

3. Domestic Economic Conditions

The Australian economy began to strengthen a little in the latter part of last year, although it continues to face headwinds, including the downturn in mining investment and planned fiscal consolidation. GDP growth picked up slightly in the December quarter, but remained a little below trend in 2013 (Graph 3.1; Table 3.1). The pick-up in growth was underpinned by strong growth of resource exports, and slightly stronger consumption growth despite weak growth in household income. In contrast, business investment – in both the mining and non-mining sectors – declined, with some of this reflected in lower capital imports as a large component of investment is imported. Quarterly growth in measured public demand has remained volatile, but its growth has been weak for several years and is expected to remain so for some time given planned fiscal restraint at both the state and federal levels of government.

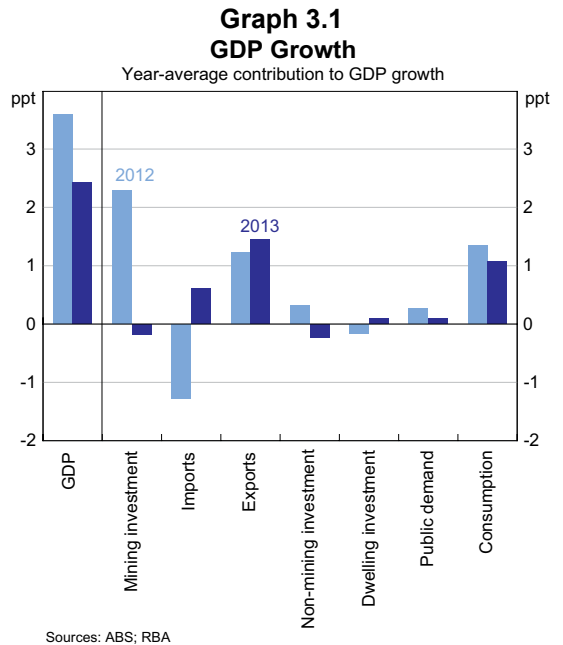


Table 3.1: Demand and Output Growth
Per cent

	December quarter 2013	Year to December quarter 2013
GDP	0.8	2.8
Domestic final demand	0.1	1.2
– Private demand	-0.2	0.3
– Public demand	1.2	4.5
Change in inventories ^(a)	0.2	-0.3
Gross national expenditure	0.3	0.9
Exports	2.4	6.5
Imports	-0.6	-4.6
Nominal GDP	1.6	4.8
Real gross domestic income	0.9	2.4

(a) Contribution to GDP growth
Source: ABS

More recent economic indicators and liaison are consistent with some improvement in the overall pace of growth. Some surveys suggest that current business conditions and business confidence have been at around average levels in recent months after increasing in late 2013. Retail spending grew strongly in the March quarter and measures of consumer sentiment also remain close to average levels, despite easing since late last year. Housing turnover and prices have continued to increase and forward-looking indicators of dwelling investment have remained at high levels. Also, exports rose sharply in the March quarter. However, growth of investment remains weak, with information from liaison and surveys of investment intentions continuing to suggest that mining investment is in the early stages of a pronounced downswing and investment intentions in the non-mining sector, at this stage, remain subdued.

Consistent with the slight pick-up in the pace of growth of economic activity from the latter part of last year, there has been some improvement in a number of labour market indicators (see 'Box B: Lags from Activity to the Labour Market'). In particular, employment growth has picked up this year following a year of only modest growth.

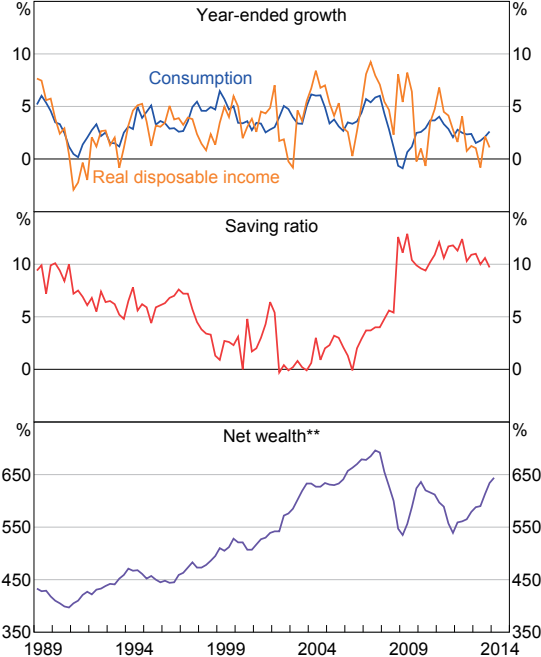
Household Sector

Household consumption strengthened gradually over 2013 and grew at a pace consistent with trend GDP growth in the latter part of the year. However, growth of real household disposable income remained weak at just 1 per cent over 2013. Real labour income was little changed over the year, consistent with weak growth of employment and wages, while a fall in interest payments as mortgage rates declined has provided some support to disposable income growth.

Growth of spending on discretionary items, such as recreational goods and hotels & cafés, has picked up in recent quarters, although it has remained relatively low; spending on non-discretionary items has continued to grow at around the average pace

of the past decade. While income growth has been weak, the pick-up in spending is consistent with the ongoing strong growth in household wealth. The household saving ratio appears to have trended down a little over the past two years, although it is still higher than it has been for most of the past few decades (Graph 3.2).

Graph 3.2
Household Income, Consumption and Wealth*



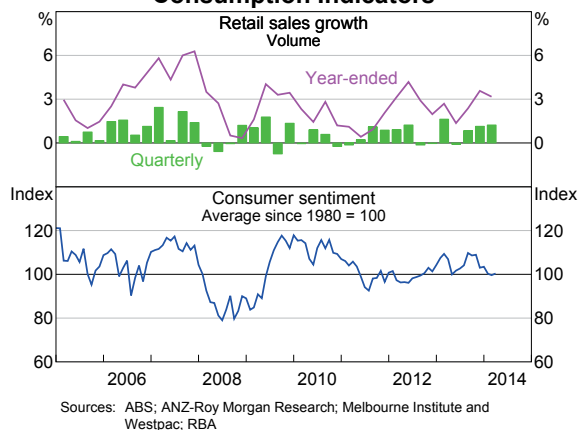
* Household sector includes unincorporated enterprises; disposable income is after tax and interest payments; income level smoothed with a two-quarter moving average between March quarter 2000 and March quarter 2002; saving ratio is net of depreciation

** Per cent of annual household disposable income, before the deduction of interest payments; RBA forecast for the March quarter 2014

Sources: ABS; RBA; RP Data-Rismark

In the March quarter, growth of household consumption appears to have continued at a similar pace to the December quarter. Retail sales volumes increased by 1.2 per cent in the quarter (Graph 3.3). Sales increased strongly at cafés, restaurants and takeaway stores and household goods retailers, both in the quarter and over the year, while sales at department stores declined. Liaison with some retailers suggests that conditions have improved since last year. Similarly, liaison with some service providers facing foreign competition, such as

Graph 3.3
Consumption Indicators



domestic tourism operators, also points to a pick-up in demand, in part owing to the depreciation of the Australian dollar over the past year. In contrast, sales of motor vehicles to households have fallen in recent months. Survey measures of consumer sentiment have eased over the past six months, but they have been around average levels. Consumers' concerns about future conditions in the labour market remain elevated. However, the share of consumers nominating debt repayment as the wisest place for savings has fallen over recent quarters, pointing to a somewhat less cautious approach to their finances, consistent with the decline in the saving rate.

Household wealth has continued to increase strongly, and is estimated to be around 10 per cent higher over the year to March 2014 (Graph 3.2). The increase has been driven mainly by higher equity and housing prices. Housing price inflation has remained strong – consistent with the current low level of interest rates – although nationwide it has eased a bit from the rapid pace seen towards the end of 2013 (Table 3.2). Price growth has been stronger in Sydney than in other capital cities, while it has slowed in Melbourne and Perth (Graph 3.4). Auction clearance rates, which typically move in line with housing prices, are a little lower in recent months, although they remain well above average in Sydney

Graph 3.4
Housing Prices

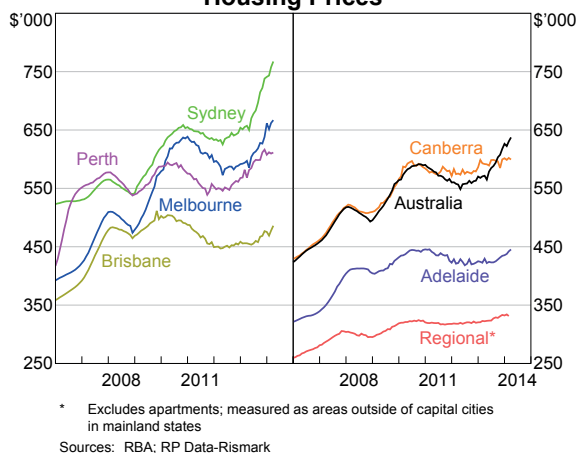
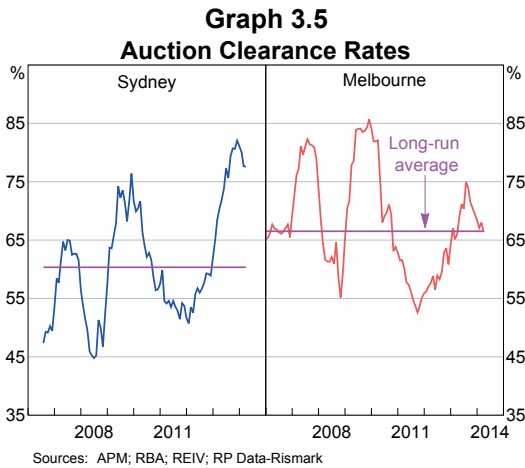


Table 3.2: Housing Price Growth
Per cent

	3 months to April 2014	3 months to January 2014	Year to April 2014
Australia	1.8	3.8	11.5
Sydney	3.6	3.7	16.8
Melbourne	0.8	5.3	11.7
Brisbane	2.2	1.7	6.6
Perth	0.6	1.5	7.6
Adelaide	2.3	1.7	3.7
Canberra	-0.4	0.9	1.3
Regional ^(a)	-0.6	1.3	2.6

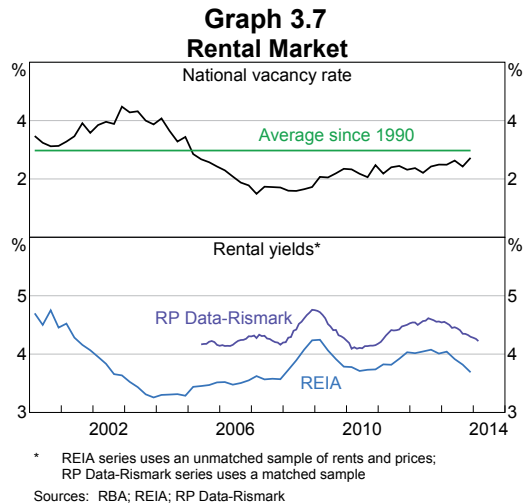
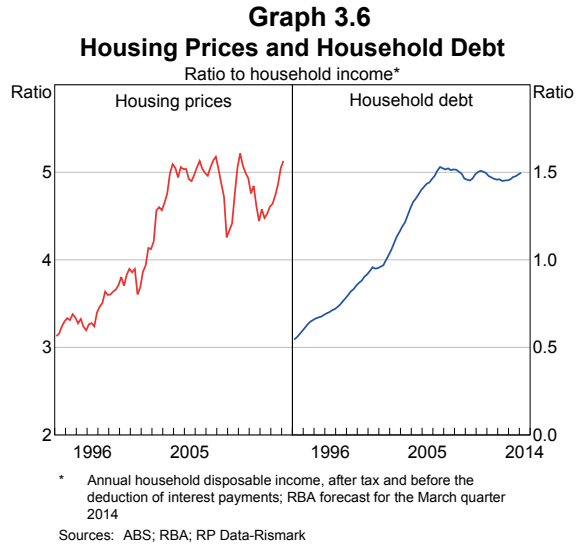
(a) Growth to March and December; detached houses only
Sources: RBA; RP Data-Rismark

(Graph 3.5). Other indicators of conditions in the established housing market have remained strong: housing turnover has risen over recent quarters and was around the decade-average level in the December quarter, while average vendor discounts and the average time taken to sell a property have both remained close to their decade lows.



Strong housing price inflation combined with relatively weak growth of household incomes has led to an increase in the housing price-to-income ratio; in the March quarter, the ratio was around the levels seen over much of the past decade (Graph 3.6). With a pick-up in housing credit growth over the past year, the household debt-to-income ratio has also increased a little, although it too remains within the range of outcomes observed over the past decade. More recently, housing credit growth and the value of housing loan approvals have stabilised, in line with the recent moderation in housing price growth.

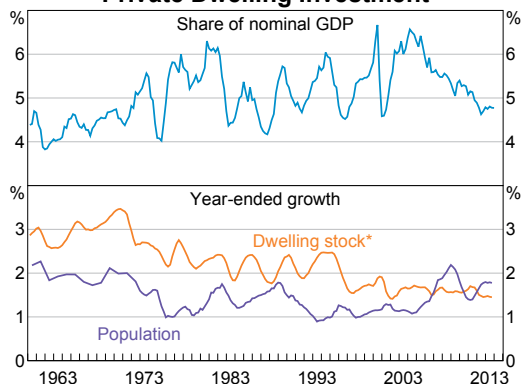
In contrast to the strength in the broader housing market, conditions in the rental market have eased somewhat in recent quarters. The nationwide rental vacancy rate increased in the December quarter to around 2¾ per cent, which is close to the long-run average (Graph 3.7). Rent inflation has also slowed to around 3 per cent annually, the slowest pace since the mid 2000s. With inflation in rents slowing and housing prices rising strongly, rental yields have



fallen over the past year to be around the average of the past decade.

Dwelling investment is beginning to pick up after having been quite weak for a number of years, both as a share of GDP and relative to population growth (Graph 3.8). The national accounts reported that dwelling investment increased by 1 per cent in the December quarter, to be 1½ per cent higher over 2013. Housing price growth, low lending rates, government assistance for first home buyers and strong population growth are expected to support a substantial increase in new dwelling construction

Graph 3.8
Private Dwelling Investment



* Number of dwellings reported in censuses, interpolated using completions data

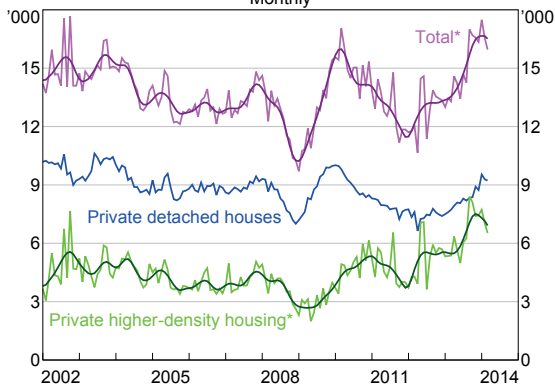
Sources: ABS; RBA

over the period ahead. Higher housing prices and the associated increase in housing turnover are also expected to underpin further increases in renovation activity.

A range of timely indicators point to a strong pick-up in dwelling construction. The number of building approvals for new private dwellings rose by around 1 per cent in the March quarter, driven by detached house approvals, to be 27 per cent higher over the year (Graph 3.9). Higher-density approvals have eased a little in recent months; however, after rising substantially over the second half of last year, the trend number of approvals has remained near record highs in all mainland states except South Australia. Approvals for detached houses have been trending higher across all states. Other timely indicators of building activity, such as loan approvals and first home owner grants (FHOs) for new dwellings, have also continued to increase, with the latter buoyed by the redirection of government assistance for first home buyers towards purchases of newly built dwellings (Graph 3.10).

Liaison suggests that demand for new dwellings remains strong in most markets, with industry participants reporting a pick-up in enquiries and visits to display centres in recent months. Demand from foreign investors for inner-city apartments in Melbourne and Sydney reportedly remains strong.

Graph 3.9
Private Dwelling Approvals
Monthly



* Smoothed lines are ABS trend measures

Source: ABS

Graph 3.10
FHOs Paid for New Dwellings*
Monthly



* Includes both new construction and newly erected dwellings

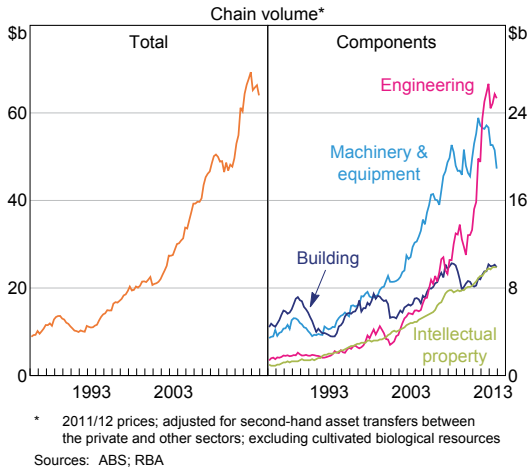
Sources: NSW Office of State Revenue; RBA

Business Sector

Business investment has continued to fall from its peak in late 2012, but it remains high as a share of GDP (Graph 3.11). The largest declines have occurred in machinery and equipment and, to a lesser extent, engineering investment.

The recent falls in machinery and equipment and engineering investment are consistent with a decline in investment in the mining sector. A range of investment indicators and the Bank's liaison suggest that mining investment has started to decline, following strong growth over the past decade.

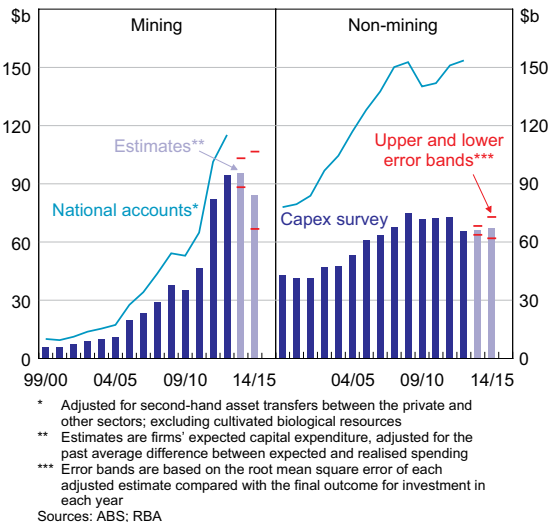
Graph 3.11
Private Business Investment



Significant falls are expected over the period ahead, with the latest ABS Capital Expenditure (Capex) survey of investment intentions, adjusted for historical realisation ratios, pointing to a significant decrease in mining investment in 2014/15 (Graph 3.12).

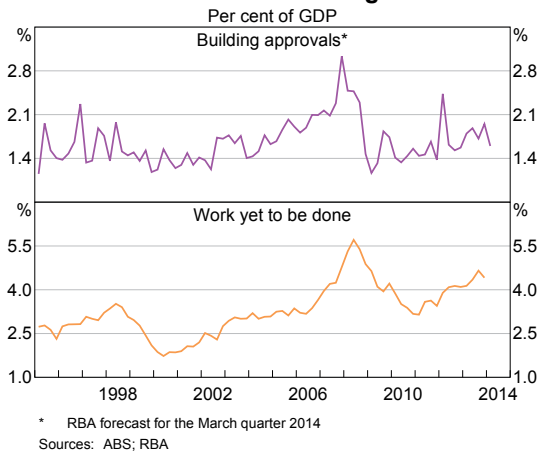
Non-mining investment is also estimated to have declined in the December quarter and is at a low level (as a share of GDP). Tentative signs of a modest pick-up in non-mining investment intentions in 2014/15 were evident in the Capex survey. While

Graph 3.12
Measures of Private Business Investment



these estimates can be subject to considerable revision over time, they currently suggest that any pick-up in investment is likely to come from industries such as rental, hiring and real estate, information, media and telecommunications, construction and retail trade. This is consistent with other signs of a pick-up in demand, such as stronger growth of retail sales and evidence of a strengthening in building activity, including in the residential sector. Approvals for non-residential construction have been trending up gradually over recent years, and there is a large stock of work yet to be done, particularly for healthcare projects and office buildings, suggesting that there could be increases in non-residential construction for some time (Graph 3.13).

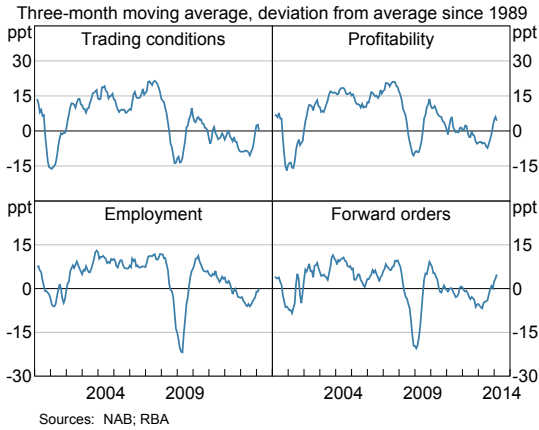
Graph 3.13
Private Non-residential Building Construction



Consistent with these early signs of improving conditions in the non-mining sector, firms have reported a pick-up in trading conditions, profitability, employment and forward orders over the past six months (Graph 3.14). One survey indicates that firms' actual capital expenditure is now close to average levels after a couple of years of being below average. Surveys also suggest that capacity utilisation has edged higher over the past year or so. However, it remains around its long-run average and the Bank's liaison suggests that many firms remain reluctant to commit to major new investments until they see sustained increases in demand.

Graph 3.14

NAB Business Conditions



Farm Sector

Slightly higher rainfall has helped to ease the extent of drought conditions in parts of Queensland and New South Wales. Overall, the Australian Bureau of Agricultural and Resource Economics and Sciences (ABARES) is forecasting farm production in 2013/14 to increase by nearly 5 per cent (Graph 3.15). This reflects increased winter crops in much of the country, as well as growth in livestock production due to high export demand and increased slaughter rates in response to the dry conditions in Queensland and parts of New South Wales. The increased slaughter rates will weigh on future farm production, however,

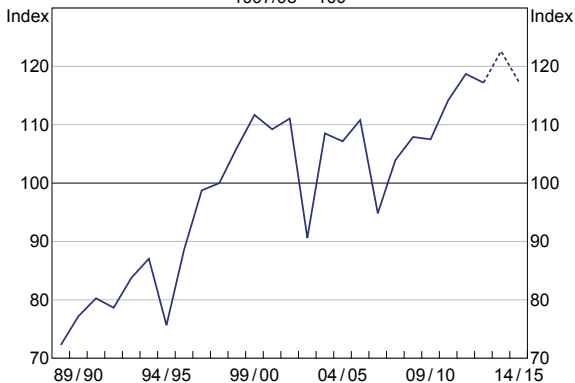
as farmers will need to rebuild their stock levels over time. The dry conditions are also expected to reduce the area planted and, therefore, crop production in 2014/15. ABARES is forecasting that the prices received by farmers will rise in 2013/14 due to higher world prices for livestock and livestock products, as well as the depreciation of the Australian dollar over the past year.

External Sector

Exports rose by 6½ per cent over 2013, contributing nearly 1½ percentage points to GDP growth. This largely reflected expansions to capacity for iron ore and coal, Australia’s two largest exports by value (Graph 3.16). The depreciation of the exchange rate over the past year may have contributed to some growth in both manufactured and services exports over 2013, while rural exports have remained at a high level. More timely trade data suggest that iron ore and coal export volumes grew strongly in the March quarter, and rural exports increased sharply.

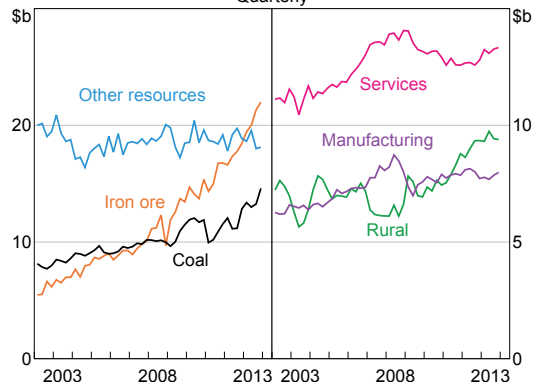
Imports fell over 2013, with significant declines in capital goods and services imports. The steep fall in capital goods imports suggests that some of the imported content of the large-scale liquefied natural gas (LNG) projects may have occurred already (or has at least been paid for). Import volumes are estimated to have declined modestly in the March quarter.

Graph 3.15
Volume of Farm Production*
1997/98 = 100



* The solid line represents ABARES’ estimate while the dotted line represents ABARES’ 2013/14 and 2014/15 forecasts
Source: ABARES

Graph 3.16
Export Volumes*
Quarterly



* 2011/12 prices
Sources: ABS; RBA

Labour Market

Labour market conditions have shown some signs of improvement recently, in line with the pick-up in a range of indicators of economic activity since late last year. Employment has risen by nearly 1 per cent over the first four months of 2014, following only modest growth over 2013. Also, the unemployment rate has ticked down over recent months and the participation rate appears to have stabilised over the past six months after declining steadily since late 2010 (Graph 3.17).

Graph 3.17
Labour Market

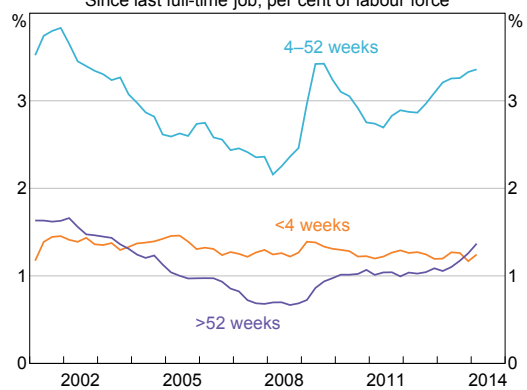


Notwithstanding these recent improvements, there is a fair degree of spare capacity in the labour market. In particular, the unemployment rate remains high relative to its recent history and the participation rate is around the lowest level of the past eight years. Also, broader measures of labour underutilisation remain relatively high. Measures of underemployment, which capture those employed who want to work more hours, remain close to their highest levels in the past decade despite declining slightly over the past couple of quarters. Since late 2010, there has also been a modest increase in the share of people marginally attached to the labour force. These are individuals who are recorded as not participating in the labour force because they are available to work but are not searching for work,

or vice versa. However, the increase in marginal attachment explains only some of the decline in the participation rate over this period, with the evidence suggesting that part of the decline in participation is related to the ageing of the population, which is more structural in nature and, therefore, more enduring.

Most of the increase in the unemployment rate since mid 2012 can be attributed to individuals that have been unemployed for between 4 and 52 weeks and, therefore, may be more likely to be unemployed for cyclical reasons (see RBA (2013), 'Box B: The Increase in the Unemployment Rate', *Statement on Monetary Policy*, November, pp 39–41; Graph 3.18). Nevertheless, the rate of long-term unemployment – defined as those unemployed for more than one year – has increased somewhat over the past 12 months. This may indicate a pick-up in the rate of structural unemployment; individuals that experience longer durations of unemployment might be less well suited to available positions, possibly due to factors such as structural changes in the labour market or a deterioration of their skills owing to a long period out of work. The proportion of the labour force unemployed for less than 4 weeks, and so most likely to be temporarily between jobs, has remained relatively stable.

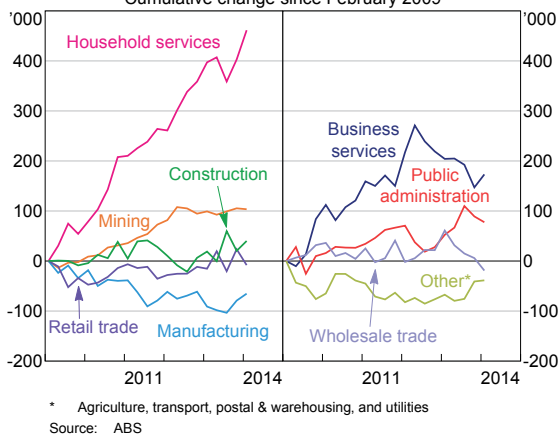
Graph 3.18
Duration of Unemployment*
Since last full-time job, per cent of labour force



* Seasonally adjusted by RBA
Sources: ABS; RBA

Much of the recent increase in employment has been attributable to the household services sector, driven by the health and education industries (Graph 3.19). Construction employment appears to have trended a little higher over the past 18 months, consistent with the pick-up in residential building activity. There has also been an increase in manufacturing employment since mid 2013. In contrast, employment in wholesale trade has experienced a pronounced fall over the past year, possibly reflecting continued pressures to contain costs through the supply chain. While employment in the business services sector is reported to have increased over the three months to February, it remains well below levels reached in mid 2012, and there has been little change in mining employment since that time. Reports from Bank liaison suggest that part of the recent decline in business services employment can be attributed to firms that conduct work related to investment in the mining industry, although a number of these firms have indicated that major job cuts may now be complete.

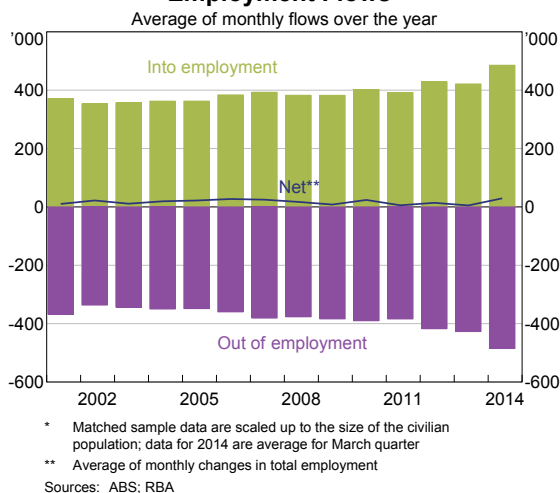
Graph 3.19
Employment Growth by Industry
Cumulative change since February 2009



Labour force data are often reported in terms of the net change in employment. However, on average, around 400 000 people have exited employment each month over the past few years (Graph 3.20). A similar, or slightly larger, number of people enter employment each month, with the sum of these

two gross flows typically resulting in a net increase in employment over time. These large gross flows into and out of employment each month are mostly accounted for by small changes in employment at many firms and so garner little public attention. In contrast, the recent high-profile announcements of job losses at some larger firms that are planned to be spread over coming quarters and years are small relative to the gross flows typically seen each month.

Graph 3.20
Employment Flows*

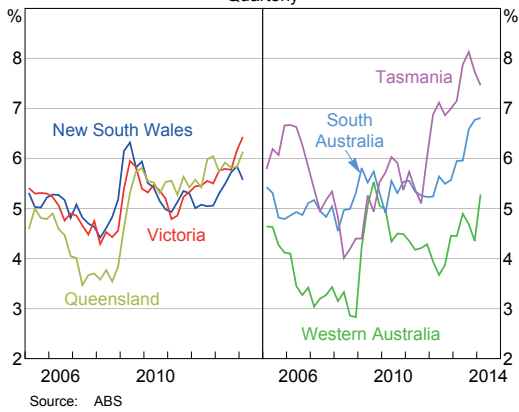


Recent labour market outcomes across the states have remained mixed (Graph 3.21). Employment in New South Wales has increased markedly since the beginning of the year, while the state's unemployment rate has been little changed of late. In Queensland, employment has trended higher over the past year and a half. In contrast, in Victoria employment has been relatively flat over the past year and the unemployment rate has risen steadily. The unemployment rate has also increased in Western Australia in recent months, while labour market conditions in South Australia and Tasmania have remained subdued.

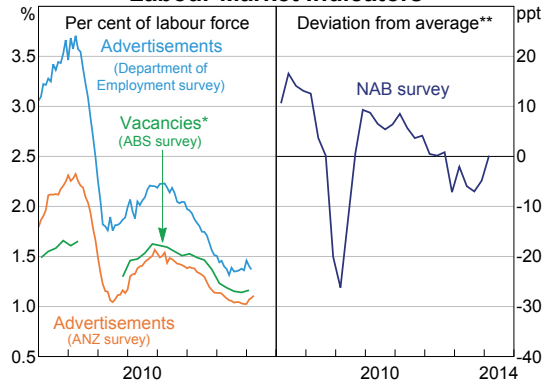
Forward-looking indicators of labour demand have shown signs of improvement recently, although they remain at low levels following earlier declines. Overall, these indicators of labour demand are

consistent with relatively moderate growth of employment over the coming months (Graph 3.22). The ABS measure of job vacancies appears to have stabilised over the past few quarters, while measures of job advertisements have increased somewhat over recent months. Business survey measures and reports from the Bank's liaison also suggest that firms' employment intentions have improved in recent months, but remain below their historical averages.

Graph 3.21
Unemployment Rates by State
Quarterly



Graph 3.22
Labour Market Indicators



* This survey was suspended between May 2008 and November 2009

** Net balance of surveyed employment intentions for the following quarter; deviation from average since 1989

Sources: ABS; ANZ; Department of Employment; NAB; RBA