Ai GROUP | ECONOMICS WEEKLY

6 September 2019

AUSTRALIAN ECONOMIC DEVELOPMENTS

This week the Reserve Bank of Australia (RBA) left the cash rate on hold at 1.00%, a record low for Australia. In explaining this decision, RBA Governor Lowe said global conditions are reasonable, but trade and technology disputes are adding to uncertainty and restricting international trade and investment. Even before confirmation from this week's GDP data release (Q2 GDP grew by just 0.5% q/q and 1.4% p.a.), the RBA noted that Australian growth has been decidedly slow in 2019 to date, mainly due to slow consumption, slow investment, the housing cycle downturn and the very extended drought. Bright points in the local economy include the labour market (relatively low unemployment); government investment and spending; robust population growth and the trade surpluses being generated from mining exports and a lower Australian dollar. Confirming muted business conditions in Australia's non-mining sectors, Ai Group's monthly business surveys (the Australian PMI®, PSI® and PCI®) continue to indicate stable or slow growth at best as of August 2019, with small improvements evident in parts of manufacturing and the services sectors, but further declines in the construction sectors.

The *National Accounts* released this week by the ABS confirm sluggish growth over the last financial year. This is consistent with Ai Group's monthly performance indicators and other data covering the same period. Australia's real output growth (real GDP) rose on a quarterly basis to 0.5% q/q in Q2, which is still slow by historical standards. On an annual basis, real output growth slowed to just 1.4% p.a., which is its slowest rate since 2009. This places actual growth in 2018-19, below the RBA's expectation of 1.7% p.a. and well below Treasury's expectation of 2.25% p.a.

Private sector spending (by households) and investment (by business) continue to be key areas of concern, with weak business investment continuing to cause concern about the potential for future productivity gains. The importance of government spending and exports in supporting Australia's economic growth was starkly evident in Q2 of 2019. Rises in government recurrent spending by national and state governments on healthcare, disability and aged care services contributed a large share of the quarter's growth. High levels of Government infrastructure investment are also a key contributor at present, although delays to the construction pipeline in Q2 (partly related to election blackout periods) saw government investment detract from growth in Q2, in an accounting sense. Despite very weak growth in local private sector output and consumption in Q2 (and even weaker results on a *per capita* basis), exports and the terms of trade resulted in robust incomes growth at a national aggregate level. This was underscored by separate trade balance data that confirmed the best trade surplus in Q2 for many decades.

Business conditions improve in August

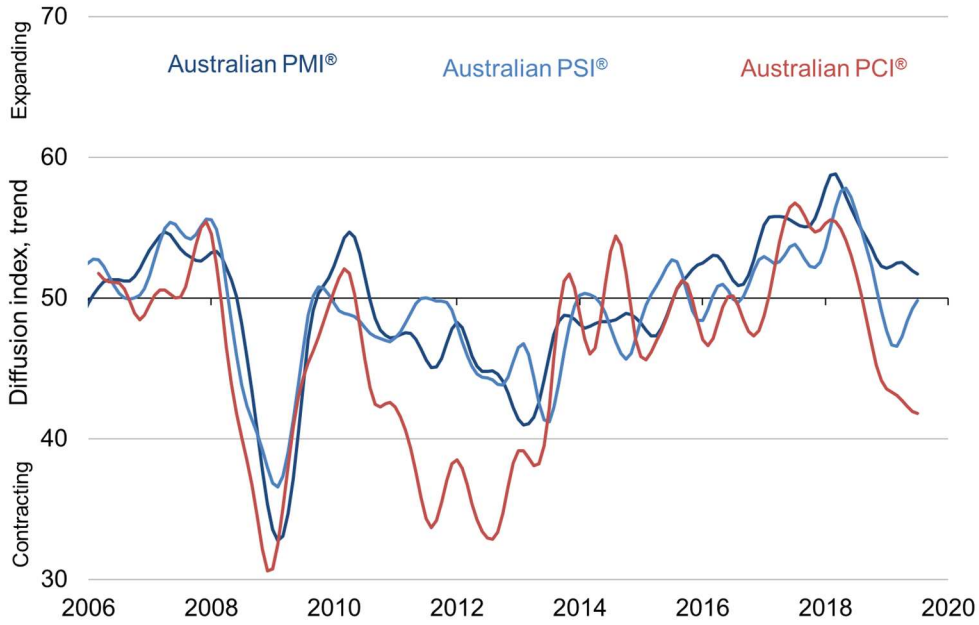
The Ai Group Australian Performance of Manufacturing, Services and Construction indices (released this week) all indicated improving conditions in August compared to July. Manufacturing and Services indicated expansion while the construction industry continued to contract, albeit at a slower pace than in recent months.

The Ai Group Australian PMI® rose 1.8 points to 53.1 in August, driven by increasing levels of production and rising exports. Results above 50 points indicate expansion, with the distance from 50 points indicating the strength of the increase. The Ai Group Australian PSI® rose by 7.5 points to 51.4 in August, marking a return to mildly positive conditions after a weak month in July.

In contrast, the Ai Group/HIA Australian PCI® registered 44.6 points in August (seasonally adjusted). This was an increase of 5.5 points from July, indicating an easing in the construction industry's overall rate of decline. It also signalled the industry's slowest contraction in five months.

Looking through the monthly volatility in the data, manufacturing is expanding albeit more modestly than at the start of 2018, while the services sector appears to be rebounding after a disappointing start to 2019. The construction industry is in deep contraction although there are signs that the contraction is slowing (see chart 1).

Chart 1: Ai Group performance indices, trend

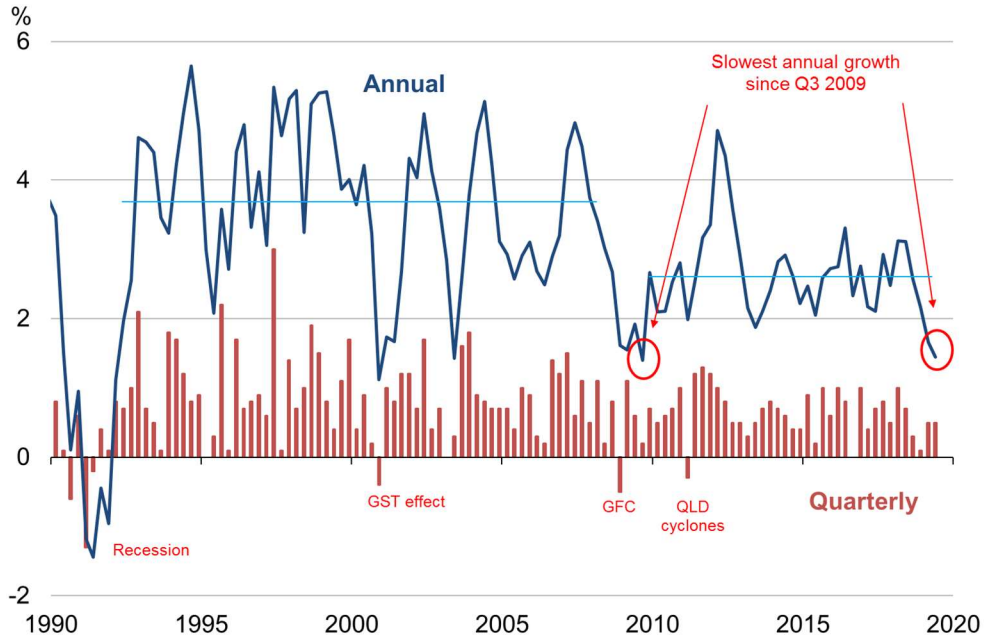


Sources: Ai Group, Aug 2019

GDP growth is slowest since 2009

The ABS *National Accounts* released this week confirm quarterly growth improved in the first half of 2019 compared to late 2018, but remained slow by historical standards. Australia's real GDP grew by 0.5% q/q in the June quarter (Q2) of 2019, bringing the annual growth rate to just 1.4% p.a., which was the slowest annual growth rate since 2009 (chart 2 and table 1).

Chart 2: Real GDP growth, annual and quarterly to Q2 2019

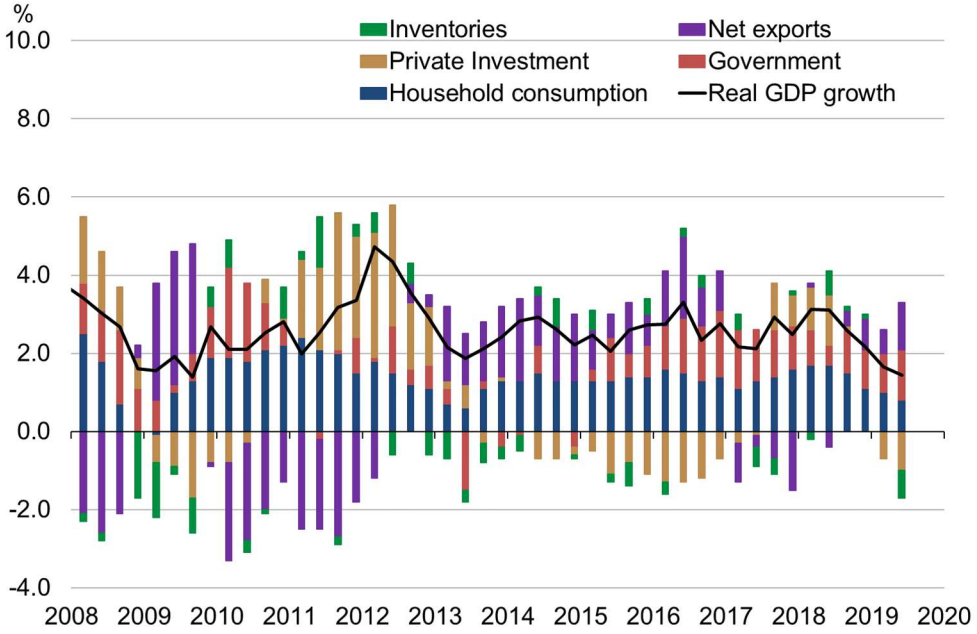


Source: ABS, *National Accounts,* Jun 2019.

On the expenditure (demand) side of the *National Accounts*, 0.5% q/q growth in Q2 2019 was supported by a 0.6 point contribution from net exports (exports minus imports) and a 0.5 point contribution from government spending. Net exports (exports minus imports) reflected a strong rise in export volumes (mainly iron ore to China) plus a decline in import volumes in Q2.

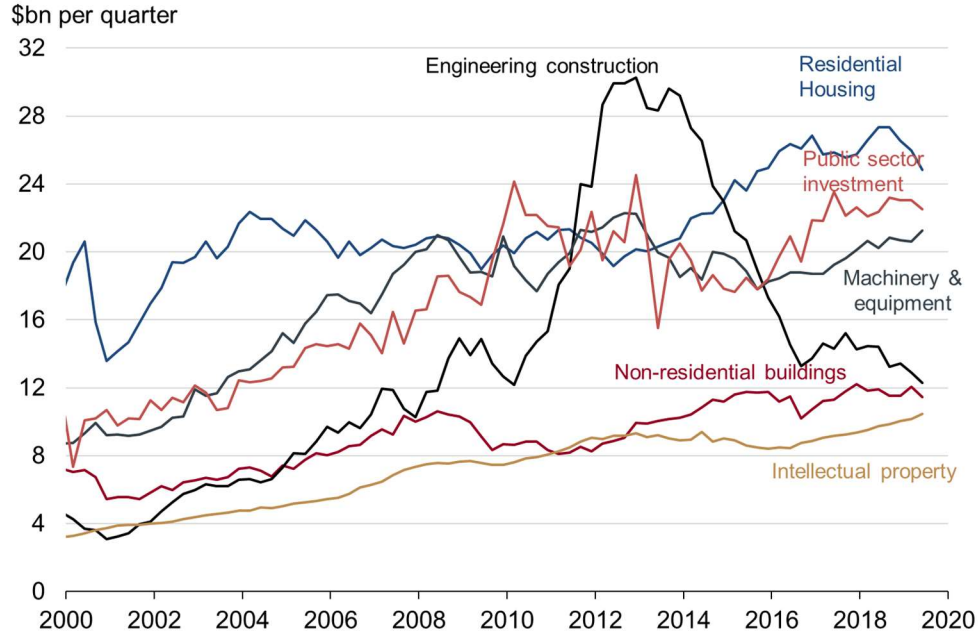
Although this decline in imports 'contributes' to GDP in an accounting sense, weak capital imports is a sign that businesses are less able to invest, which does not bode well for future growth prospects. This might already be occurring, with private investment detracting from growth, along with a fall in business inventories in Q2 (see chart 3). Dwelling investment fell by 9.1% over the year to Q2, while private business investment (on buildings, machinery & equipment, engineering projects and intellectual property) fell by 1.2% over the year. Weak business investment remains a major concern for economic growth, since weak investment will prolong the current sluggish state of productivity growth and weigh on future growth in wages and incomes (see chart 4).

Chart 3: Contributions to annual real GDP growth



Source: ABS, *National Accounts,* Jun 2019.

Chart 4: Investment spending per quarter, to Q2 2019



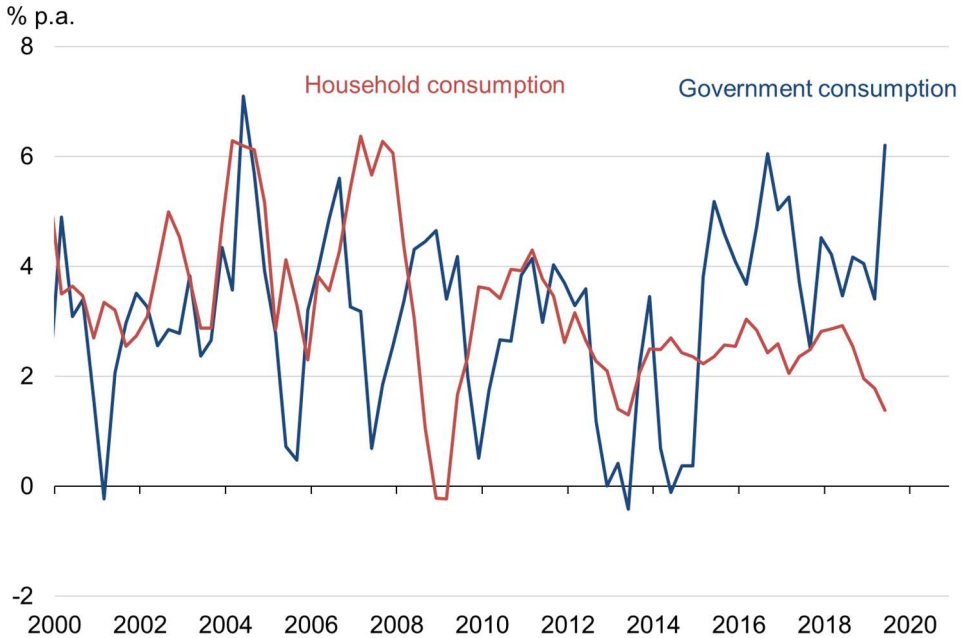
Source: ABS, *National Accounts,* Jun 2019.

Another concern arising from the *National Accounts* data this quarter was the divergence between Government consumption and household consumption growth (see chart 5). Government consumption rose by 2.7% q/q and 6.2% p.a., due to stronger spending from federal and state governments on health, aged care and disability services. Without this outsized increase in public sector spending in Q2, GDP growth would have been zero and domestic final demand would have been negative (see table 1). Less positively, real household consumption grew by just 0.4% q/q and 1.4% p.a. in Q2 2019. Household consumption has been weighed down by a protracted period of low-income growth and declining housing prices and turnover. This has a large effect on headline GDP because household consumption accounts around 60% of GDP expenditure. This is why the RBA has repeatedly highlighted that weak household consumption is the "*main domestic uncertainty"* for the Australian economy.

Household consumption has remained weak over an extended period, despite ongoing support from robust population growth which was 1.6% p.a. to Q4 2018 - adding 400,000 more people to bring the estimated resident population to 25,180,200 at the end of 2018. With population growth outpacing household consumption growth, this implies that consumption per capita (i.e. per person) is probably falling in 2019. On the production side, the *National Accounts* indicate that output (real GDP) per capita was flat in Q2 of 2019 and shrank by 0.2% over the year to Q2 (table 1).

In another sign that household budgets are under more stress in 2019, the national household savings ratio (calculated from the residual between aggregate household incomes and aggregate household spending) dropped to 2.3% of income, its lowest rate since 2007. This might also be a reaction to ultra-low interest rates, since bank balance savings are attracting minimal returns.

Chart 5: Household and government consumption growth, to Q2 2019



Source: ABS, *National Accounts,* Jun 2019.

Table 1: Key components of GDP, Q2 2019

seasonally adjusted	% q/q	% p.a.	ppt, contribution to growth
Real GDP	0.5	1.4	**0.5**
Household consumption	0.4	1.4	0.2
General government consumption	2.7	6.2	0.5
Total investment	-1.7	-4.0	-0.4
Dwelling investment	-4.4	-9.1	-0.2
Private business investment	-0.9	-1.2	-0.1
New building	-5.0	-3.8	-0.1
New engineering construction	-4.7	-14.8	-0.1
New machinery and equipment	3.2	5.2	0.1
Intellectual property investment	2.9	7.3	0.1
Public (government) investment	-2.3	0.7	-0.1
Domestic final demand	**0.3**	**1.0**	**0.3**
Change in inventories	-454.6	-244.1	-0.5
Exports	1.4	2.9	0.3
Imports	-1.3	-2.8	0.3
Net exports			**0.6**
Terms of trade	1.5	8.9	
Real gross domestic income	0.8	3.5	
Real net national disposable income	1.4	4.4	
Real GDP per capita	0.0	-0.2	
Nominal GDP	1.2	5.4	
Compensation of employees (wages & incomes)	1.3	5.0	
Private profits - total	2.3	11.9	
Private profits financial corporations	0.7	6.6	
Private profits non-financial corporations	2.9	14.9	

Source: ABS, *National Accounts,* Jun 2019.

Industrials and agriculture struggle in Q2 2019

On the production (supply) side of the *National Accounts*, industry output volumes [1] grew in 14 of the 19 major industries. Demonstrating the importance of government spending and resources exports as drivers of growth in 2019, output growth was strongest in healthcare (7.9% p.a.), mining (6.2% p.a.) and administrative services (5.6% p.a.) in the year to Q2.

Healthcare and social services is growing strongly because of increased demand for services for older Australians and more recently, by the roll-out of the NDIS. Administrative services growth reflects strong demand for employment services and contract services to the public sector.

In mining, newly completed LNG facilities are now adding to oil and gas output, while strong global demand is prompting an increase in coal production. Iron ore mining rose as production volumes recovered, following adverse weather conditions in Q1 2019. Mining is Australia's second largest

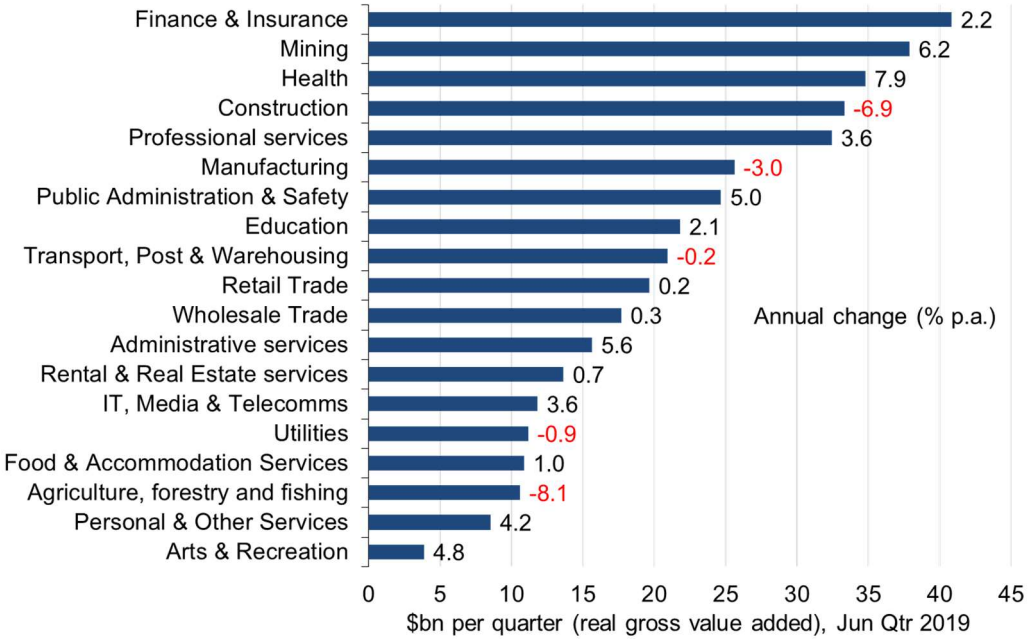
[1] Industry 'output' is measured in the *National Accounts* as real 'value-added output' volumes (that is, total outputs minus total inputs and inflation adjusted).

industry in terms of output (behind finance & insurance) but it is capital-intensive rather than labour-intensive and employs less than 2% of the workforce. Finance and insurance (including superannuation funds) has been Australia's single largest sector (by output) since 2014.

Weakness was evident in Q2 in the industrial sectors of construction, utilities, manufacturing, transport and agriculture:

- Agriculture contracted the most of any industry due to drought related losses of livestock and grain. Winter crops continue to be hit by drought in the eastern states.
- Construction contracted by 6.9% over the year to Q2, reflecting reduced activity in both residential and non-residential construction. This downturn has been evident in the Ai Group-HIA Australian PCI® for some time.
- Transport and warehousing activity fell because of reduced workloads for courier and delivery services. Transport and warehousing is a good leading indicator of retail sales and probably reflects reduced deliveries to and from the retail sector.
- Manufacturing output fell by 1.4% in Q2, due to falls in 'other manufacturing' and 'metal product manufacturing' (see table 2). Weak conditions in these sectors reflect the downturn in the construction industry. Partially offsetting these falls were further gains in food & beverage manufacturing and chemical and rubber product manufacturing. These sectors have reported strong conditions in the Ai Group Australian PMI® over the past year.

Chart 6: Industry output, size and annual growth rates, Q2 2019



Source: ABS, *National Accounts,* Jun 2019.

Table 2: Manufacturing sub-sector output, Q2 2019

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	7,022	27.4	0.7	2.5
Chemicals	4,798	18.7	0.3	0.8
Metal products	4,255	16.6	-2.3	0.6
Machinery and equipment	4,590	17.9	0.1	-3.7
Other manufacturing	4,952	19.3	-6.4	-14.6
Manufacturing	**25,618**	**5.5% of GDP**	**-1.4**	**-3.0**
GDP	465,885	**100.0**	**0.5**	**1.4**

Source: ABS, *National Accounts,* Jun 2019.

West recovers in Q2 2019

Quarterly state final demand (the state equivalent of national 'domestic final demand' or total expenditure net of exports) increased in Western Australia, the ACT, Victoria and Tasmania, was flat in Queensland and New South Wales, and contracted in South Australia and the Northern Territory (see table 3).

Over the year to Q2, growth ranged from -13.2% p.a. in the Northern Territory to 3.1% p.a. in Tasmania. Annual growth has slowed across all states and territories except for Western Australia, which has improved in recent quarters because of growing private investment and government investment. Investment in machinery and equipment drove growth in Western Australia with continued investment in automation by the mining sector. Private investment in the resources-based states is especially volatile due to the timing and nature of large one-off mining and related projects (see chart 7).

Across the other states in Q2:

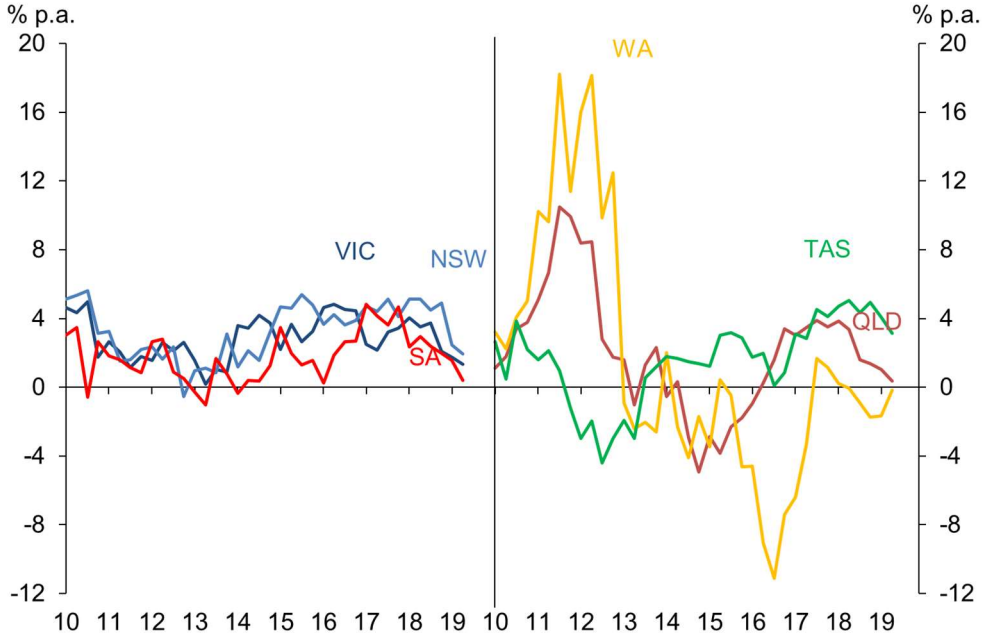
- NSW slowed to be flat in Q2 due to falls in state and local investment such as on infrastructure projects and a decline in dwelling investment because of the housing slow down.
- Victoria's growth picked up to 0.5% q/q after rising to 0.1% q/q in Q1 2019. Growth was driven by rising government spending on health services and continued investment in infrastructure, while private investment declined because of lower building work and declines in engineering construction on energy related projects.
- Queensland's state final demand was flat in Q2. Government consumption rose because of spending related to flood remediation work while business investment fell.
- South Australia's state final demand fell by 0.2% in Q2. Weakness in non-dwelling construction was driven by falls in energy related projects. Household consumption expenditure partly offset this fall, driven by increased spending on discretionary items.
- Tasmania's state final demand increased 0.3% in Q2 to be up 3.1% over the year. This result was driven by government consumption expenditure (such as on public services and the NDIS), while also dwelling investment increased.

Table 3: State final demand and components of expenditure, Q2 2019

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	2.0	0.2	-0.7	-5.2	0.0	1.3
Victoria	4.2	0.4	-3.2	3.9	0.5	1.9
Queensland	4.1	0.7	-5.5	-4.1	0.0	0.4
South Australia	0.7	0.3	-2.1	-4.1	-0.2	0.4
Western Australia	-0.9	0.3	3.3	3.1	0.8	-0.1
Tasmania	3.3	0.2	-0.3	-8.4	0.3	3.1
NT	1.9	0.2	-2.4	-14.9	-0.6	-13.2
ACT	3.6	0.5	-5.5	-4.8	0.8	2.7
Australia (domestic final demand)	2.7	0.4	-1.6	-2.3	0.3	1.0

* State Final Demand plus net exports is a proxy estimate of State Domestic Product (the state equivalent of GDP).
Source: ABS, *National Accounts,* Jun 2019.

Chart 7: State final demand, Q2 2019



Source: ABS, *National Accounts,* Jun 2019.

National income rises due to mining exports and the terms of trade (again)

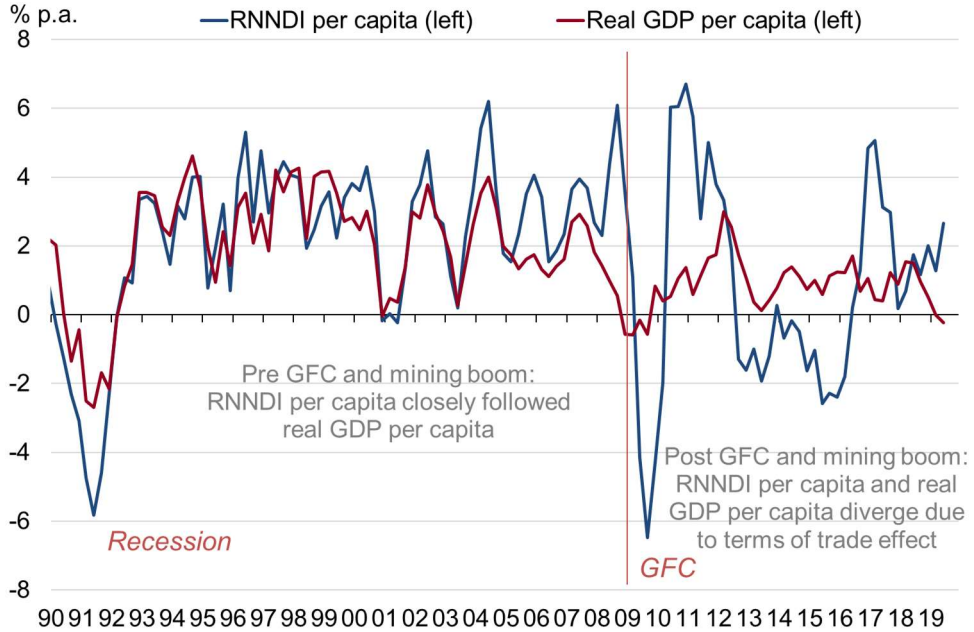
In national aggregate terms, real net national disposable income (RNNDI, the ABS' preferred measure of national income and living standards) increased by a robust 1.4% q/q and 4.4% p.a. in Q2 of 2019. This mainly reflected stronger export earnings, due to another rise in the terms of trade, which were 8.9% higher in Q2 than one year earlier. At a national aggregate level, Australia's income is more exposed to the terms of trade than in the past, due to the rising reliance on resources exports to generate income and profits. This has been especially evident since the

mining investment boom (directly after the GFC) of 2010 to 2015, which added significantly to mining output capacity (chart 8 and 9). As a result, RNNDI per capita rose by 1.0% q/q and 2.7% p.a. in Q2, even though real output (GDP) per capita was flat in the quarter and declined by 0.2% over the year.

With so much of national income growth derived from resources exports and the terms of trade, it comes as no surprise that gross operating profits by mining companies hit a new record high of $41bn in Q2 of 2019 (in seasonally adjusted nominal dollars), up by 10.9% q/q and 31.9% p.a. (chart 10). Mining companies now account for 48% of the company profits published in the ABS *Business Indicators* industries, up from 28% one decade earlier and 20% two decades earlier.

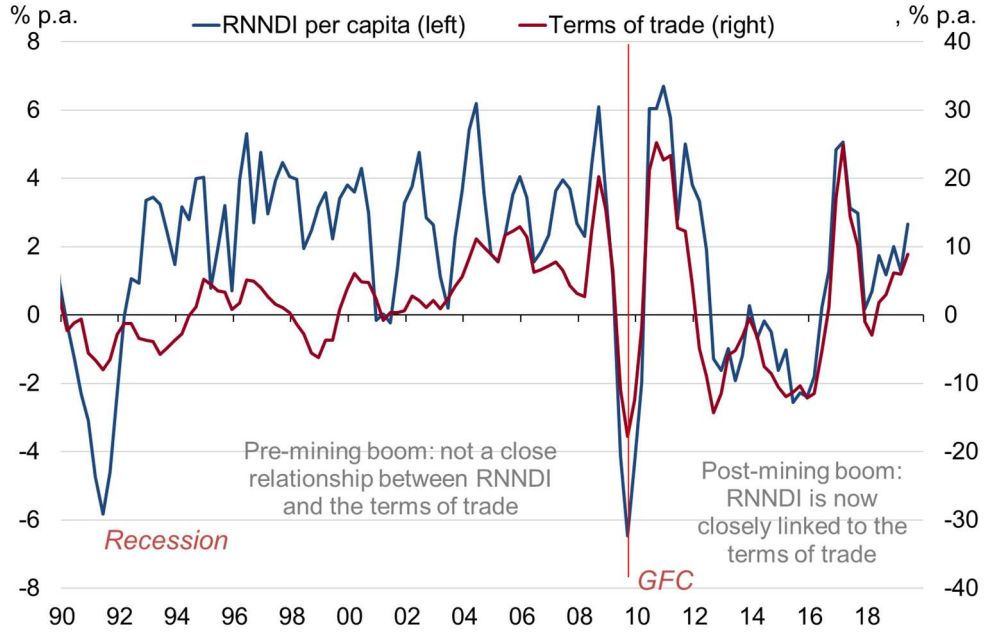
Outside the mining sector, company operating profits were lacklustre, with all non-mining company profits up just 0.3% q/q and 1.5% p.a. in Q2 of 2019 and barely keeping pace with inflation. In the industrial sectors, aggregate nominal company operating profits fell in Q2 in manufacturing (by -3.4% q/q and -10.7% p.a.), utilities, transport and telecommunications.

Chart 8: real net national disposable income per capita, 1990 to 2019



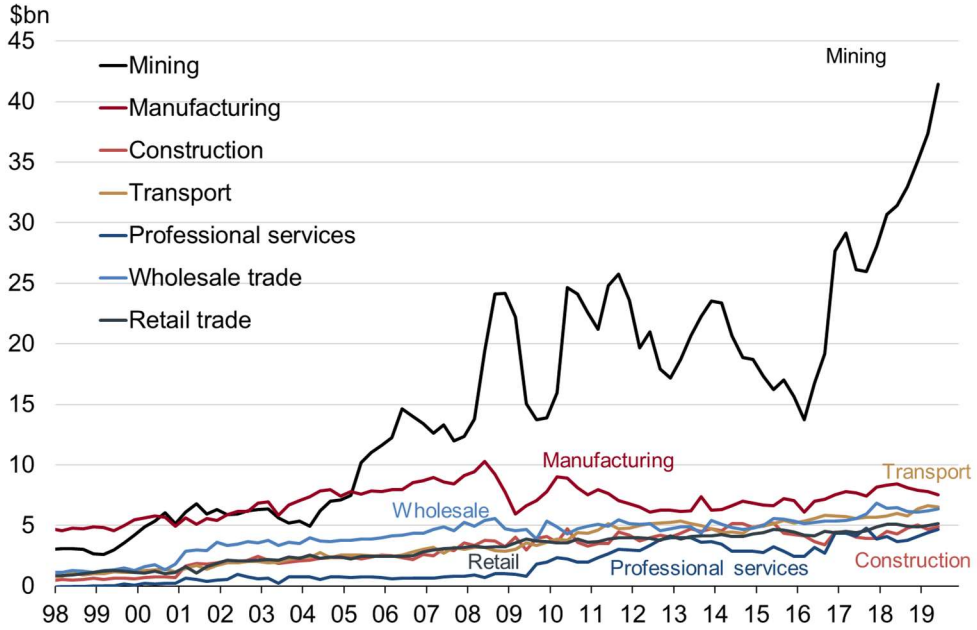
Source: ABS, *National Accounts,* Jun 2019.

Chart 9: real net national disposable income per capita, 1990 to 2019



Source: ABS, *National Accounts,* Jun 2019.

Chart 10: Nominal company profits, major industries, seasonally adjusted



Source: ABS, *Business Indicators,* Jun 2019.

This week's data and events, 2 September – 6 September 2019

Day	Date	Data/event	Data period	Result
Mon	2 Sep	**Australian PMI®**	Aug (M)	**53.1 points**
		ABS Business Indicators	Jun (Q)	Gross operating profits: +4.5% q/q, 12.5% p.a.
Tue	**3 Sep**	**RBA monetary policy decision (cash rate) and board meeting**	**Sep (M)**	**Cash rate: 1.00%**
		ABS Retail Trade	Jul (M)	Nominal turnover: -0.1% m/m
		ABS Balance of Payments	Jun (Q)	Current account: +5.9 bn (surplus)
Wed	4 Sep	**Australian PSI®**	**Aug (M)**	**51.4 points**
		ABS National Accounts	Jun (Q)	Real GDP: +0.5% q/q, +1.4% p.a.
Thu	5 Sep	ABS Industrial Disputes	Jun (Q)	Working days lost: 112,500 in the last year
		ABS International Trade in Goods and Services	Jul (M)	Balance on goods and services: $7.3 bn (surplus)
Fri	6 Sep	**Australian PCI®**	**Aug (M)**	**44.6 points**

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

Next week's data and events, 9 September – 13 September 2019

Day	Date	Data/event	Data period due for release	Previous release
Mon	9 Sep	ABS Lending to Households	Jul (M)	Jun (M): Lending to business -16.5% m/m, -4.4% p.a.
Tue	10 Sep	ABS Labour Account	Jun (Q)	Mar (Q): Filled jobs +2.8% p.a.
Wed	11 Sep	ABS Overseas and Arrivals	Jul (M)	Jun (M): arrivals 791,900 departures 953,700
		NAB Business Survey	Aug (M)	Jul (M): conditions +2 points Confidence +4 points
Thu	12 Sep	-	-	-
Fri	13 Sep	-	-	-

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

Australian economy: latest indicators

Economic activity, investment and employment			Prices, wages and interest rates		
Real GDP growth, % p.a.	Jun (Q)	1.4% ▼	Headline CPI, % p.a.	Jun (Q)	1.6% ▲
Real Business Investment % p.a.	Jun (Q)	-1.0% ▲	Core CPI, % p.a.	Jun (Q)	1.4% ▼
Employment growth, % p.a. trend	Jul (M)	2.7% -	WPI, % p.a.	Jun (Q)	2.3% -
Unemployment rate, % trend	Jul (M)	5.3% -	RBA cash rate, %	Sep (M)	1.00 -

Australian Industry Group monthly performance of industry indices

Australian PMI®	Aug (M)	53.1 ▲
Australian PSI®	Aug (M)	51.4 ▲
Australian PCI®	Aug (M)	44.6 ▲

M = monthly. Q = quarterly. All data are seasonally adjusted unless otherwise noted.
Arrows represent direction of movement relative to last observation. Sources: ABS various data, Ai Group.

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

RBA, SoMP (August 2019)	Jun 19 est. / f	Dec 19 f	Jun 20 f	Jun 21 f		
GDP, % change p.a., year end	1.7 (f)	2.4	2.7	3.0		
Unemployment rate, %, year end	5.2 (e)	5.2	5.2	5.1		
Inflation (CPI), % change p.a., year end	1.6 (e)	1.7	1.7	2.0		
Wages (WPI), % change p.a., year end	2.3 (e)	2.3	2.3	2.4		
Treasury, Federal Budget 2019-20 (Apr 2019)	**18-19 f**	**Dec 19 f**	**19-20 f**	**20-21 f**	**21-22 p**	**22-23 p**
GDP, % change p.a., year average	2.25	-	2.75	2.75	3.0	3.0
Household consumption, % p.a., year average	2.25	-	2.75	3.0	-	-
Dwelling investment, % p.a., year average	0.5	-	-7.0	-4.0	-	-
Business investment, % p.a., year average	1.0	-	5.0	4.5	-	-
Employment growth, % p.a., year end	2.0	-	1.75	1.75	1.5	1.5
Unemployment rate, %, year end	5.0	-	5.0	5.0	5.0	5.0
Inflation (CPI), % change p.a., year end	1.5	-	2.25	2.5	2.5	2.5
Wages (WPI), % change p.a., year end	2.5	-	2.75	3.25	3.5	3.5
Terms of trade, % change p.a., year end	4.0	-	-5.25	-4.75	-	-

e = ABS estimate. f = forecast. p = projection. Sources: ABS various data; RBA *Statement on Monetary Policy* (SoMP), latest quarter; Australian Treasury, *Federal Budget 2019-20* (April 2019).

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