

3. Domestic Economic Conditions

The Australian economy continues to benefit from strong growth in Asia, with the terms of trade estimated to be at a record high in the June quarter. Conditions, however, are quite uneven across the economy. In the mining sector, conditions are very strong, notwithstanding the lingering effects of the floods on coal production. Work commenced on a number of major mining projects in the first half of the year and prices received for resource exports remain very high (see 'Box B: Measuring the Mining and Non-mining Sectors'). According to surveys, conditions in a number of service industries are generally at, or above, average levels, consistent with solid employment growth in these industries. In contrast, conditions are difficult in industries exposed to the high level of the exchange rate, including parts of manufacturing and tourism,

and continuing household cautiousness is having a notable effect on the retail sector. In aggregate, business conditions are around long-run average levels, while both consumer and business confidence have fallen to below-average levels. The pace of employment growth has slowed from the rapid pace seen in late 2010, though the unemployment rate has remained steady at just below 5 per cent.

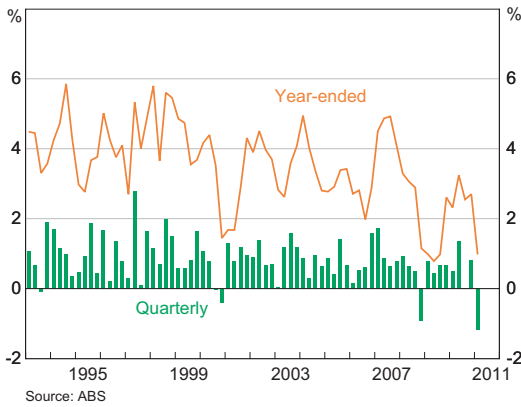
Economic activity in the March quarter was significantly affected by the Queensland floods in late 2010 and early 2011. Output contracted by 1.2 per cent in the quarter with the decline in coal and iron ore exports subtracting around 1¾ percentage points from GDP growth (Table 3.1, Graph 3.1).

Table 3.1: Demand and Output Growth
Per cent

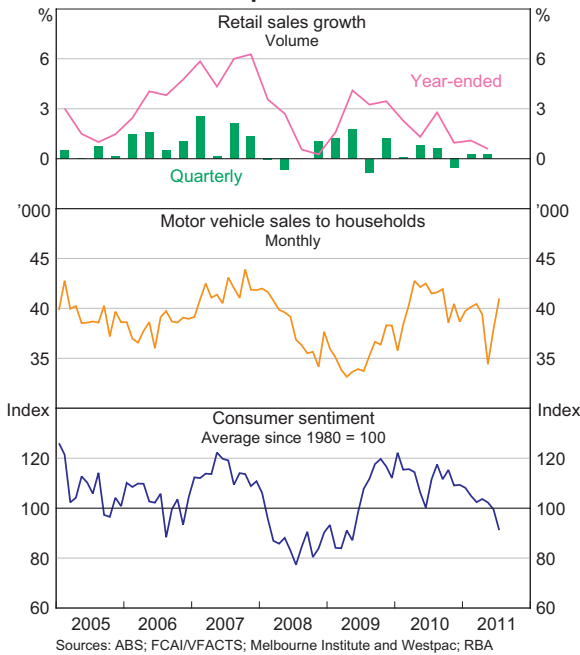
	March quarter 2011	Year to March quarter 2011
Domestic final demand	1.3	3.3
– Private demand	1.3	3.8
– Public demand	1.1	1.8
Change in inventories ^(a)	–0.5	–0.2
GNE	0.8	3.1
Net exports ^(a)	–2.4	–2.8
GDP	–1.2	1.0
Nominal GDP	0.7	7.1

(a) Contributions to GDP growth
Source: ABS

Graph 3.1
GDP Growth



Graph 3.2
Consumption Indicators



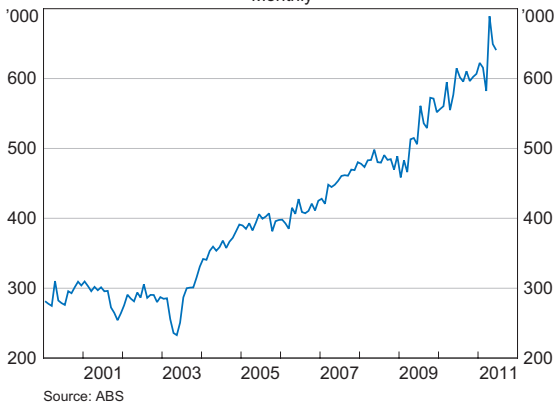
In contrast, domestic demand recorded a solid increase in the quarter; growth was reasonably broad based across the major components, and particularly strong in business investment. Iron ore exports have recovered in the June quarter to be at around record highs, and the gradual recovery in coal exports should provide a boost to GDP growth through to early 2012.

Household Sector

Household consumption is growing at a slower-than-trend pace, despite strong growth in disposable income. The volume of retail sales increased by 0.3 per cent in the June quarter to be 0.6 per cent higher over the year (Graph 3.2). Liaison with retailers suggests that consumers remain cautious, particularly regarding the purchase of non-essential items, and are often reluctant to buy products that are at full price. Accordingly, a number of retailers have scaled back their expectations for sales in the second half of 2011. Motor vehicle sales to households were affected by supply disruptions from the Japanese earthquake, but have rebounded early in the September quarter (see 'Box A: The Japanese Earthquake and Global Supply Chains'). Spending on services appears to have continued at a moderate pace, and households are also travelling overseas in record numbers, partly in response to the high level of the exchange rate (Graph 3.3). Overseas departures were 13 per cent higher over the year to the June quarter.

Household net worth is estimated to have fallen slightly in the June quarter to be 1¾ per cent higher over the year, with recent weakness driven by a fall in dwelling prices (Graph 3.4). This is in contrast to average annual growth in household net worth of almost 9 per cent over the past decade. Survey measures of consumer confidence have also fallen recently and are now at below-average levels. The weak growth in net worth, higher utilities prices, and the uncertainties about the global economy, amongst other things, are weighing on expectations of both the general economic outlook and household finances.

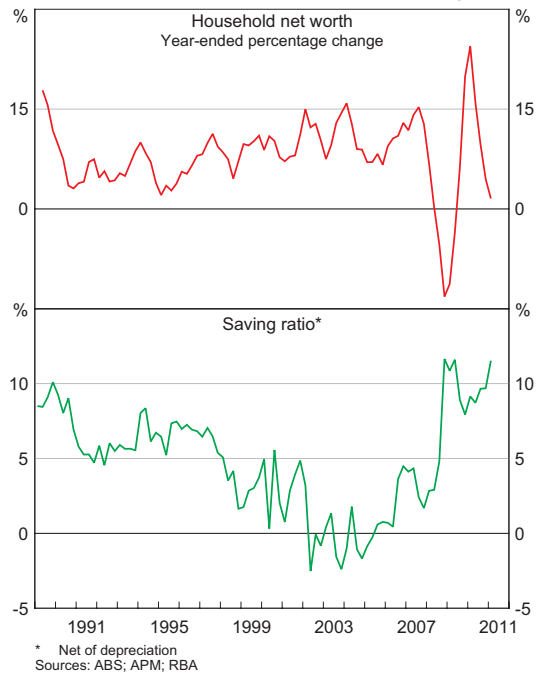
Graph 3.3
Short-term Overseas Departures
Monthly



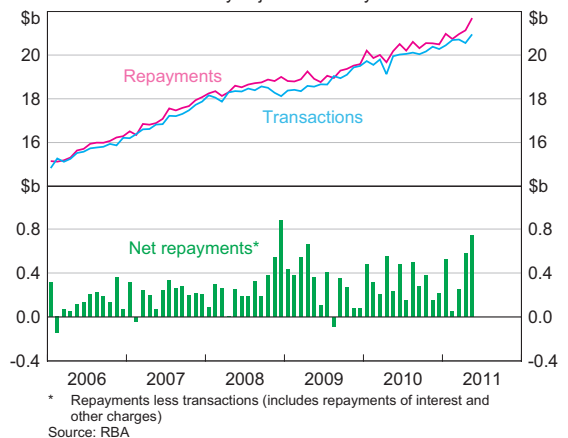
Reflecting these developments, the household saving ratio is estimated to have increased further in the March quarter, reaching 11½ per cent of disposable income, back to levels recorded in the mid 1980s. Consistent with this increase, credit card repayments have risen sharply over recent months, and are now around the levels of late 2008 and early 2009 when government stimulus payments facilitated some paying down of credit card debt (Graph 3.5).

The cautiousness of households is also reflected in slowing household credit growth and an increase in housing equity injection, which is estimated to have been the equivalent of around 4 per cent of household disposable income in the March quarter, compared to rates of equity withdrawal averaging 4 per cent over 2002 and 2003. Based on previous analysis showing that housing equity withdrawal tends to be associated with housing transactions, the increase in housing equity injection is likely to be partly related to the slowdown in housing market turnover (Graph 3.6).

Graph 3.4
Household Net Worth and Saving

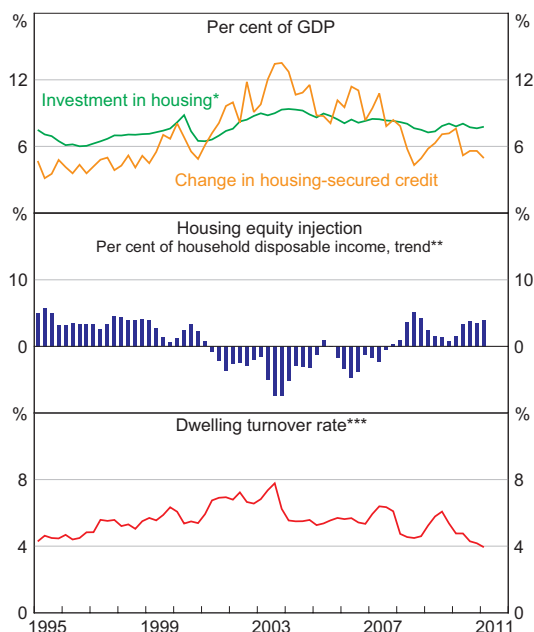


Graph 3.5
Credit and Charge Card Activity
Seasonally adjusted monthly value



Graph 3.6

Housing Equity Injection and Dwelling Turnover



* Assumes 50 per cent of new dwellings are built upon newly acquired land from outside the household sector
 ** Household disposable income excludes unincorporated enterprises and is before interest payments
 *** Dwelling turnover divided by the estimated dwelling stock, annualised
 Sources: ABS; APM; Australian Treasury; RBA

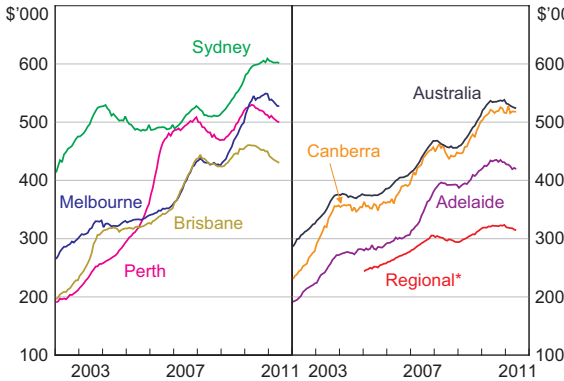
The housing market has continued to ease over recent months. Nationwide housing prices are estimated to have fallen by around 1 per cent in the June quarter and by 2 per cent over the year (Table 3.2, Graph 3.7). Brisbane and Perth continue to be the weakest markets, with prices 5–6 per cent lower over the year, while Sydney is the only state capital to have recorded positive year-ended price growth. The prices of more expensive dwellings have generally fallen by more than the prices of less expensive dwellings, with the most expensive 20 per cent of Australian suburbs experiencing falls of around 5½ per cent over the year versus falls of 1½ per cent in other suburbs. The ratio of median nationwide dwelling prices to household disposable income is currently around the average of the past decade and well below its peaks in 2003 and 2009. Auction clearance rates, which provide a timely indicator of housing market conditions, are currently close to decade-average levels in Sydney but well below decade-average levels in Melbourne (Graph 3.8). Demand for housing finance has slowed, following the increase in mortgage rates in November 2010 and flooding in Queensland and Victoria earlier in the year. Although loan approvals have picked up in recent months, they are still around 6 per cent lower over the year.

Table 3.2: National Housing Price Growth
Per cent

	3 months to March 2011	3 months to June 2011	Year to June 2011
Capital cities			
ABS ^{(a) (b)}	-1.1	-0.1	-1.9
APM	-0.9	-1.5	-2.6
RP Data-Rismark	-1.8	-0.9	-2.0
Regional areas			
APM ^(b)	-0.3	0.4	0.0
RP Data-Rismark ^(a)	-1.7	-1.1	-2.4

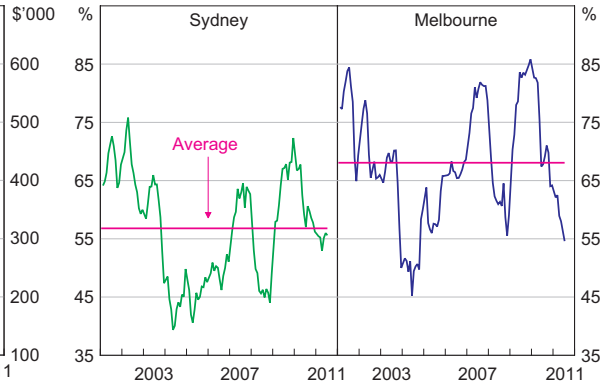
(a) Detached houses only
 (b) Quarter-on-quarter growth rate
 Sources: ABS; APM; RBA; RP Data-Rismark

Graph 3.7
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

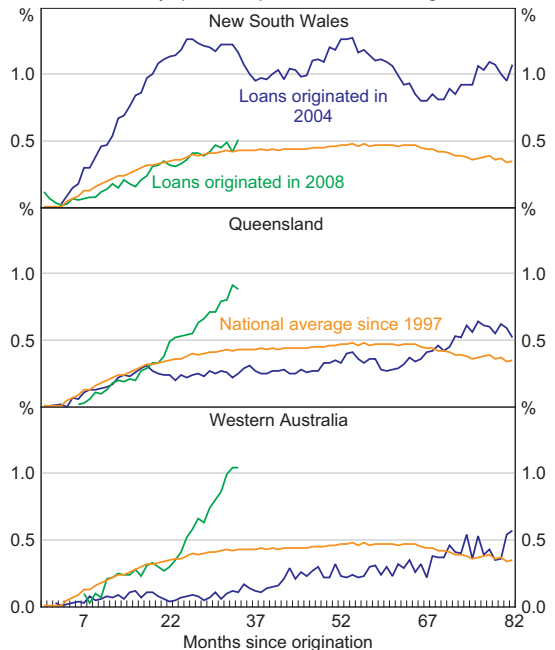
Graph 3.8
Auction Clearance Rates*



* RBA estimates for July 2011
Sources: APM; RBA; REIV; RP Data-Rismark

Mortgage arrears rates – both for banks' on-balance sheet loans and securitised loans – picked up in the early part of 2011, though by international standards they are still low. Arrears rates have risen in all states, but most noticeably in Queensland. The worst performing loans in recent years have generally been those extended towards the end of earlier periods of strong local housing price growth and easier lending standards. In Queensland and Western Australia, these are the loans that were extended between 2006 and 2008, while in New South Wales, it was the loans made between 2003 and 2005 (Graph 3.9). In contrast, borrowers that purchased their home in 2009, including many first-home buyers, appear to be performing better than some previous cohorts, despite the increases in interest rates since 2009. The arrears rate for this cohort is only half the long-run national average, and likely reflects an improvement in loan quality due to the tightening in lending standards in 2008.

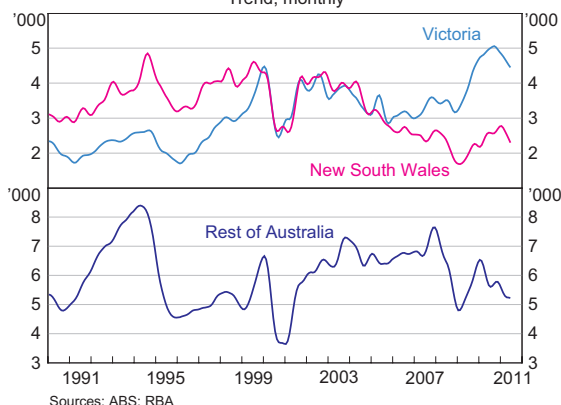
Graph 3.9
Securitised Housing Loan Arrears by Cohort*
90+ days past due, per cent of outstandings



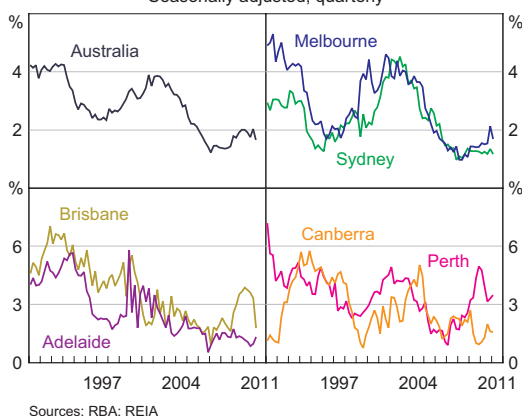
* Full-doc and low-doc securitised by all lenders; includes self-securitisations
Source: Perpetual

Indicators of dwelling investment have softened over the first half of 2011 (Graph 3.10). The number of building approvals for detached houses fell by 8½ per cent over the first half of 2011, to be well below decade-average levels. Apartment building activity remains relatively stronger, particularly in Victoria, reflecting work committed in 2010;

Graph 3.10
Private Residential Approvals
 Trend, monthly



Graph 3.11
Rental Vacancy Rates
 Seasonally adjusted, quarterly



however, apartment approvals have also moderated over the first half of 2011. Adjusting for the downward bias inherent in initial estimates for these data, the current flow of residential approvals implies around 140 000 completions a year, which is below the average level of the past two decades.

The relatively slow pace of dwelling investment is likely to be one factor contributing to a tightening in the rental market. Over the March quarter, estimates from the state Real Estate Institutes suggest that the nationwide rental vacancy rate fell 0.4 percentage points to 1.7 per cent (Graph 3.11). This is above the

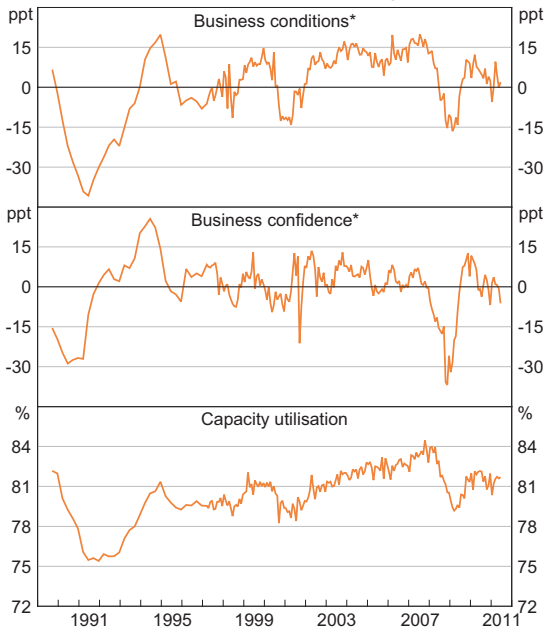
low reached in early 2007 but well below decade-average levels of around 2½ per cent. The estimates suggest Sydney is the tightest market, with a vacancy rate of 1.2 per cent, and Brisbane tightened the most over the quarter, with the vacancy rate almost halving to 1.8 per cent as natural disasters reduced the stock of housing. Reflecting these developments, the pace of rental growth has increased slightly, although it remains well below rates reached in 2008.

Business Sector

Survey measures of overall business conditions have moderated in recent months to be around average levels, while confidence has deteriorated to be below-average levels (Graph 3.12). Conditions, however, vary significantly across sectors. Conditions in the mining sector are well above their historical average, and close to their high levels recorded prior to the onset of the global financial crisis (Graph 3.13). According to business surveys, conditions in the construction and manufacturing sectors are around their long-run average levels. Within these sectors there is considerable variation, with firms that service mining better placed than those that are exposed to the contractionary effects of the high exchange rate or to the fading of the public investment stimulus. For some time now, retail conditions have been quite weak, reflecting the ongoing subdued level of consumer spending on goods. Conditions in most service industries are generally stronger than those in the goods production or distribution sectors.

The outlook for mining sector investment remains very strong, reflecting the high level of commodity prices and the robust outlook for growth in emerging economies in Asia. The ABS capital expenditure survey of firms' spending plans points to a large rise in mining sector investment in 2011/12, which is broadly in line with the large stock of work in the pipeline as reported by liaison contacts (Graph 3.14). Work on the large Gorgon LNG project approved in late 2009 is well underway. A number of other LNG projects have either commenced construction or are expected to commence construction by the end of

Graph 3.12
NAB Business Survey

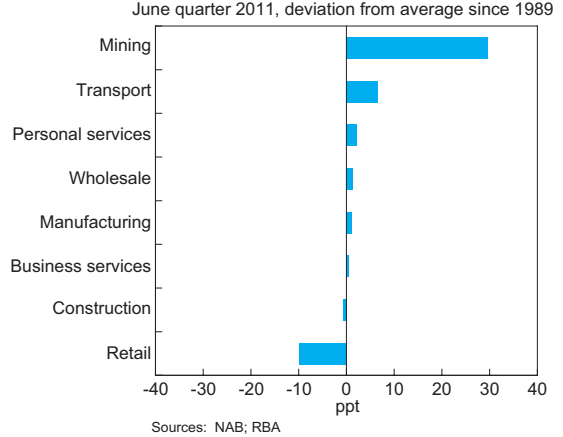


* Net balance; deviation from average since 1989
Sources: NAB; RBA

the year, including the recently approved Australia Pacific LNG project worth \$US14 billion (Table 3.3). Production of LNG is expected to triple from current capacity when work finishes on projects underway or due to commence this year. In the iron ore sector, Rio Tinto and Fortescue Metals have recently announced plans to accelerate their capacity expansion programs in the Pilbara. Mineral and petroleum exploration as a share of GDP remained high in the June quarter, supporting the pipeline of future projects.

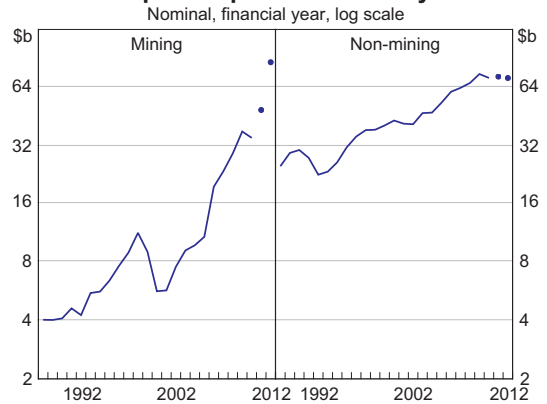
Outside the mining sector, investment intentions remain subdued, with the ABS capital expenditure survey pointing to little growth in non-mining sector investment in 2011/12 and other surveys of investment intentions generally at, or below, average levels (Graph 3.15). In the construction sector, the value of private-sector non-residential building approvals has increased a little from 2009 lows, but remains around levels last seen in the downturns in the early 1990s and

Graph 3.13
Business Conditions by Industry



Sources: NAB; RBA

Graph 3.14
Capital Expenditure Survey*



* Sample of firms' spending plans; dots represent the survey's most recent estimates for 2010/11 and 2011/12 adjusted for historical realised spend
Sources: ABS; RBA

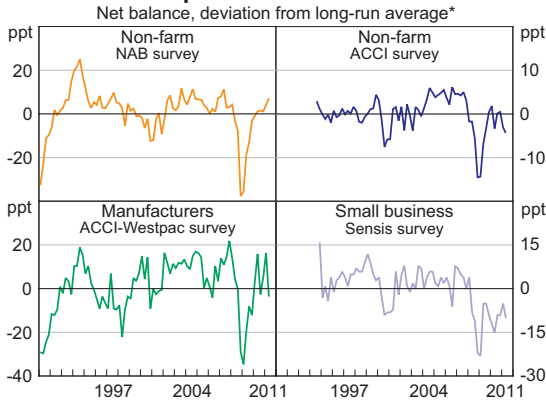
Table 3.3:
LNG Projects Commencing in 2011
US\$ billion

Committed	
Gladstone LNG	16
Queensland Curtis LNG	15
Australia Pacific LNG (Phase 1)	14
Prelude LNG	12
Likely	
Wheatstone LNG	25

Source: publicly available information

Graph 3.15

Expected Investment

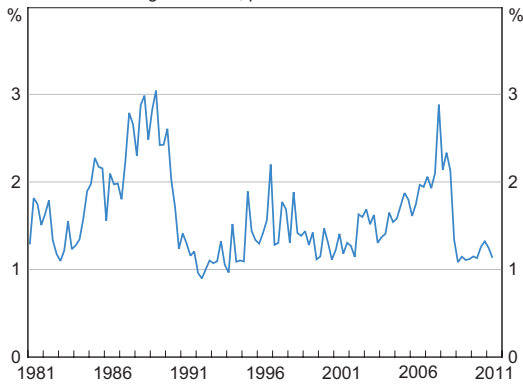


* Deviation from long-run average since 1989 for ACCI-Westpac and NAB, 1994 for ACCI and Sensis
Sources: ACCI; NAB; RBA; Sensis; Westpac

Graph 3.16

Private Non-residential Building Approvals

Excluding education, per cent of nominal GDP*

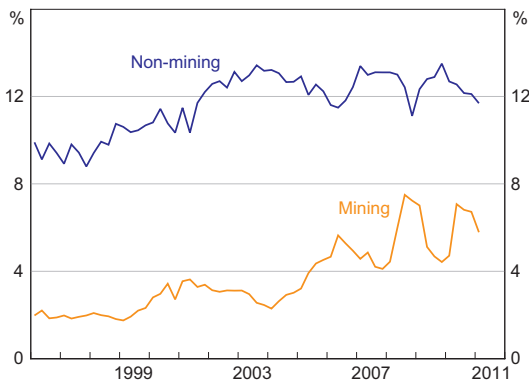


* RBA estimate for June quarter 2011 GDP
Sources: ABS; RBA

Graph 3.17

Private Non-financial Corporation Profits*

Share of nominal GDP



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

2000s when measured relative to nominal GDP (Graph 3.16). Office building activity, in particular, has fallen sharply since 2008, which has seen the national CBD office vacancy rate decline recently (see 'Box C: Conditions in the Commercial Property Market' for a more detailed discussion of the commercial property market). Conditions are also subdued in the retail property market.

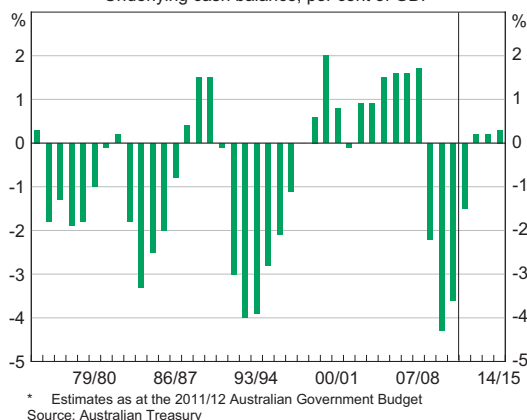
Company profits fell by 6½ per cent in the March quarter to be 7½ per cent higher over the year (Graph 3.17). Mining profits fell by 13 per cent in the quarter as adverse weather conditions affected production, but were still more than 30 per cent higher over the year. Non-mining profits fell by 3 per cent in the quarter, with the largest declines occurring amongst retailers, wholesalers and manufacturers. Over the year, non-mining profits were down by around 1½ per cent. Businesses continue to consolidate their balance sheets, with the gearing ratio (the ratio of debt to assets) falling a little to be slightly below its decade average.

Government Sector

Government budgets released since the start of May indicate that the stance of fiscal policy is set to tighten further. In the May Budget, the Australian Government budget deficit was forecast to narrow from 3.6 per cent of GDP in 2010/11 to 1.5 per cent of GDP in 2011/12, before moving to a small surplus in 2012/13 (Graph 3.18). The deficit for 2010/11 was revised upwards, partly reflecting government spending on repairs and rebuilding of public infrastructure and community programs following Cyclone Yasi and flooding, as well as the impact of the floods on government revenues.

In mid July, the Australian Government announced a carbon pricing scheme, under which there will be a fixed carbon price from July 2012 before the transition to an emissions trading scheme in 2015. The package also includes a range of other policies, including payments and tax cuts to compensate households and certain industries. The Government estimates that the new policy measures will have

Graph 3.18
Australian Government Budget Balance*
 Underlying cash balance, per cent of GDP



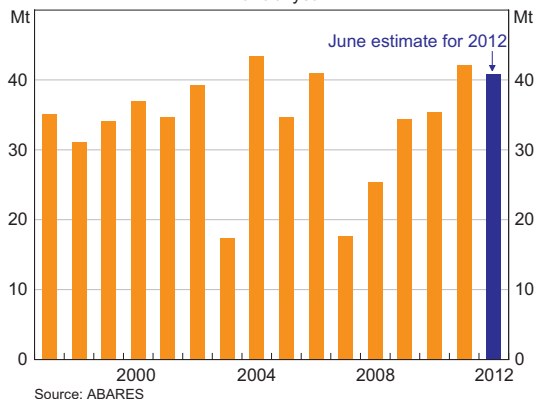
a net cost to the budget of \$4 billion over the four years to 2014/15. The largest net impact on the budget balance is expected to occur in 2011/12, as some of the transfer payments to households and other spending measures will be paid out before the carbon tax takes effect in mid 2012.

Farm Sector

The Australian Bureau of Agricultural and Resource Economics and Sciences (ABARES) estimates that farm production increased by around 8 per cent in 2010/11, despite the disruptions from flooding in early 2011 across the eastern states and drought conditions in Western Australia. Winter crop production rose solidly, underpinned by an increase in the national wheat harvest. Summer crop production, which includes cotton and rice, is estimated to have risen to the highest level in almost a decade, despite damage from heavy rainfall in early 2011.

The outlook for the farm sector over the coming year is generally favourable. ABARES expects farm production to increase by a further 3 per cent in 2011/12, which is slightly stronger than earlier forecasts. Another large winter crop is expected, reflecting good subsoil moisture in the eastern states and an increase in area planted (Graph 3.19).

Graph 3.19
Winter Crop Production
 Financial year



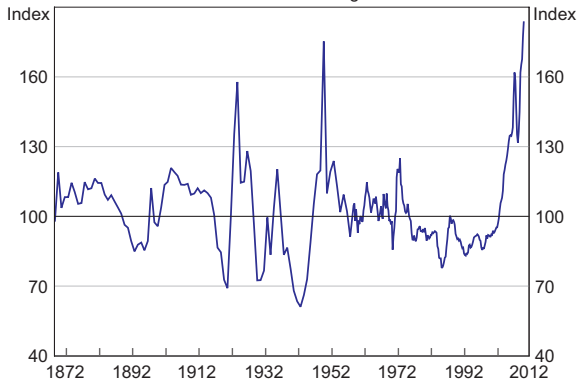
After a patchy start to the winter season, rainfall has improved recently, including some timely rain for the Western Australian cropping regions. Summer crop production in 2011/12 should again benefit from the high availability of water for irrigation, with water storage levels remaining high in the eastern states. Beef production is also forecast to increase this year, as herd rebuilding in response to improved pastoral conditions gradually slows.

External Sector

Australia continues to benefit from strong growth in export receipts, as contract prices for iron ore and coal have pushed the terms of trade to their highest level on record (Graph 3.20). The large rise in the terms of trade has contributed to a significant appreciation of the exchange rate, which in real terms is back around levels last recorded in the mid 1970s (Graph 3.21). While the high exchange rate is restraining export growth in some sectors, it has also lowered the price of imports. Higher commodity prices have also resulted in the trade surplus reaching levels not seen since the early 1970s (as a percentage of GDP), with the current account deficit declining to around 2 per cent of GDP over the past year (Graph 3.22).

Graph 3.20
Terms of Trade*

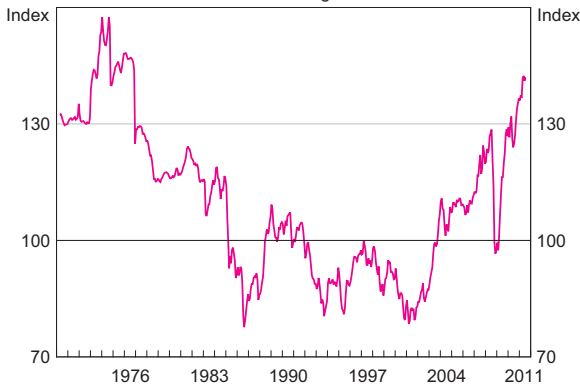
1900/01–1999/00 average = 100



* Calendar years prior to 1900, financial years 1900/01 to 1958/59, quarterly data thereafter; RBA estimate for June quarter 2011
Sources: ABS; RBA

Graph 3.21
Real Exchange Rate*

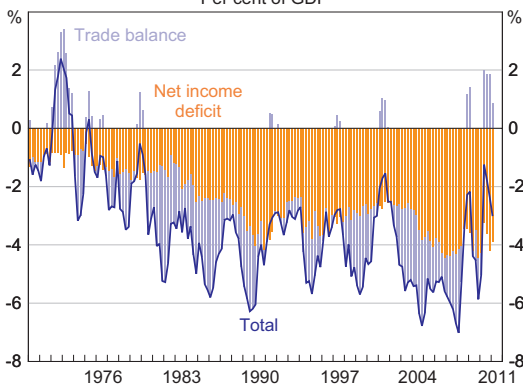
Post-float average = 100



* Trade-weighted index adjusted for relative price levels
Sources: ABS; RBA; Thomson Reuters

Graph 3.22
Current Account Balance*

Per cent of GDP



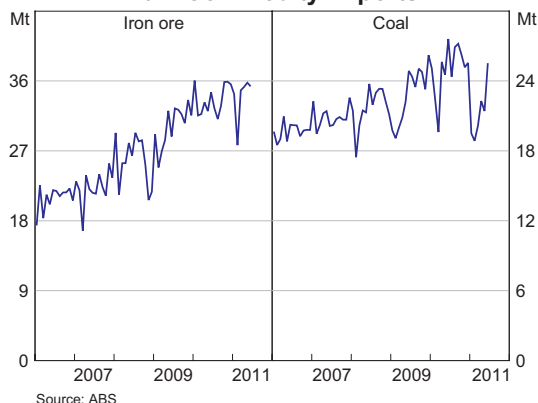
* Excluding RBA gold sales
Source: ABS

Exports of iron ore and coal – Australia’s two largest commodity exports – fell sharply in early 2011 owing to adverse weather events (Graph 3.23). Subsequently, iron ore export volumes have recovered strongly in the June quarter and are now back around previous highs. In contrast, the recovery in coal export volumes has been slower than expected at the time of the *May Statement*, with difficulties in removing water from flood-affected mines continuing to hinder production in Queensland. Coal exports were around 5 per cent of GDP in 2010; the large loss to exports in the March quarter subtracted around 1.4 percentage points off quarterly GDP growth. As at June, Queensland coal exports remained around 10 per cent below pre-flood levels, and liaison suggests that production may not return to normal until early 2012. Resource commodity exports are expected to increase strongly over coming years, driven by expansions in mine capacity and transport infrastructure.

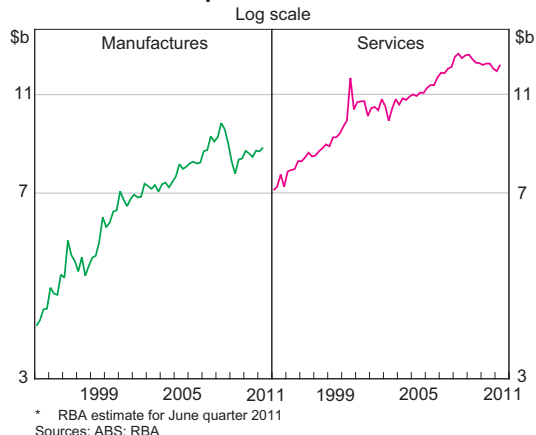
Exports of rural commodities have risen over the past year, buoyed by the large 2010 wheat harvest. Growth in non-commodity exports remains subdued, with the high level of the exchange rate creating significant headwinds (Graph 3.24). Services exports have also been affected by tighter access to student visas, with exports of education-related services falling by around 13 per cent over the year to the March quarter.

Import volumes are estimated to have grown strongly in the first half of 2011, despite significant disruption to imports from Japan following the earthquake in March. Imports from Japan – which normally account for a little under 10 per cent of Australia’s goods imports – fell sharply in April, driven by a drop in motor vehicle imports, although the fall was largely reversed in May and June. Capital and intermediate import volumes have risen strongly in the June quarter as import-intensive mining investment gathers pace (Graph 3.25). Services imports have risen strongly over the past year, as the high level of the exchange rate has encouraged more overseas travel.

Graph 3.23
Bulk Commodity Exports



Graph 3.24
Export Volumes*



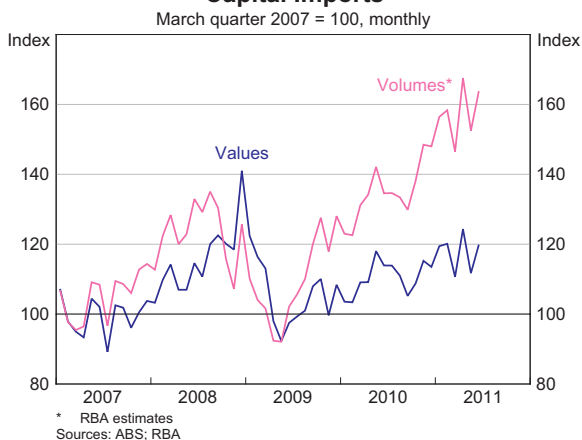
Labour Market

After falling through 2010, the unemployment rate has stabilised around 5 per cent over the past six months (Graph 3.26). Looking through the monthly volatility, employment growth has slowed noticeably in comparison to the rapid pace of growth throughout 2010.

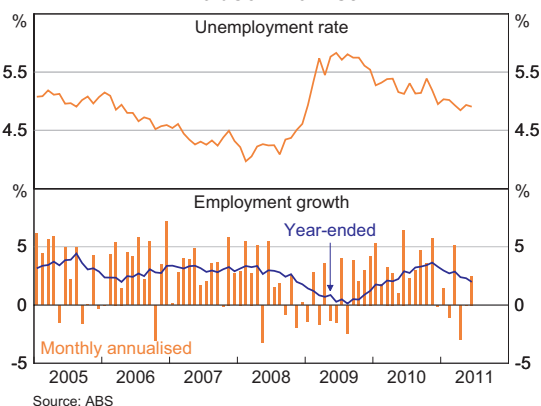
Despite the recent slowing, overall employment growth over the year to the June quarter remained firm. Growth in mining employment has been exceptionally strong (Graph 3.27). In the large household and business services sectors, increases in employment have been broad based and stronger than the average pace of growth over the past decade. Construction employment has also continued to expand but at a pace slower than the decade trend. Employment growth in the manufacturing, wholesale trade and transport industries has been weak compared with the past decade.

A number of developments suggest that the growth rate of labour supply has also slowed. Most recently, the participation rate has fallen slightly from its record peak in the December quarter; notwithstanding this, cohort effects suggest that the participation rate is likely to drift higher in the medium term as older workers remain in the labour market longer than

Graph 3.25
Capital Imports



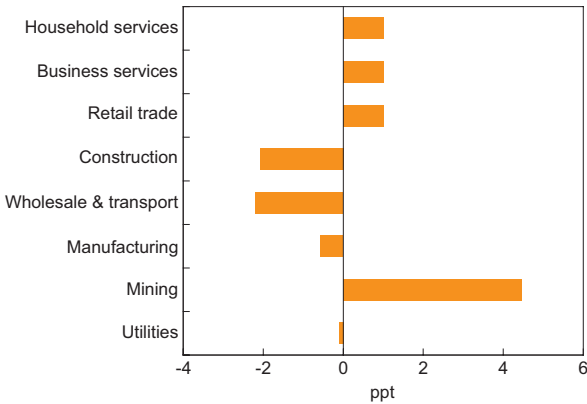
Graph 3.26
Labour Market



Graph 3.27

Employment Growth by Industry

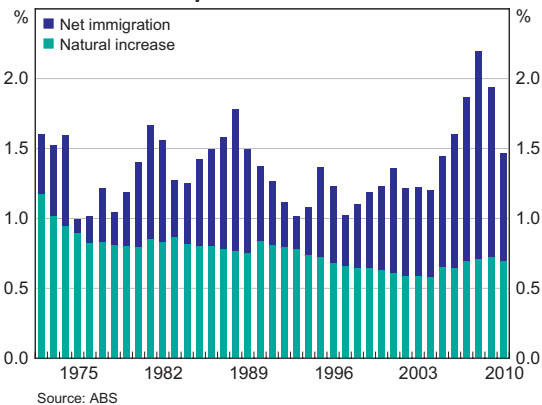
Year to May 2011, deviation from decade average, trend



Source: ABS

Graph 3.28

Population Growth

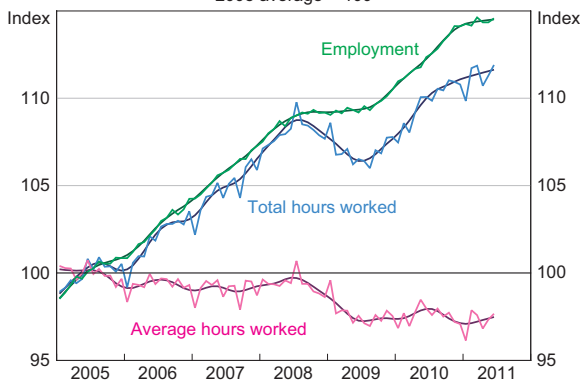


Source: ABS

Graph 3.29

Employment and Hours Worked*

2005 average = 100



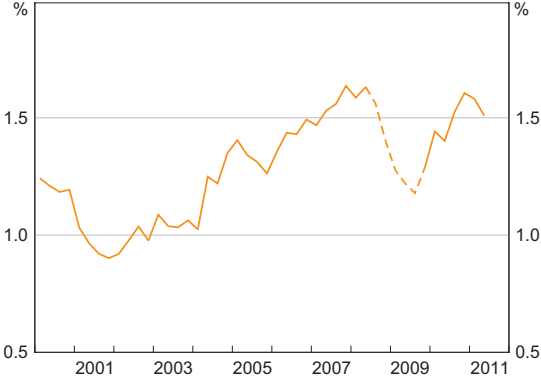
* Smoothed lines are 13-period Henderson trends
Sources: ABS; RBA

did previous cohorts. Perhaps more significantly in the short term, slower population growth, owing to a significant decline in the level of net immigration from the peak reached in 2008, has also reduced growth in labour supply (Graph 3.28). Most of the decline in immigration reflects lower numbers of new international students in response to a range of economic and policy factors including the high exchange rate, the effect of the global financial crisis on demand, and tighter access to student visas and changes to immigration rules.

Average hours worked have remained noticeably lower than prior to the onset of the global slowdown in 2008, despite the recovery in labour demand and employment since late 2009 (Graph 3.29). Although this partly reflects some firms hiring new staff in anticipation of stronger future demand, it is also likely to reflect developments in labour supply. Average hours worked were at a relatively high level in the tight labour market prior to the slowdown, and some workers may have chosen not to return to working as many hours as previously. Older workers in particular, who are growing in significance as the labour force ages, tend to work fewer hours on average than other workers.

Looking ahead, based on their historical relationships with employment growth, most leading indicators of labour demand point to moderate employment growth over coming months. The ABS vacancies survey and the ANZ job advertisement series remain at high levels as a share of the labour force despite having eased in the June quarter (Graph 3.30). Business surveys and the Bank’s liaison suggest that firms’ hiring intentions for the year ahead are lower than in 2010, but nevertheless also continue to point to moderate growth in employment.

Graph 3.30
Job Vacancy Rate*
 Per cent of labour force



* Dashed line represents estimates for August 2008 to August 2009
 Source: ABS