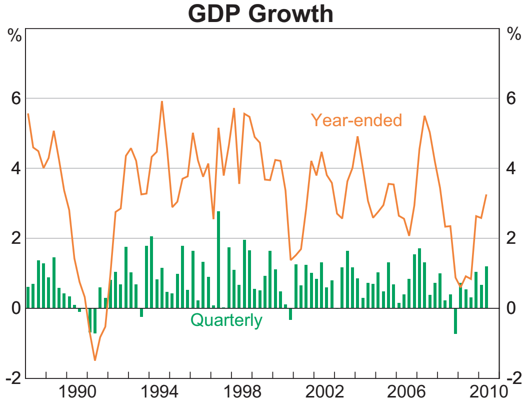
Domestic Economic Conditions*

The Australian economy has grown at an around trend pace over the past year, supported by the high level of commodity prices, strong public investment and ongoing solid growth in the population. Employment growth has been strong, underpinning growth in household income, and consumer confidence remains high. While public spending made a significant contribution to aggregate demand in 2009 and early 2010, this impact is now lessening, with public investment estimated to now be declining as stimulus projects are completed. The expected rebalancing of public and private demand appears to be underway, with signs that private demand is firming. Household spending has been growing at a solid pace recently, although many consumers continue to take a more cautious approach to spending and borrowing than in earlier years. The outlook for business investment remains positive, especially in the resources sector, with the large rise in Australia's terms of trade boosting national income and demand.

The latest available quarterly data for real GDP show an increase of 1.2 per cent in the June quarter and 3.3 per cent over the year, which is around the average annual growth rate for the past two decades (Graph 37, Table 7). With the terms of trade rising

Graph 37
GDP Growth



Source: ABS

Table 7: Demand and Output Growth
Per cent

	June quarter 2010	Year to June quarter 2010
Domestic final demand	1.3	5.3
– Private demand	1.4	3.0
– Public demand	1.2	13.1
Change in inventories[(a)]	–0.7	0.5
GNE	0.6	5.8
Net exports[(a)]	0.4	–2.5
GDP	1.2	3.3
Nominal GDP	3.6	10.0

(a) Contribution to GDP growth
Source: ABS

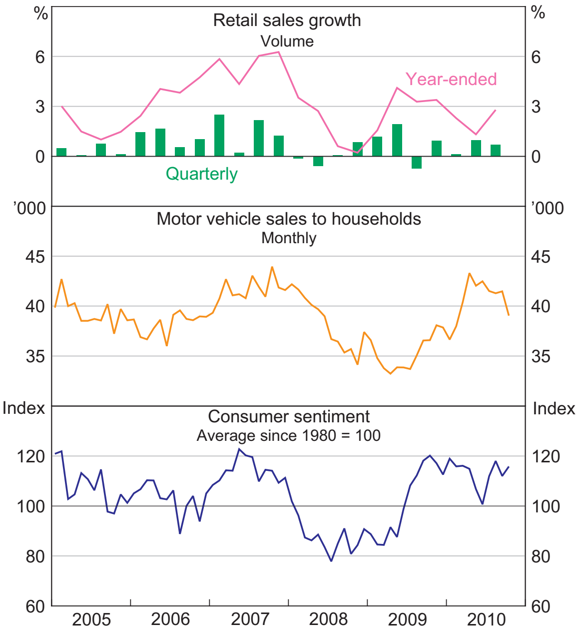
* The national accounts data used in this Chapter are from the June quarter 2010 release, rather than the 2009/10 annual national accounts.

by 25 per cent over the year to the June quarter, nominal GDP increased by 10 per cent over the year.

Household Sector

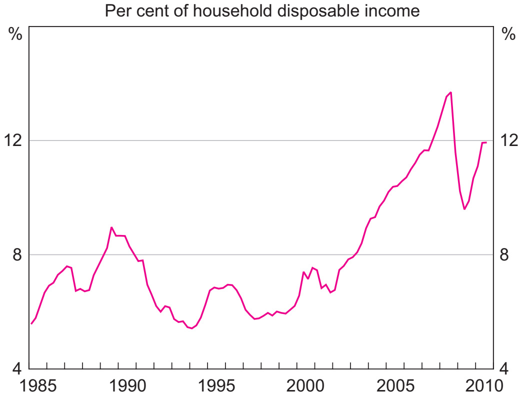
Households continue to display some caution in their behaviour, with this most evident on the financial side. Growth in mortgage debt remains well below the average for the previous decade and credit card debt has been broadly flat over 2010. In addition, the household saving rate has remained above the levels seen in the middle of the decade and there has been solid growth in the household sector's holdings of deposits. Liaison with retailers suggests that household spending has grown moderately over recent months, with sales volumes supported by ongoing discounting. Most retailers continue to report that consumers remain cautious, though the latest national accounts had suggested that overall consumer spending grew strongly in the June quarter. In the September quarter, the volume of retail sales increased at a moderate pace, rising by 0.7 per cent after increasing by 1 per cent in the June quarter (Graph 38). Motor vehicle sales have softened in recent months after having been boosted earlier this year by the replacement of hail damaged cars.

Graph 38
Consumption Indicators



Sources: ABS; Melbourne Institute and Westpac; RBA; VFACTS

Graph 39
Household Interest Payments*
Per cent of household disposable income



* Excludes unincorporated enterprises. Income is before the deduction of interest payments. RBA estimate for September quarter 2010.
Sources: ABS; RBA

Household income and the high level of consumer confidence are being underpinned by strong employment growth. The recovery in household net worth is also supporting consumer sentiment; net worth is estimated to have increased by 11 per cent over the year to September to be equivalent to around six times annual disposable income and 25 per cent above its early 2009 trough. Although net worth was flat in the June quarter, it is estimated to have grown by around 2 per cent in the September quarter, reflecting an increase in equity prices.

While the pace of borrowing has moderated over recent years, the increase in mortgage rates over the past year has resulted in an increase in the ratio of household interest payments to disposable income to 12 per cent in the September quarter, although this is below the peak of 14 per cent reached in September 2008 (Graph 39). Despite the increase in debt servicing, at the aggregate level there are relatively few signs of financial stress in the household sector, with the labour market supporting households' debt-servicing capacity. Housing loans in arrears have drifted higher over the past year, but remain less than 1 per cent of the total stock of loans.

Table 8: National Housing Price Growth(a)

Per cent

	3 months to June 2010	3 months to September 2010	Year to September 2010
Capital cities			
ABS(b)	2.0	0.1	11.5
APM	1.2	–0.1	10.1
RP Data-Rismark	0.7	–0.4	7.9
Regional areas			
APM	0.6	–0.6	5.3
RP Data-Rismark(b)	0.9	–1.9	2.7

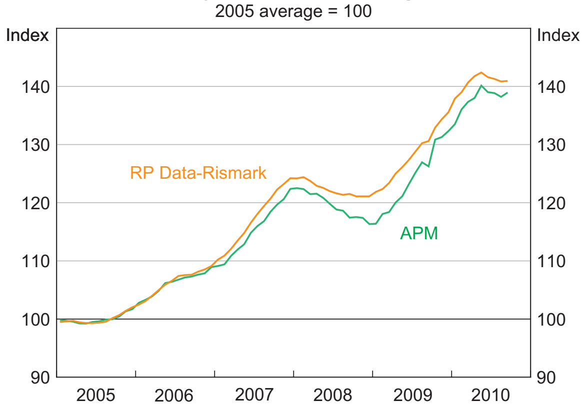
(a) ABS and APM regional data are quarterly; all other data series are monthly
(b) Detached houses only
Sources: ABS; APM; RBA; RP Data-Rismark

The established housing market has cooled in recent months, with data from private-sector providers indicating dwelling prices in capital cities fell modestly in the September quarter (Table 8, Graph 40). After the unsustainable growth of around 1 per cent per month over 2009 and the early part of 2010, the easing in dwelling prices is a welcome development. Over the past six months, dwelling prices in lower-priced suburbs have been relatively flat, while prices have declined a little in the more expensive suburbs. By city, prices in Brisbane and Perth have declined most notably, while prices in Sydney, Melbourne and Adelaide have been relatively flat (Graph 41). Auction clearance rates, which are a timely indicator of housing market conditions, have also fallen from very high levels in the early part of the year to be around their long-run average levels.

In line with developments in the housing market, housing finance activity has continued to ease from its peak in late 2009. The value of loan approvals for first-home buyers are around decade-average levels, following the expiration of the boost to federal government grants to first-home buyers. Demand for housing finance from other owner-occupiers has also slowed over the past year as mortgage rates have risen. Investor activity was broadly steady over the first half of the year, but looks to have declined in recent months.

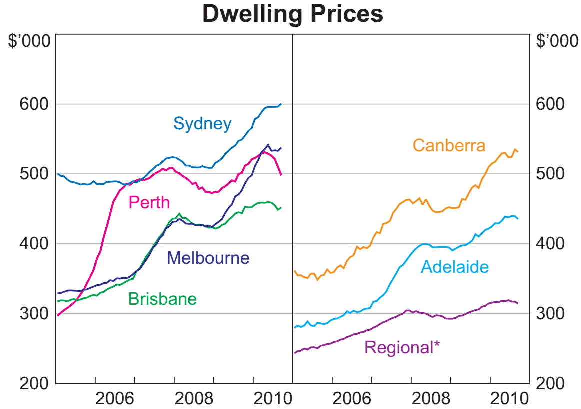
Graph 40
Capital City Median Dwelling Prices*

2005 average = 100



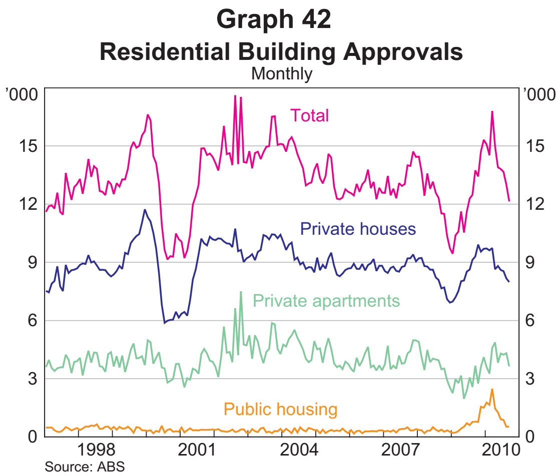
* Weighted average of houses and apartments
Sources: APM; RBA; RP Data-Rismark

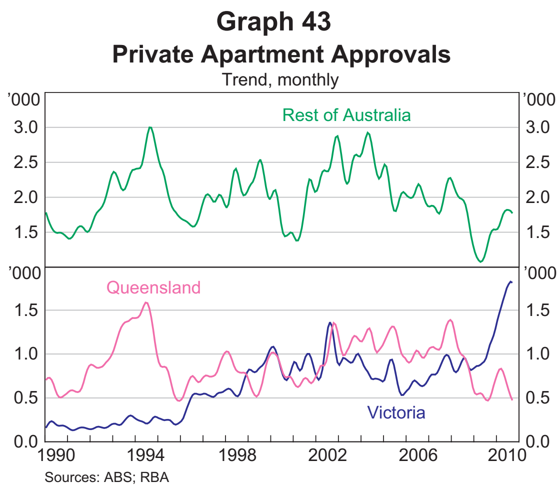
Graph 41
Dwelling Prices



* Excluding apartments; measured as areas outside of capital cities in New South Wales, Queensland, South Australia, Victoria and Western Australia
Sources: RBA; RP Data-Rismark

After an upswing over 2009, indicators of dwelling investment have softened, reflecting a step-down in house-building activity as the boosts from higher first-home buyer grants and low interest rates have been unwound (Graph 42). Private building approvals, which rose by close to 50 per cent over 2009, have fallen by 16 per cent since late 2009, reflecting a sharp fall in building approvals for new houses. There has been a gradual recovery in apartment building, with building approvals for new apartments broadly unchanged since late 2009 and around 25 per cent higher than the average level of approvals over last year. The recovery in approvals for apartments has been particularly strong in Victoria; solid growth in demand has assisted developers to achieve the required pre-sales in order to secure finance approval and progress to construction (Graph 43). Liaison suggests that investor demand in Victoria has been underpinned by low vacancy rates, while owner-occupier demand has also gradually increased. In contrast, continuing weakness in dwelling construction is evident in Queensland.





Despite the decline in total building approvals since late 2009, private dwelling investment increased by 5 per cent in the June quarter, reflecting a large amount of work done on projects that had been approved during 2009. This pipeline of work should continue to support activity over the coming quarters. Nonetheless, the pick-up in housing construction is moderate by historical standards, especially given strong demand for housing from a growing population.

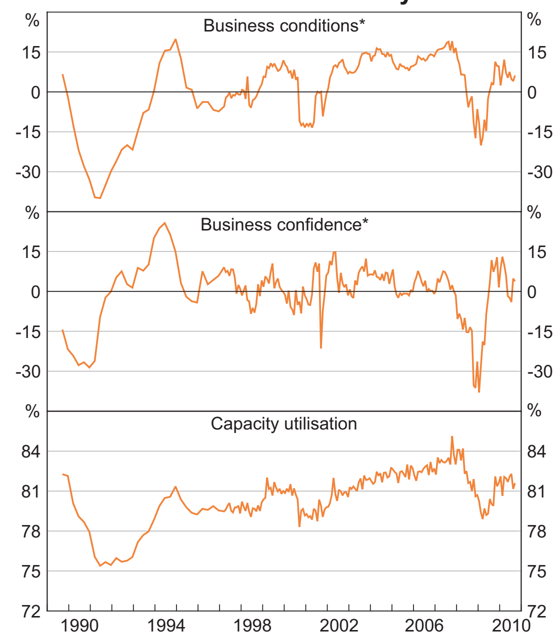
Business Sector

Conditions in the business sector are broadly favourable, although there is considerable variation across industries. While measures of mining conditions are at the highest level since late 2007, with strong growth in mining employment over the past year, conditions in the construction industry have softened as the impetus from stimulus-related public building activity has faded. Conditions remain weak in the tourism industry, in part reflecting the appreciation of the Australian dollar, with overseas arrivals broadly unchanged over the past year while overseas departures have increased strongly. Overall, measures of business confidence and conditions are a little lower than earlier in the year, although they remain at or above average levels (Graph 44). Surveys also suggest that capacity utilisation is around average levels.

After being broadly unchanged over 2009/10, there are signs that private business investment is starting to pick up. The stock of engineering construction work in the pipeline is at a very high level, with the $43 billion Gorgon LNG project now under construction, and a number of other resource projects also underway (Graph 45). There are also several significant projects in the advanced stages of planning, including conventional LNG projects in Western Australia and the Northern Territory and coal-seam methane to LNG projects in Queensland.

Business investment is being supported by solid internal funding, with elevated commodity prices underpinning particularly strong mining profits (Graph 46). Although the corporate sector has access to healthy levels of internal funding for capital expenditure, business credit growth remains weak, with firms continuing to repay loans and there has been little growth in commercial loan approvals. Survey measures suggest that business conditions are weaker for small businesses than large businesses, with investment intentions below average for small firms. Although liaison suggests

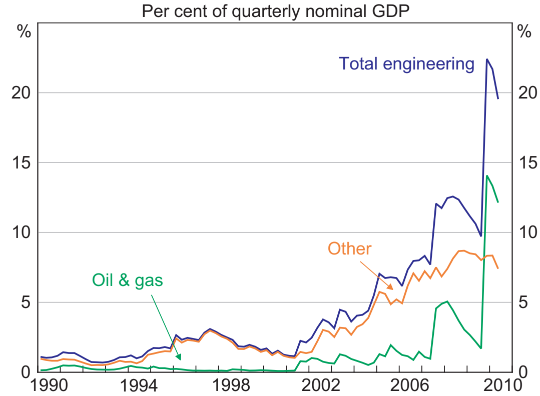
Graph 44
NAB Business Survey



* Net balance, deviation from average since 1989
Sources: NAB; RBA

Graph 45
Engineering Construction Work yet to be Done

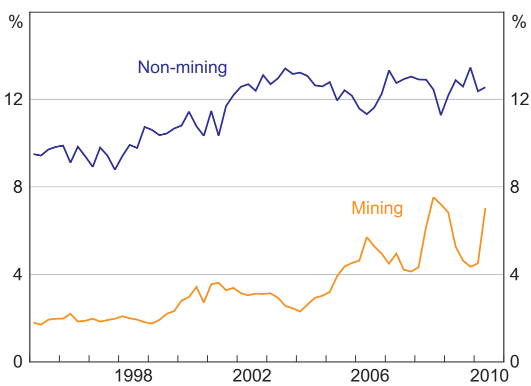
Per cent of quarterly nominal GDP



Source: ABS

Graph 46
Private Non-financial Corporation Profits*

Share of nominal GDP

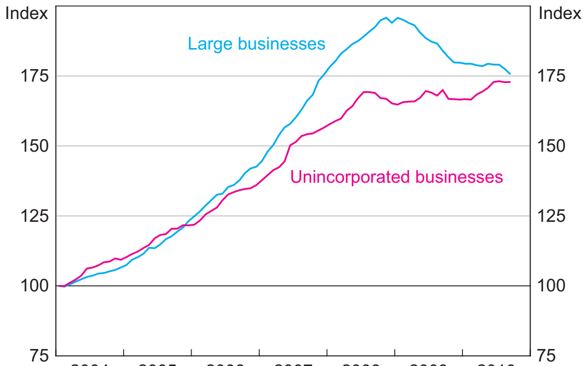


* Gross operating profits; inventory valuation adjusted
Sources: ABS; RBA

that some small businesses are encountering difficulty in accessing finance, outstanding business credit to unincorporated businesses has grown at an annualised rate of around 5 per cent over the past six months (Graph 47).

Measures of investment intentions suggest a positive outlook, particularly for the resources sector. The capital expenditure (Capex) survey's third estimate of firms' spending plans points to a large rise in mining sector investment in 2010/11, although these data may overstate the actual spending that will take place in the near-term as delays often occur given the complexity of projects. While there is uncertainty as to the timing of when some projects will ramp up, the favourable medium-term outlook for China and other trading partners in Asia suggest that strong demand for a number of Australian commodities will continue to support a high level of engineering investment activity in the period ahead.

Graph 47
Business Credit by Type of Borrower
January 2004 = 100

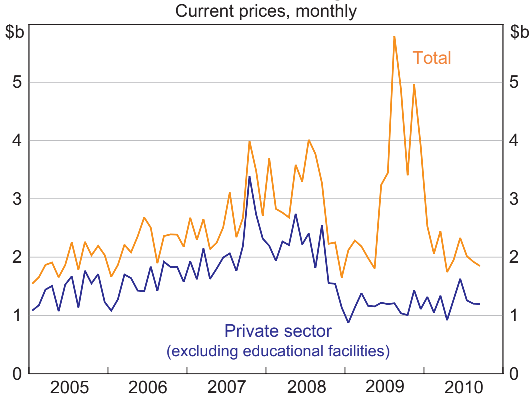


Sources: APRA; RBA

Outside of the mining sector, investment intentions are around average levels and the Bank's liaison suggests that firms remain cautious in their spending decisions. Motor vehicle sales were broadly flat in the September quarter and rose by 5 per cent in October, after declining in recent quarters. Capital imports are estimated to have fallen a little in the September quarter, though they remain at a relatively high level. While the recent pattern of machinery and equipment investment has been affected by the temporary investment tax deductions that were in place in 2009 – with investment declining over the first half of this year – the end of the tax incentives is expected to have less of an impact going forward.

Non-residential building investment remains weak, with developers' access to funding continuing to be tight and the boost to construction from the fiscal stimulus spending on school facilities starting to unwind (Graph 48). Excluding public spending on education facilities, the value of non-residential building approvals has been at a low level since early 2009. While in recent quarters there has been a tentative recovery in approvals for commercial developments, building remains subdued. Over the next few years, office markets in some capital cities are likely to tighten, due to strong tenant demand and expected modest additions to office space.

Graph 48
Non-residential Building Approvals
Current prices, monthly

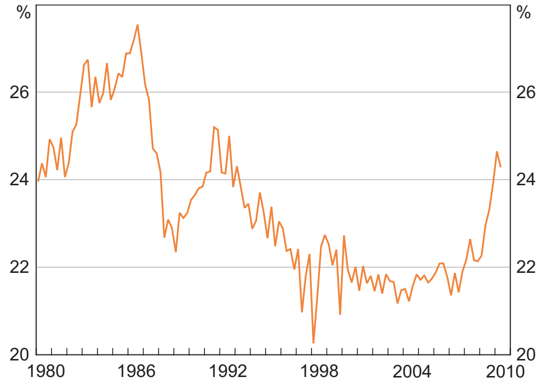


Source: ABS

Government Spending

After making a significant contribution to GDP growth in earlier quarters, the pace of public demand growth eased in the June quarter (Graph 49). In particular, public investment was flat in the quarter following growth of around 40 per cent over the year to the March quarter 2010 due to the commencement of stimulus-related projects. Public investment is expected to fall over the period ahead as these projects are completed.

Graph 49
Public Demand
Share of nominal GDP

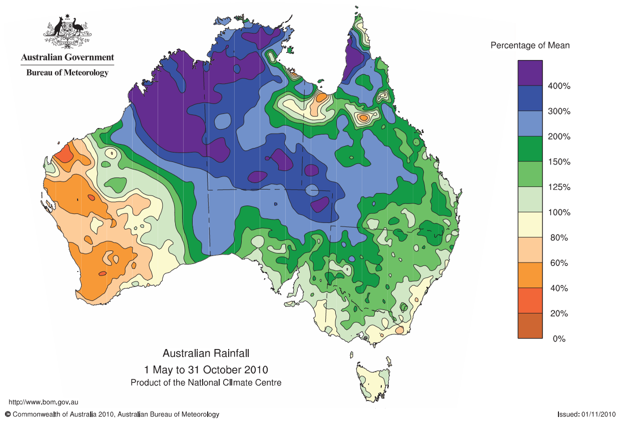


Source: ABS

Farm Sector

The outlook for farm production in 2010/11 is positive, although there are significant divergences between the eastern and western parts of the nation. After a good start to the season, most cropping regions in the eastern states have received average or above-average rainfall in the second half of 2010 (Graph 50). A La Niña weather pattern is now well established in the Pacific Ocean, as indicated by the high level of the Southern Oscillation Index; this would typically be associated with above-average rainfall in most parts of eastern and northern Australia over the remainder of 2010. In contrast, most cropping regions in Western Australia have experienced very dry conditions and a significant fall in crop production is expected.

Graph 50
Australian Rainfall
1 May to 31 October 2010



Source: Bureau of Meteorology

Overall, reflecting the higher production in the eastern states, ABARE has revised up its forecast for winter crop production to 41 million tonnes, a 16 per cent increase on 2009. However, one potential downside risk to this is damage from plague locusts. Hatchings of plague locusts have been reported in parts of New South Wales, Victoria and South Australia, and the spraying of insecticides has commenced in affected regions. In previous episodes this has been broadly effective in minimising damage to crops and pasture.

Inflows into the Murray-Darling basin surged in September, with the largest amount of water flowing into the system in any one month since 1996. Non-metropolitan water storage levels in New South Wales and Victoria have increased substantially recently, and are at high levels in Queensland. The Murray-Darling Basin Authority recently released the preliminary plan for water usage in the basin. The plan recommends reduction by water users of between 3000–4000 gigalitres in order to increase the environmental allocation to the river system and boost Murray mouth outflows. The final plan is expected to be released in 2011.

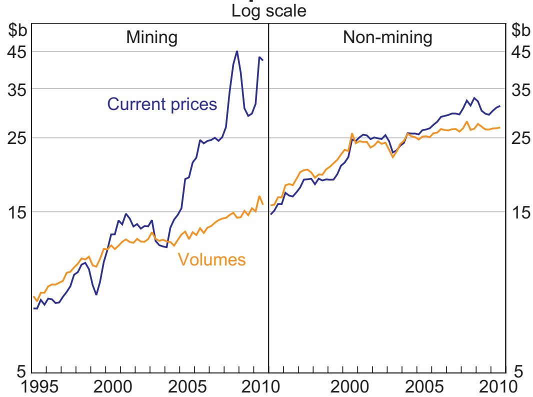
External Sector

The increase in export prices for Australia's major commodity exports has provided a significant boost to export revenue over the past year (Graph 51). As a result, in the June quarter the trade balance recorded the largest surplus since 1973 (2 per cent of GDP) and remained close to this level in the September quarter. The large increases in bulk commodity prices have also led to a sharp rise in the terms of trade over the past year to be around the highest level in 60 years (Graph 52). Although the terms of trade are expected to ease over the medium term as further supply comes online and commodity export prices decline a little, they are expected to remain at high levels.

Graph 51

Exports*

Log scale



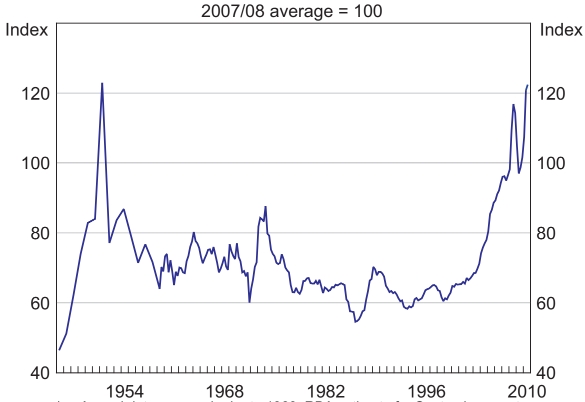
* Volumes data referenced to 2003/04 prices; RBA estimate for September quarter 2010

Sources: ABS; RBA

Graph 52

Terms of Trade*

2007/08 average = 100



* Annual data are used prior to 1960; RBA estimate for September quarter 2010

Sources: ABS; RBA

Over recent years, export volumes have increased, driven higher by resource exports. Although export volumes are estimated to have declined in the September quarter, they remain at a high level after rising sharply in the June quarter. This recent decline largely reflected lower resource exports, with iron ore exports falling in the September quarter partly due to supply issues associated with scheduled maintenance and infrastructure upgrades and a range of supply disruptions constraining coal exports. Nevertheless, the outlook remains positive, with strong demand for Australian resource commodities and high prices expected to underpin strong growth in mining investment and exports in the years ahead, particularly in iron ore, coal and LNG.

Rural exports are estimated to have increased in the September quarter, reflecting higher wheat exports. Manufactures and services exports are estimated to have declined a little in the quarter, and they remain well below their pre-crisis peaks. While trading partner growth is expected to remain solid, the high level of the Australian dollar – which, in real terms, is around 35 per cent above its post-float average – will likely weigh on manufactures and services exports going forward. Education exports have been facing a number of additional headwinds, including tighter access to student visas, and the associated decline in the number of overseas students commencing study in Australia is likely to continue into 2011.

After rebounding sharply in 2009/10, import volumes are estimated to have declined a little in the September quarter, driven by falls in capital and gold imports. Imports are expected to grow at a solid pace going forward, reflecting the high exchange rate and expected growth in domestic demand. In particular, strong growth in mining investment is expected to boost imports as this sector typically imports a significant proportion of its capital inputs.

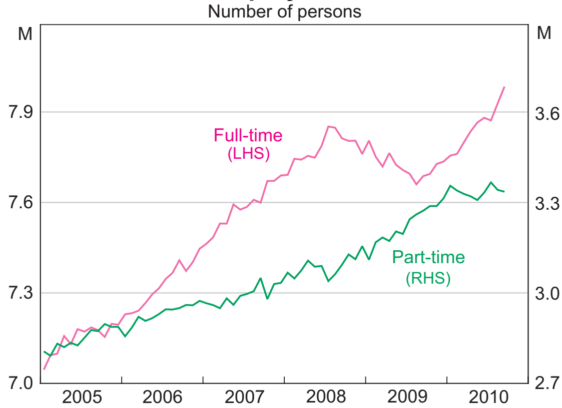
Labour Market

Employment has continued to grow strongly in recent months, and the unemployment rate has been steady at around 5.1 per cent (for further discussion, see 'Box C: Spare Capacity in the Labour Market'). Employment grew by 0.9 per cent in the September quarter, to be more than 3 per cent higher than in the corresponding quarter last year. Full-time employment has grown particularly strongly in recent months, and is now well above its earlier peak in mid 2008 (Graph 53). Average hours worked have risen by around ½ per cent in trend terms since mid 2009 – reflecting a pick-up in average hours worked by both full-time and part-time workers, as well as the strength in full-time employment – although they remain around 1¾ per cent below their recent peak in mid 2008 when the labour market was tight (Graph 54).

Employment has increased in the majority of industries over the past year or so (Graph 55). The services sector continues to record solid employment growth, particularly in professional, scientific & technical services where the level of employment has increased by around 60 000 (7 per cent) in trend terms over the past year. Mining sector employment is estimated to have grown rapidly, increasing by more than 30 000 (20 per cent) over the past year after earlier falls, while employment in manufacturing and arts & recreation services has been weak. Most states have recorded solid employment growth over the past year, with Western Australia and Victoria particularly strong. In trend terms, all mainland states have recorded declining unemployment rates over the past year; trend unemployment rates currently range between 4.4 per cent in Western Australia and 5.9 per cent in Tasmania.

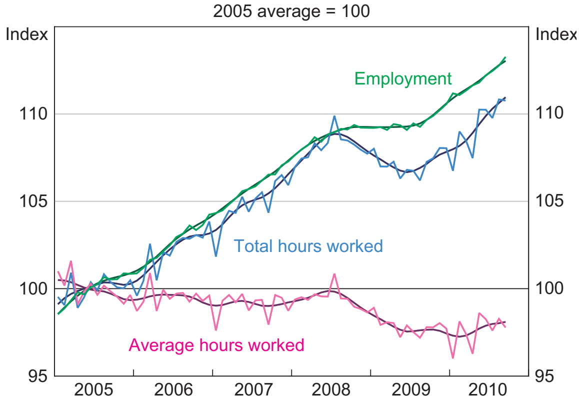
Forward-looking indicators of labour demand point to continued growth in employment in coming months, though an easing in some indicators – such as those from the business surveys – suggests that there could be some moderation from the current

Graph 53
Employment
Number of persons



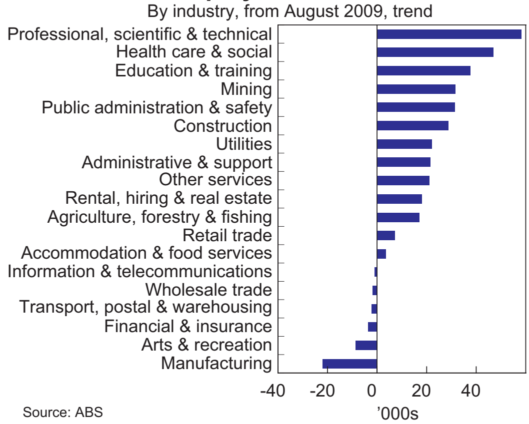
Source: ABS

Graph 54
Employment and Hours Worked*
2005 average = 100



* Smoothed lines are 13-period Henderson trends
Sources: ABS; RBA

Graph 55
Employment Growth
By industry, from August 2009, trend

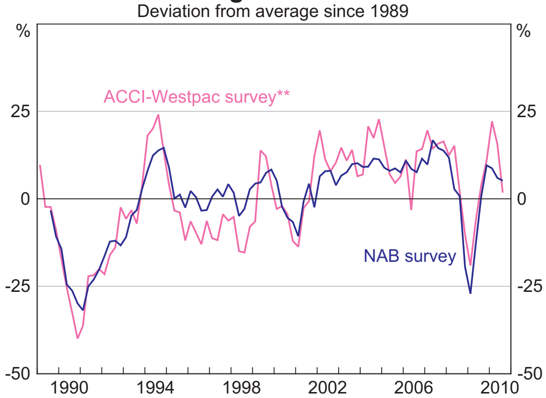


Source: ABS

Graph 56

Hiring Intentions*

Deviation from average since 1989



* Net balance of expectations for the following quarter

** Seasonally adjusted by RBA

Sources: ACCI-Westpac; NAB; RBA

strong pace of growth (Graph 56). Survey measures of hiring intentions have eased from the high levels reported earlier in the year to be closer to their average levels over the past two decades. The pace of growth in the ANZ measure of job advertisements has moderated over recent months, with the level of newspaper job advertisements broadly unchanged. In contrast, the ABS measure of job vacancies rose sharply in the three months to August, increasing by 10 per cent, following a 2½ per cent decline in the previous quarter. ✠