the year, due to falls in output of grains and other crops. This was partially offset by a rise in livestock output as farmers destocked in response to the drought. Abstracting from these contractionary effects from the drought-affected agricultural sector, output from the non-farm economy grew by 3.0% p.a.

Chart 4: Industry output, size and annual growth rates, Q3 2018



Source: ABS, *National Accounts,* Sep 2018.

In the manufacturing sector, output fell by 0.7% q/q in Q3 2018, partially unwinding some of the much-needed recovery in 2017 and early 2018. This fall was driven by output from 'other manufacturing' which fell by 4.1% q/q due to a decline in the production of building materials for the construction industry. Metal products rose by 2.6% q/q because of strong international demand, particularly for copper products. Over the year to Q3, manufacturing output fell by 0.4% p.a. to $26.2bn. It now accounts for 5.7% of total industry output (see Table 2).

[1] Industry 'output' is measured in the *National Accounts* as real 'value-added output' volumes (that is, total outputs minus total inputs and inflation adjusted).

Table 2: Manufacturing sub-sector output, Q3 2018

Manufacturing seasonally adjusted, inflation adjusted	Size of output per quarter $bn	% of manufac	Rate of change % q/q	% p.a.
Food, beverage and tobacco products	6,813	26.0	-0.5	1.8
Chemicals	4,729	18.1	-0.7	-0.5
Metal products	4,339	16.6	2.6	10.2
Machinery and equipment	4,776	18.2	0.2	-6.4
Other manufacturing	5,522	21.1	-4.0	-4.7
Manufacturing	**26,179**	**5.7% of GDP**	-0.7	-0.4
GDP	460,827	**100.0**	0.3	2.8

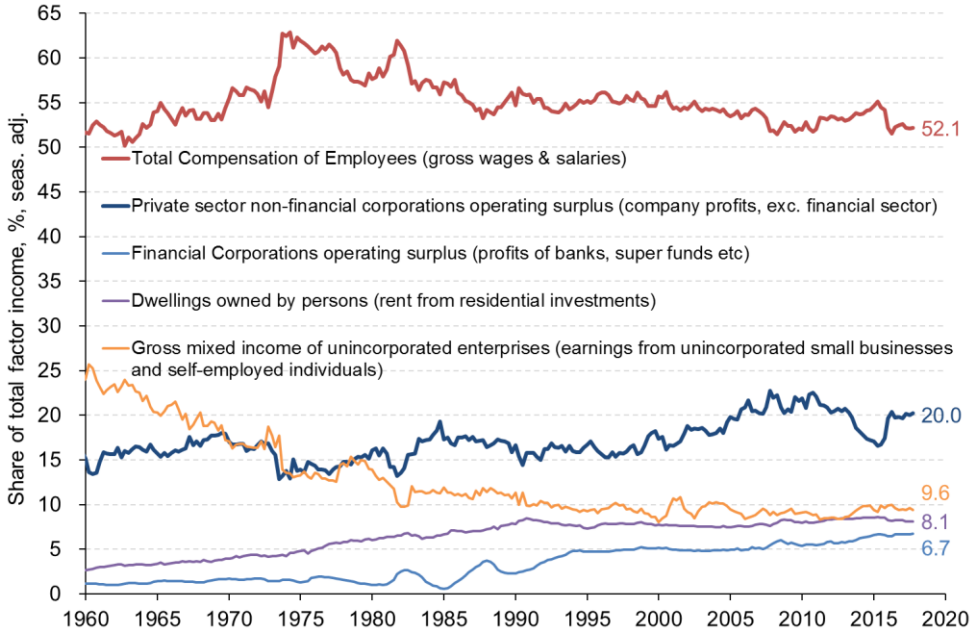
Source: ABS, *National Accounts,* Sep 2018.

National incomes rise across the board in Q3 2018

National income is affected by changes in nominal prices as well as changes in real output. Chief among these pricing effects is the terms of trade, which is the ratio between export prices and import prices (that is, what Australia can buy compared to what it sells globally). In Q3, recovering commodity prices lifted the terms of trade by 0.8% to be 2.7% higher than one year earlier. This helped push up real gross domestic income (GDI) by more than just output alone; real GDI rose by 0.4% q/q and 3.4% p.a., compared to 0.3%q/q and 2.8% p.a. for real GDP (see Table 1).

In nominal terms, GDP grew by 1.0% q/q and 5.2% p.a. in Q3 2018. Growth in the quarter was spread fairly evenly across all categories of income, including employees, financial corporations (banks, superannuation funds and related entities), non-financial corporations and dwelling owned by individuals. Annual growth was stronger for business profits than for wages, reflecting gains made by mining companies in early 2018 (see table 1). This saw the share of total income derived from each type of income remaining relatively stable during 2018 to date (see chart 5).

Chart 5: Shares of total factor income, by income type, to Q3 2018



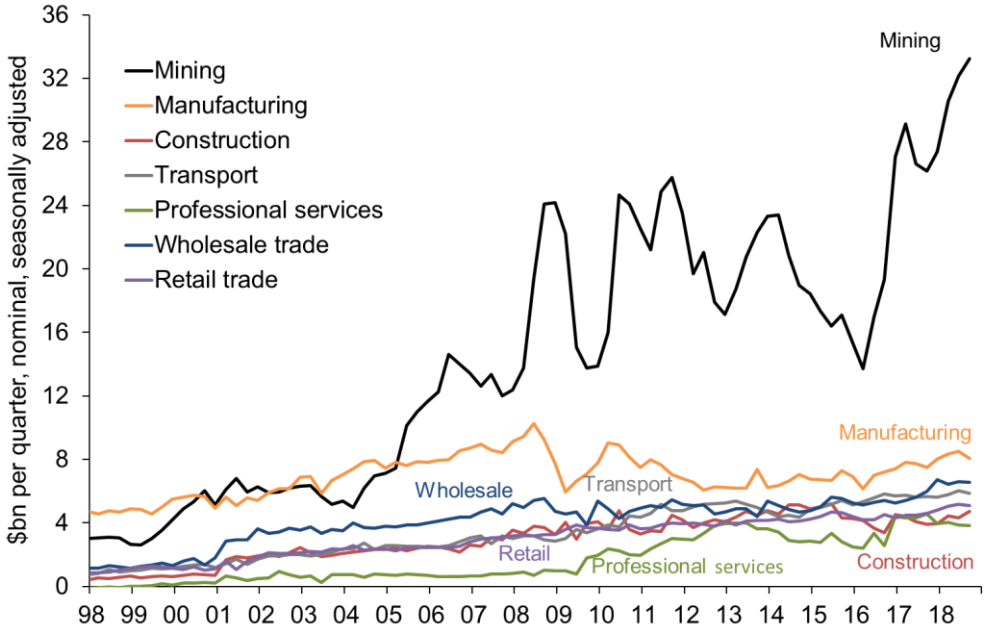
Company profits jump in mining, improve modestly elsewhere in Q3 2018

More detail on the relative trends in earnings by companies (profits) and employees (wages and salaries) is provided by the ABS *Business Indicators* (released earlier this week). These data indicate that nominal corporate gross operating profits (GOP) in the market sector (all industries except public administration, education and health) rose by 1.4% q/q and 6.9% p.a. in Q3 2018 while spending on wages and salaries by corporate market sector industries rose by 0.9% q/q and 3.9% p.a. (nominal and seasonally adjusted).

The location of gross operating profits is the key to explaining this apparent discrepancy, since the bulk of this recent increase in nominal profits (GOP) occurred in the mining sector, which rose by about $7.1 billion from this time last year. Corporate profits in the mining sector are now up by 27.1% p.a. to $33.2 billion in Q3 2018. This increase in mining profits accounted for 64% of the increase in company profits over the year to Q3 and now accounts for 37% of all corporate profits.

Nominal aggregate profits in the non-mining sectors grew by a far more modest 1.0% q/q and 6.8% p.a. in Q3. Results across the non-mining sectors were mixed, with nominal profits rising in all the industrial sectors but falling in finance and insurance services and professional services over the year. The recent recovery in GOP in the manufacturing sector abated, with nominal profits falling by 5.1% q/q to $8.1 billion in Q3, but are still 7.7% higher than they were at this time last year. Even after this rise in nominal terms however, aggregate manufacturing profits are still well below the high point reached just before the GFC in June 2008, of $10.1bn (chart 6).

Chart 6: Nominal company profits, major industries, $bn per quarter



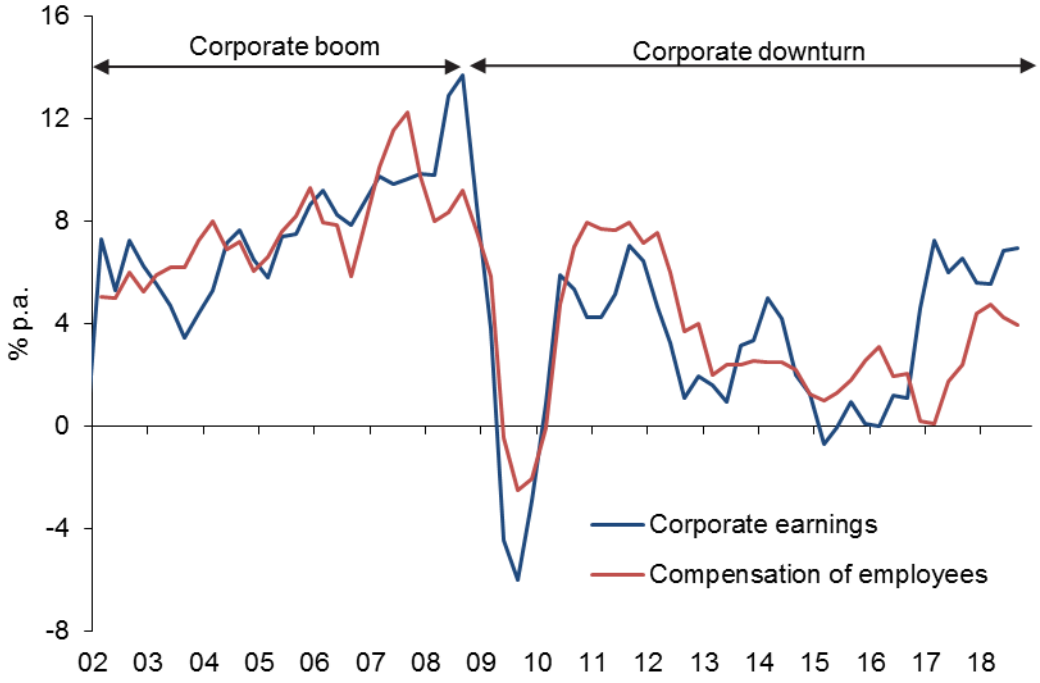
Source: ABS, *Business Indicators,* Sep 2018.

It is important to distinguish between corporate profits (GOP) and nominal sales or turnover. Sales is the total gross revenue a company is paid. Profits are what is left from this revenue for the company, after all wages, rents, materials, inputs, interest and other costs are paid. Historically,

corporate sales growth and corporate spending on wages and salaries in Australia are highly correlated. From 2002 to 2008, nominal corporate sales growth averaged 7.8% p.a. while corporate spending growth on wages and salaries rose by an average of 7.6% p.a. After the GFC however, corporate sales growth moved substantially lower than wages growth. From 2008 to 2016, growth in corporate spending on wages and salaries exceeded growth in corporate sales in 25 out of the 32 quarters, on an annual basis. Over this period, corporate sales growth averaged 2.9% p.a. while corporate spending on wages and salaries rose by an average of about 3.2% p.a. (see chart 7).

Since the end of 2016, Australian market-sector companies have managed to increase their sales revenue faster than their wages bill, in aggregate. This has coincided with an improvement in the terms of trade and a large jump in mining earnings. The growing dominance of mining revenues means the old correlation between corporate sales and corporate spending on wages might now be diminishing, as the mining sector moves into a heavy production phase. Going forward, a growing proportion of Australian sales will be derived from global commodity sales. Even with weaker sales growth in the non-mining market sectors however, 2017 and 2018 have seen strong growth in aggregate nominal wages in the market sector, which is consistent with strong employment growth.

Chart 7: Growth in corporate nominal sales and compensation of employees in market-sector industries



Source: ABS, *Business Indicators,* Sep 2018.

Diverging growth across states in 2018

State final demand (SFD, the state equivalent of national 'domestic final demand' or total expenditure net of exports) was positive in the south eastern parts of Australia and in the west. Queensland, South Australia and the Northern Territory went backwards in Q3, all experiencing large falls in non-dwelling construction. Over the year, growth ranged from a low of -17.2% p.a. in the Northern Territory to a high of 4.3% p.a. in the Victoria. The Northern Territory was negatively affected by a 28.1% q/q decrease in private investment in Q3, probably relating to the withdrawal of mining projects. Private investment in the resource-based states can be especially volatile due to the timing and nature of large 'lumpy' mining and related projects.

Table 3: State final demand, Q3 2018

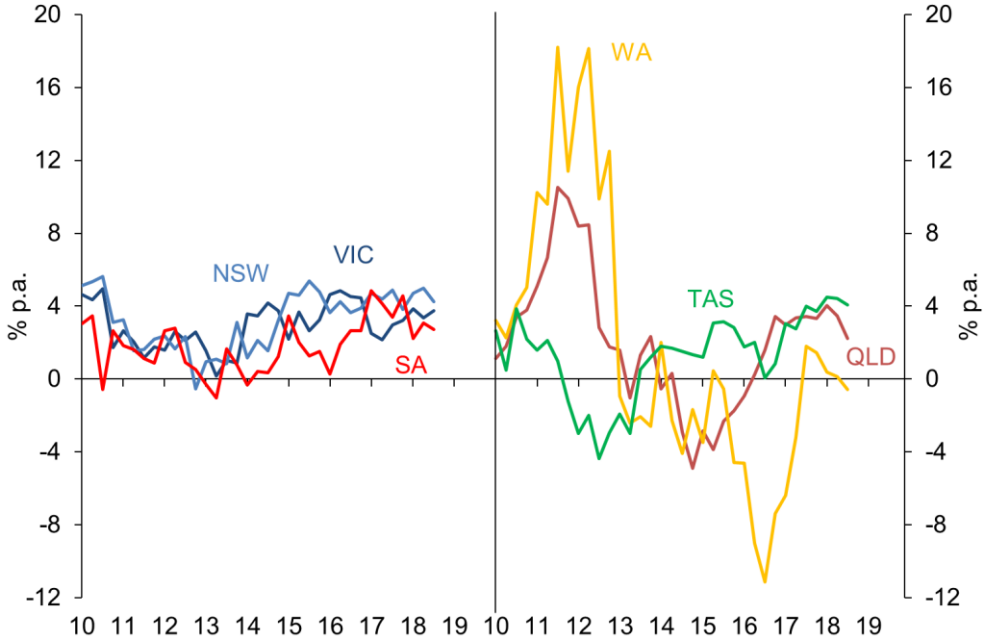
Seasonally adjusted, real	Government consumption	Household consumption	Private investment	Government investment	State final demand	State final demand
	% q/q	% q/q	% q/q	% q/q	% q/q	*% p.a.*
NSW	1.8	0.2	1.1	8.9	1.1	3.7
Victoria	-0.7	0.5	1.0	-2.9	0.2	4.3
Queensland	0.3	0.5	-4.3	2.8	-0.4	2.2
South Australia	2.8	0.2	-5.6	2.6	-0.2	2.7
Western Australia	0.0	-0.1	1.8	0.5	0.4	-0.6
Tasmania	-0.1	0.7	-4.1	15.8	0.6	4.1
NT	-3.6	-1.0	-28.1	2.4	-8.2	-17.5
ACT	-0.4	0.0	8.7	2.3	0.9	3.9
Australia (domestic final demand)	0.5	0.3	-0.8	3.4	0.3	2.7

* State Final Demand plus net exports is a proxy measure of State Domestic Product (the state equivalent of GDP) but is not exactly equal to it. Source: ABS, *National Accounts,* Sep 2018.

Changes in the growth of state final demand this decade confirms important geographical changes in economic growth within Australia (see Chart 8). Domestic demand is now faster along the eastern seaboard than in the mining locations of Western Australia, Queensland and the Northern Territory (although Queensland has recovered somewhat). Western Australia, Queensland and the Northern Territory grew substantially faster than the rest of the states and territories until about 2013, because of the mining infrastructure and construction boom in those locations. During this period, demand in the non-mining states and the ACT was weaker, partially because some industries were adversely affected by the fallout from the GFC and/or the very high Australian dollar during 2010-13.

Since about 2014, growth in final demand has returned to the non-mining states. Domestic demand is now 14.2% lower in Western Australia and 19.6% lower in the Northern Territory than what it was this time five year ago, while Queensland domestic demand is only 1.9% higher than five years ago (inflation-adjusted). In contrast, domestic demand is now 21.3% higher in Victoria, 19.4% higher in New South Wales, 13.4% higher in Tasmania and 10.8% higher in South Australia than what it was in Q3 2013.

Chart 8: State final demand, to Q3 2018



Source: ABS, *National Accounts,* Sep 2018.

This week's data and events, 3 Dec – 7 Dec 2018

Day	Date	Data/event	Data period	Result
Mon	3 Dec	**Ai Group Australian PMI®**	**Nov (M)**	**51.3 points**
		ABS Business Indicators	Sep (Q)	Corp. profits: +1.9% q/q, +13.5% p.a.
		ABS Building Approvals	Oct (M)	Number of dwellings approved: -1.5% m/m; -13.4% p.a.
Tue	4 Dec	ABS Balance of Payments	Sep (Q)	Current account -$10.7bn
		RBA Board Meeting	**Dec (M)**	**Cash rate: 1.50%**
Wed	5 Dec	**ABS National Accounts (GDP)**	**Sep (Q)**	**Real GDP +0.3% q/q; +2.8% p.a.**
		Ai Group Australian PSI®	**Nov (M)**	**55.1 points**
Thu	6 Dec	ABS International Trade	Oct (M)	Exports $37.9bn; Imports $35.7bn
		ABS Retail Trade	Oct (M)	Nominal value of sales $27.0bn, +0.3% m/m
Fri	7 Dec	**Ai Group Australian PCI®**	**Nov (M)**	**44.5 points**

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

Australian economy: latest full-year growth rates and government forecasts

RBA SoMP (November 2018)	2016-17 a	2017-18 a	2018-19 f	2019-20 f	2020-21 p	2021-22 p
GDP, % change p.a., year end	1.8	3.4	3.25	3.25		
Unemployment rate, %, year end	5.6	5.4	5.0	4.75		
Inflation (CPI), % change p.a., year end	1.9	2.1	2.0	2.25		
Treasury Budget 2018-19 (May 2018)						
GDP, % change p.a., year average	2.1	2.9	3.0	3.0	3.0	3.0
Household consumption, % p.a., year average	2.6	3.0	2.75	3.0		
Dwelling investment, % p.a., year average	2.8	-0.4	1.5	0.0		
Business investment, % p.a., year average	-4.0	8.7	3.0	4.5		
Terms of trade, % change p.a., year end	14.4	2.1	-5.25	-2.25		
Employment growth, % p.a., year end	1.9	2.7	1.5	1.5	1.25	1.25
Unemployment rate, %, year end	5.6	5.4	5.25	5.25	5.25	5.0
Inflation (CPI), % change p.a., year end	1.9	2.1	2.25	2.5	2.5	2.5
Wages (WPI), % change p.a., year end	1.9	2.1	2.75	3.25	3.5	3.5

a = actual f = forecast p = projection
Sources: ABS various data; RBA *Statement on Monetary Policy* (SoMP), latest quarter; Australian Treasury, *Budget 2018-19* (May 2018).

Australian economy: latest indicators

Economy				FX and commodity prices (Friday morning)		
RBA official cash rate, %	Dec (M)	1.50	-	AUD/USD exchange rate	US$0.7235	▼
Real GDP, % change p.a.	Sep (Q)	2.8%	▼	Oil price (WTI light crude, USD/BBL)	US$51.71	▲
Headline CPI, % change p.a.	Sep (Q)	1.9%	▼	Gold price (USD/OZ)	US$1,237.11	▲
Unemployment rate, % trend	Oct (M)	5.1%	▼	Copper price (USD/tonne, LME spot)	US$6161.00	▼

Australian Industry Group monthly performance of industry indices

Australian PMI®	Nov (M)	51.3 ▼
Australian PSI®	Nov (M)	55.1 ▲
Australian PCI®	Nov (M)	44.5 ▼

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 indices.
Sources: ABS various data; Ai Group; Australian Financial Review market prices (as of Fri); London Metals Exchange market prices (as of Fri).

Ai Group Economics and Research Team

Julie Toth	**Chief Economist**	**(03) 9867 0124**
David Richardson	Senior Economist	(02) 9466 5456
Colleen Dowling	Senior Research Analyst	(03) 9867 0251
Andrew Bridger	Economist	(03) 9867 0231
Molly Knox	Research Assistant	(03) 9867 0108

economics@aigroup.com.au **www.aigroup.com.au/policy-and-research/economics/**