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AUSTRALIAN QUARTERLY ECONOMIC REPORT – MARCH 2013

OVERVIEW

The Australian **economy grew** by 0.6% for the December quarter and by 3.1% on an annual basis. The main contributors to the quarterly growth were public capital formation and net exports.

The *Economist* March poll of GDP **forecasts** has revised up Australian economic growth in 2013 to 2.8% and has growth at 3.1% in 2014, while a slightly earlier Reserve Bank of Australia (RBA) outlook expected growth to be at around 2½% over 2013 before picking up to just under 3% over 2014.

On the external trade front, the December quarter **current account deficit** narrowed slightly 2% to -$A-14.7bn or -3.9% of GDP; while the January trade statistics recorded a **trade deficit** of $A1.1bn in trade in goods and services, which is a 54% increase on the December deficit but still 55% lower than November. In 2012 the **EU remained Australia's third largest merchandise trading partner** (after China and Japan) in terms of two-way trade.

Demand, as measured by **retail** sales, new **vehicle sales** and the forward indicators for the **building sector**, has been lacklustre so far in 2013. The **labour market** is exhibiting mixed signals, with the unemployment rate steady at 5.4%. There is a benign inflation outlook with the rate of underlying **inflation** in December quarter at 2.3% and the RBA expecting inflation to remain at around 2½% through to mid-2015, the middle of its target band of 2-3% on average over the course of the economic cycle.

Following a period of loosening **monetary policy** during 2012, it has been on hold so far this year at the 'moderately stimulating' rate of 3.0%. At its March meeting the RBA confirmed that the current settings are appropriate.

On **fiscal policy**, and in the run-up to the 14 May Budget, the government has had to concede that it is unlikely the budget would achieve a surplus in 2012-13, representing a significant political back down from a promise first made in the May 2010 budget. Since then there has been further speculation on the ability of the government to achieve budget surpluses in the outlook years in the absence of further austerity measures.

This quarterly report includes a focus on structural changes in Australia's household savings.

AUSTRALIAN ECONOMIC DATA UPDATE

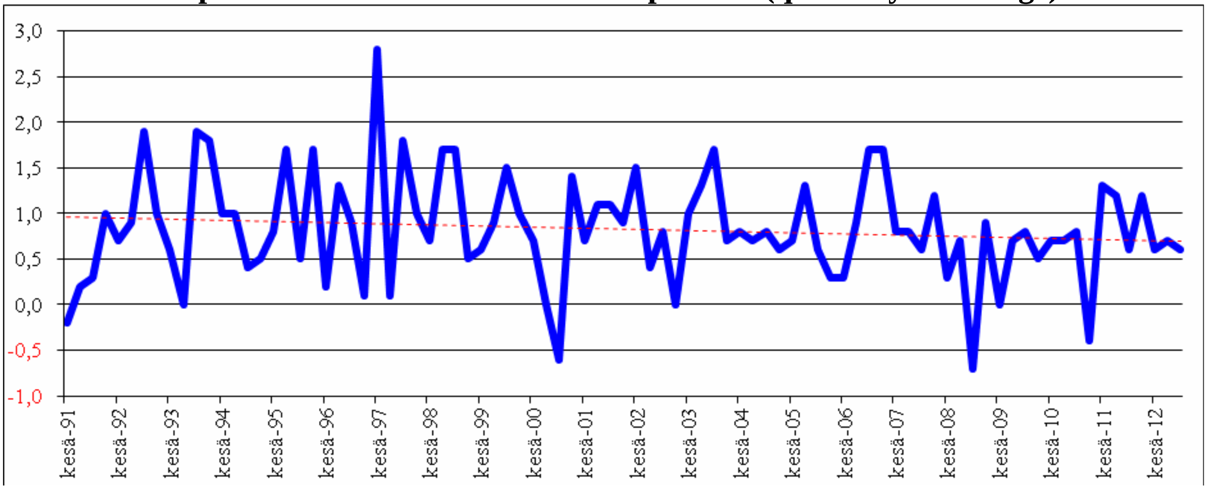
National Accounts

According to the National Accounts (released on 6/3), **Gross Domestic Product** in seasonally adjusted[1] volume terms increased by 0.6% for the December quarter which was in line with market expectations and slightly down from the 0.7% (revised up from 0.5%) growth achieved in the September quarter (see graph 1). On an annual year-on-year basis (quarter 2012 on quarter 2011) GDP growth of 3.1% was recorded for the December quarter, unchanged from September 2011 and slightly below trend (3.3%). However, the annualised growth for the last three quarters was a lower 2.5%, suggesting that the future growth may be more subdued.

[1] All indicators are in seasonally adjusted terms, unless otherwise indicated

Delegation of the European Union to Australia
18 Arkana Street Yarralumla ACT 2600 tel: +61 2 6271 2734 fax: +61 2 6273 4445 john.tuckwell@eeas.europa.eu

Graph 1: Australian Gross domestic product (quarterly % change)



The December quarter outcome was driven on the **expenditure side** by public capital formation (contributing +1.1 percentage points [ppts] to GDP growth, +24.6% quarterly and +6.6% annually)[2] and a solid positive contribution by net exports of goods and services (+0.6ppts), with exports (+0.7ppts) only being partially offset by a negative contribution by imports (-0.1pts). Although household expenditure is restrained (+0.2% quarterly, +2.8% annually), it still made a positive contribution to growth (+0.1ppt). Dwelling investment, intellectual property products, and a statistical discrepancy also all made a positive contribution of 0.1ppts. These were offset in part by a negative contributions from non-dwelling construction (-0.8ppts, -9% quarterly and +16% annually), changes in inventories (-0.4ppts) and weaker private machinery and equipment investment (-0.2ppts, -3.3% quarterly and -0.7% annually).

On the **production side** there were small positive contributions to growth (+0.1ppts) from a range of sectors including: mining; manufacturing; construction; financial and insurance services; public administration and safety; health care and social assistance; with a statistical discrepancy (-0.1ppts) subtracting from growth.

At a **state / territory level**, total state final demand grew by 0.3% for the December quarter and 3.5% annually. The Northern Territory made the largest contribution to this growth (+0.2ppts, +9.76% for the quarter and +32.8% annually), followed by Western Australia (+0.1ppts, +.05% quarterly, +14.2% annually), NSW (+0.1ppts, +0.4% quarterly and +2.4% annually) and the ACT (+0.4% quarterly and +3.4% annually). Queensland was flat for the quarter (+2.2% annually); while Victoria contracted (-0.2ppt, -1.1% and 0.1% annually), as did Tasmania (-0.6% quarterly and -4.6% annually) and South Australia (-0.5% quarterly and +0.3% annually), all three states now having experienced at least two consecutive quarters of negative growth in state final demand.

On the back of very strong iron ore and coal prices (*Mining Boom Mark II*), Australia's **terms of trade** (the relationship between prices and exports and imports) reached their highest point since records commenced (1959) during the September 2011 quarter. Since then commodity prices have been easing, with the terms of trade falling by 2.7% in the December quarter to be 13% lower annually. Nevertheless, it is still 17% above the average for the last decade and over 50% above the average since 1959 (see graph 2).

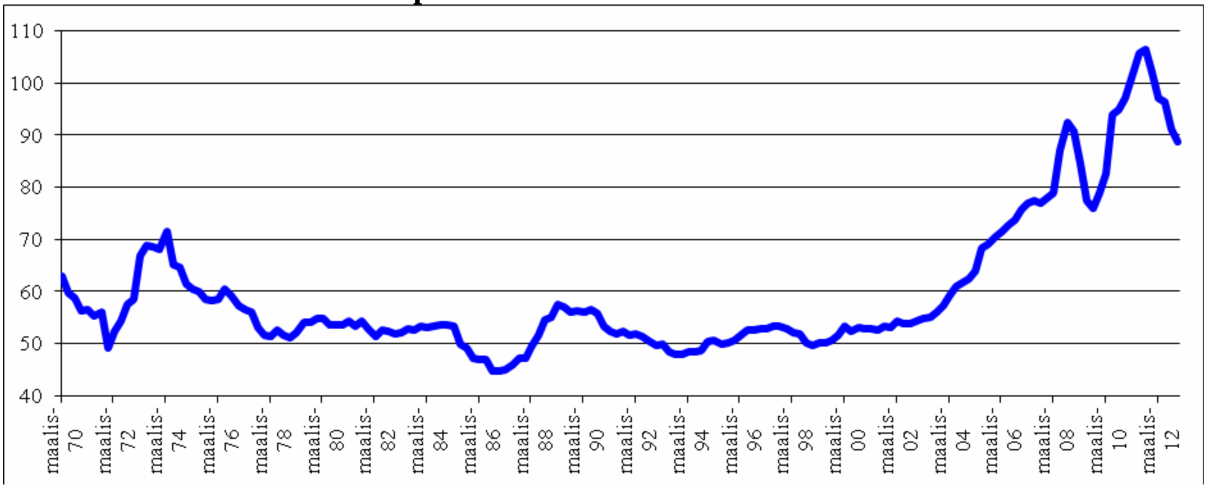
As a result, real net national disposable income, a broader indicator of national economic well-being which includes both the volume measure of GDP and the terms of trade effect,

[2] Public and private investment were impacted by a significant sale of a private asset to the public sector. While this remains confidential, media reports suggest this is a desalination plant sold to the Victorian government for around $A4.5bn.

declined by 0.1% and growth over the past year has been just 0.3%, compared with 3.1% for GDP.

Underlying the importance of population growth to Australia's economic growth, GDP per capita grew by just 0.2% in the December quarter and increased by just 1.5% annually. Productivity, as measured in GDP per hour worked increased by a healthy 0.7% on the previous quarter and by 3.5% year-on-year (average since 1978 is 1.6%).

Graph 2: Australia's terms of trade



Demand

Retail sales (5/3) in January rose by 0.9%, following a fall of 0.4% in December 2012 to be 3% higher than a year ago. Sales during the December quarter increased by just 0.1% in volume terms to $A63.7bn.

Sales of new motor vehicles in February (18/3) fell by 2.4% on the previous month to be 10.8% higher annually. Industry estimates (45/1) suggest that annual total sales of new motor vehicles in 2012 increased by 10.3% on 2011 to reach a new record level of 1.1 million units.

The housing **building sector** is showing mixed, but generally weak signals in early-2012 with the leading indicator of the number of commitments for housing finance for owner-occupation (13/3) falling by 1.5% in January, while the value of commitments rose by 2.4%. On an annual basis the number of commitments was 4% lower, while the value of the commitments was 5.6% higher. The total number of building approvals (4/3) for dwellings fell by 2.4% in January, with the number approved some 10% higher year-on-year. Average house prices (1/2) increased by 1.6% in the December quarter to be 2.1% higher year-on-year. Overall construction work done (27/2) rose by 0.6% for the December quarter to $A52.1bn to be 8.4% higher annually.

Headline **inflation** (23/1) as measured by the Consumer Price Index (CPI) for the December quarter increased by just 0.2% and eased to 2.2% annually. More importantly for monetary policy, the RBA's preferred core inflation rate (weighted median) increased by 0.5% for the quarter and eased slightly to 2.3% annually. This is in the bottom half of the RBA's target band of 2-3% on average over the course of the economic cycle. Further, the RBA is forecasting that inflation will remain at around 2½% through to mid-2015, suggesting a benign inflation outlook.

Producer Price Indices (1/2), which measure inflation at a wholesale level, are showing only modest inflationary pressures as the final stage prices increased by 0.2% for the December quarter (+1% annually); intermediate commodities prices increased by 0.6% (+1.7% annually) and preliminary stage commodities also rose by 0.6% for the quarter (+1.4% year-on-year).

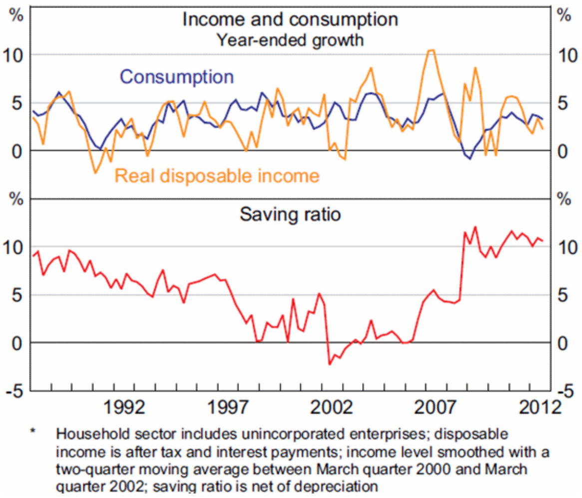
Household Thrift - The New Normal?

Australia's level of household saving has exhibited a marked readjustment since 2006, climbing from negative levels to above 10% of net household disposable income (10.1% in the December quarter 2012). A realisation of the structural nature of this change prompted a series of analyses during 2011, featuring contributions from the Reserve Bank of Australia (RBA) and the Australian Treasury. These sought to contextualize the turnaround in the saving ratio and explore the possible implications for the Australian economy. This note revisits the issue, now almost two years on.

The cautious consumer revisited

From the early-1980s until the mid-2000s, household saving in Australia declined from 15% of net disposable income to around -2%. A number of factors are seen to have contributed to this fall: financial deregulation facilitated rising household indebtedness; nominal interest rates declined; and household wealth rose on the back of strong capital gains; all of which encouraged growth in consumption to largely outpace income growth at the time (see Graph 3).

Graph 3: Household Income and Consumption



Source: Reserve Bank of Australia, *Statement on Monetary Policy*, February 2013

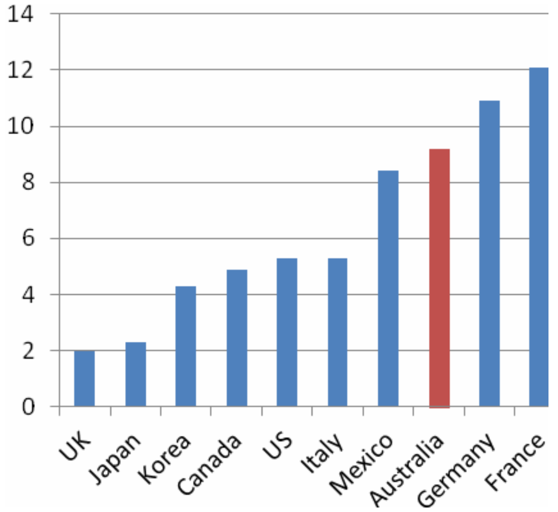
However, income growth picked up thereafter (in parallel with the rising terms of trade) and from the end of 2007, household consumption growth slowed significantly (following the onset of the global financial crisis), giving rise to the "*cautious consumer*" described in a speech by RBA Governor Glenn Stevens on 26 July 2011. The resulting higher savings partly reflects an adjustment to the earlier accumulation of housing debt and coincides with lower asset values and increased uncertainty about the future. That said, the current level of household saving appears more a return to historical norms, with the Trade and Competitiveness Minister Dr Craig Emerson stating on 9 March 2013 that "*households have been shifting towards being sustainable consumers after completing the task of rebuilding their* savings".

The international perspective

Savings rates in Australia are now rather high, among OECD economies, being exceeded only by France, Switzerland, Germany and Belgium in 2010 (see Graph 4).

Graph 4: Household net saving

Percentage of household disposable income, 2010



Source: OECD, *National Accounts at a Glance*, 2013

Looking ahead, the OECD projects Australia's household net saving to remain at around 9% through to 2014, echoing the Australian Government's expectation in its October 2012 Mid-Year outlook that the saving ratio will remain elevated over the forecast period.

Implications for the Australian economy

A Treasury paper in September 2011 talked up the benefits of higher household saving, arguing that it has reduced the impact of the mining boom on the current account deficit (reducing the reliance on overseas investment sources), and weighed on prices and wages, and therefore interest rates. The stability of the local banking sector (and its funding sources) has also been underpinned by the resulting increase in deposits.

Yet, with the unwinding of the terms of trade, and savings unlikely to revert to the low rates observed prior to 2006 any time soon (notwithstanding consumer confidence being at a two-year high in March 2013), the question remains whether policymakers will seek to encourage greater household consumption as an economic driver in a post-mining boom scenario, should certain sectors of the economy continue to struggle.

Total private sector credit (28/2) provided by financial intermediaries increased by 0.2% in January 2013 to $A2,137bn, following a 0.4% increase during December. Over the year to January, total credit rose by a subdued 3.6%. The growth is being led by housing credit (+0.4% monthly and +4.4% annually to $A1,271bn); business credit was flat in January (0.0%) and increased by 2.8% annually to $A732bn); with personal credit declining in January (-0.1%) and annually (-0.3%) to $A134bn.

Business conditions

Manufacturing sales (4/3) of goods and services increased by 0.8% in the December quarter 2012, but were flat year-on year (-0.1%); while wholesale sector sales increased by 0.4% on the previous quarter to be a strong 6.6% higher than the previous year.

Company inventories (4/3) for the December quarter were 0.2% higher, and 2.9% higher on an annual basis.

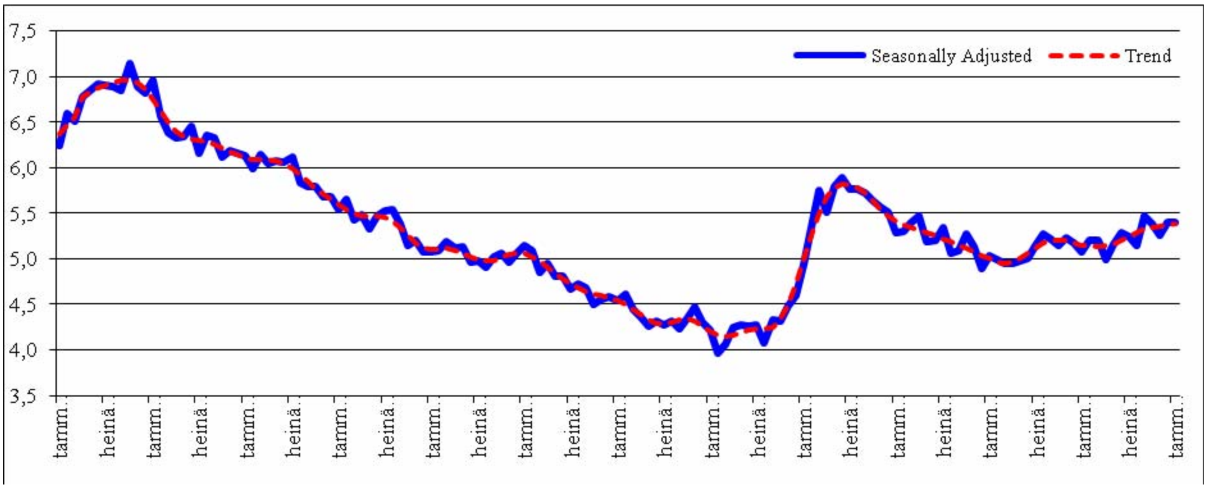
Company gross operating profits (4/3) fell by 1% in the December quarter, to be 7.6% higher lower than December quarter 2011.

Private new capital expenditure (28/2) in the December quarter 2012 fell by 1.2% for the quarter and year-on-year was 10% higher annually (buildings and structures +14.2%; equipment, plant and machinery +3.5%). Expected new capital expenditure (estimate 5) for 2012-13 (July-June) is at $A168.2bn which is 4% higher than 2011-12, but slightly lower than was previously expected (-1.3% on estimate 4). The first estimate for 2013-14 is at $A152.5bn, which is 8% lower than the corresponding estimate for 2012-13.

Labour Market

The labour market (14/3) has displayed mixed signals and volatility, but on balance has been more resilient than market expectations. Employment rose by an unexpectedly strong 71,500 persons in February to 11.6 million persons, having increased by 13,100 (revised) in January. Year-on-year employment has increased by 1.7%. With the participation rate jumping by 0.3 percentage points to 65.3%, the unemployment rate was unchanged at just 5.4% (see Graph 5).

Graph 5: Australia's unemployment rate (%)



Looking forward, job advertisements (4/3) in newspapers and on the internet recorded by the ANZ job advertisement series (which provides a leading indicator of employment ~4-6 months), increased by 3% in February, to be almost 17% lower higher annually. ANZ observes that '*Despite tentative signs that labour demand might be stabilising, we expect a continued gradual rise in the unemployment rate to around 5¾% by mid year*'.

Wage growth remains reasonably strong. The Wage Price Index (20/2) increased by +0.8% (trend) in the December quarter 2012 and increased by 3.4% year-on-year (down from 3.7% in the September quarter). Full-time adult ordinary time average weekly earnings (21/2) rose by 5% over the year November 2012 (up from 3.4% for the previous period). Part of the reason for the resilience in wage inflation is the common practice of multi-year enterprise bargaining (6/3), with new agreements in the December quarter having a 3.4% average annualised wage increase (-0.2ppts on the September quarter) and all current wage agreements having a 3.8% average annualised wage increase.

External Transactions

The balance of payments (5/3) data showed that the current account deficit (CAD) narrowed slightly in the December quarter by 2% to -$A-14.7bn or -3.9% of GDP. This was due to a decrease in the investment income deficit by 6% to $A9.1bn, with the deficit on goods and services increasing by 4% to -$A5.6bn (credits +1% to $A74.2bn and debits +1% to $A79.8bn).

Arguably, a potential structural weakness in the Australian economy is the size of its net foreign debt. For the December quarter 2012, this indicator increased by 1.7% on the previous quarter to a new record level of $A760bn (52% of annual GDP). Over 70% of this debt is in the private sector. The net interest cost on the debt for the December quarter was $A4.6bn or 1.2% of quarterly GDP.

December trade data (5/2) provided preliminary values for trade in goods for 2012, and subsequent revisions in the latest monthly trade statistics (7/3) show that total Australian exports of goods decreased by 5% in 2012 to $A248bn and imports increased by 7% to $A242bn, leading to total two-way trade being flat (+0.3%) at $A491bn.

The data also confirmed that the **EU remained Australia's third-largest merchandise trading partner in 2012** (after China and Japan), being its second-largest source of imports (17.6% of total Australian imports) and fourth largest market for exports (6.9%, after China, Japan and South Korea) - see Table 1. The EU accounted for 12.3% of Australia’s total two-way merchandise trade in 2012, with bilateral trade worth $A59.7 billion, marginally down on 2011.

Australian imports from the EU increased by 5.5% in 2012 to $A42.6 billion, while Australian exports to the EU fell by 13.0%, to $A17.1 billion. As a result, the EU's longstanding merchandise trade surplus with Australia rose by 22.9% on the previous year to a record A$25.6 billion in 2012.

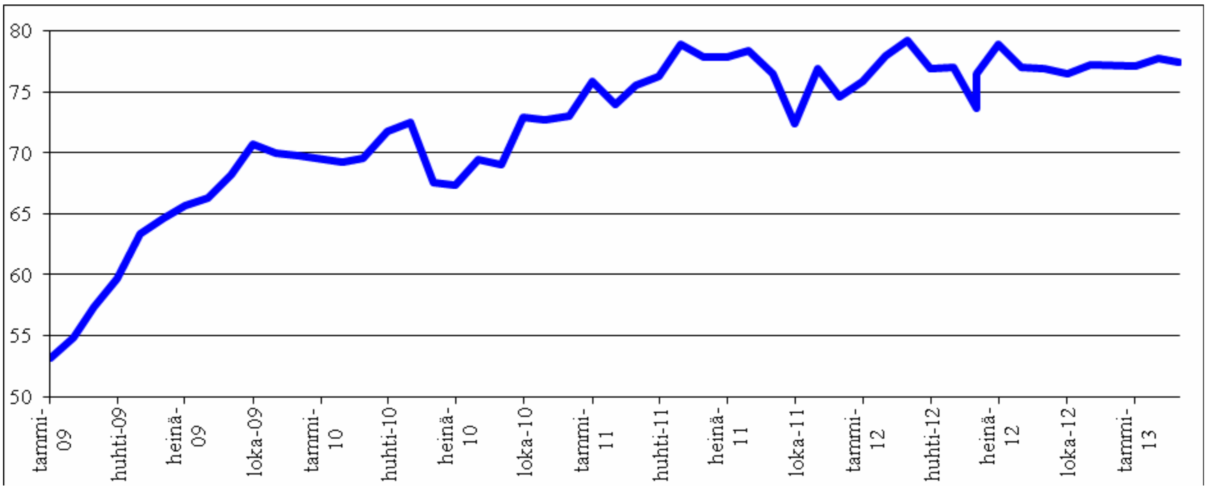
Table 1: Australia's trade in goods by major partners

	January to December ($Amn)			Share of total %			% change
	2010	2011	2012	2010	2011	2012	2012/11
Exports							
China	58,420	71,451	73,285	27.8	27.3	29.5	2.6
Japan	43,590	50,441	48,030	20.8	19.3	19.3	-4.8
Korea	20,468	23,240	19,849	9.8	8.9	8.0	-14.6
EU	18,569	19,618	17,069	8.8	7.5	6.9	-13.0
Total	*209,851*	*261,697*	*248,332*				*-5.1*
Imports							
China	39,255	42,145	44,463	18.7	18.6	18.4	5.5
EU	38,417	40,416	42,629	18.3	17.8	17.6	5.5
United States	22,682	25,347	27,789	10.8	11.2	11.5	9.6
Japan	18,191	18,003	19,054	8.7	7.9	7.9	5.8
Total	*210,061*	*227,108*	*242,173*				*6.6*

In January, exports of goods and services eased by 0.7% to $A25bn to be flat annually; while imports increased by 0.7% to $A26.1bn to be 2.4% lower annually. These changes resulted in a deficit of $A1.1bn in trade in goods and services in January, which is a 54% increase on the December deficit but sill 55% lower than the November deficit.

The Australian dollar on a TWI basis has largely been flat over much of the second half of 2012 and was at 77.4, just 2% below the 27 year high reached on 02/03/12 (see graph 6). Against the euro it was worth 1$A=€ 0.782 at the end of February; some 9% below the all-time high reached on 13/08/12; while against the $US to reach 1$A=$A1.028 some 7% below the late-July 2011 peak.

Graph 6: Movements in Australian dollar - Trade Weighted Index (end month)



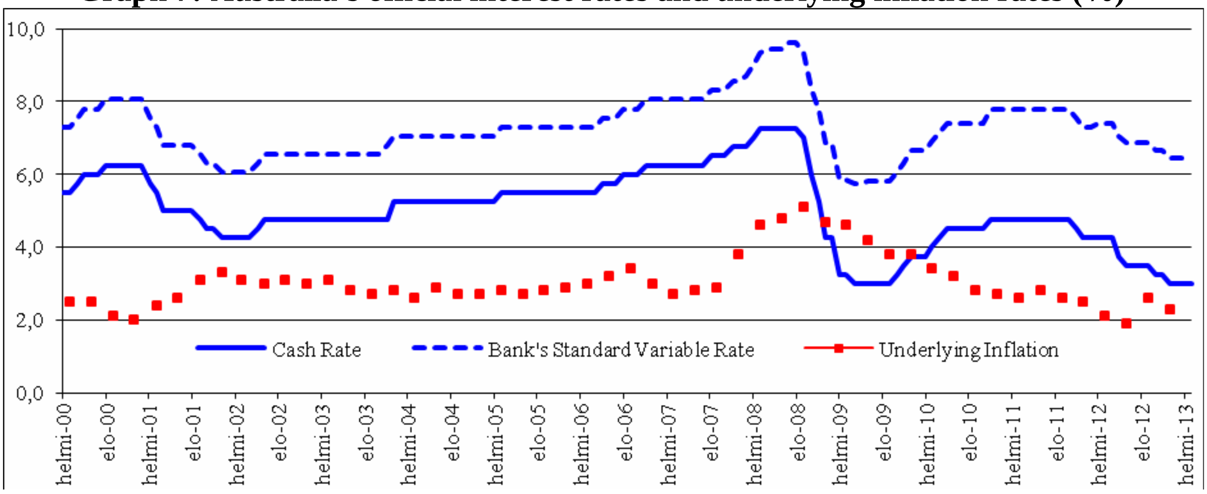
MONETARY POLICY

The Board of the RBA decided at its last meeting (5/3) to again keep the cash rate unchanged at the 'moderately stimulating' rate of 3.00%. As stated in their media release:

"The Board's view is that with inflation likely to be consistent with the target, and with growth likely to be a little below trend over the coming year, an accommodative stance of monetary policy is appropriate. The inflation outlook, as assessed at present, would afford scope to ease policy further, should that be necessary to support demand. At today's meeting, taking into account the flow of recent information and noting that there had been a substantial easing of policy as a result of previous decisions, the Board judged that it was prudent to leave the cash rate unchanged."

Therefore, having cut the official cash rate by 125 basis points during 2012, the RBA could be said to be in a 'wait-and-see' mode, with a bias towards a further easing of monetary policy. This was at least until the very strong employment data in February, with most market commentators still expecting one final easing in monetary policy by mid-2013.

Graph 7: Australia's official interest rates and underlying inflation rates (%)



However, faced with higher costs in the deposit market and in global funding markets, the major banks have not cut their standard variable mortgage rates in line with the cash rate with the margin between the banks' standard variable rates and the cash rate increasing to 3.45 percentage points (*cf* with 1.8ppts between 2000 and 2007) - see Graph 7.

FISCAL POLICY

On 16 December, Treasurer Swan invited pre-budget submissions for the 2013-14 Budget to be handed down on 14 May.

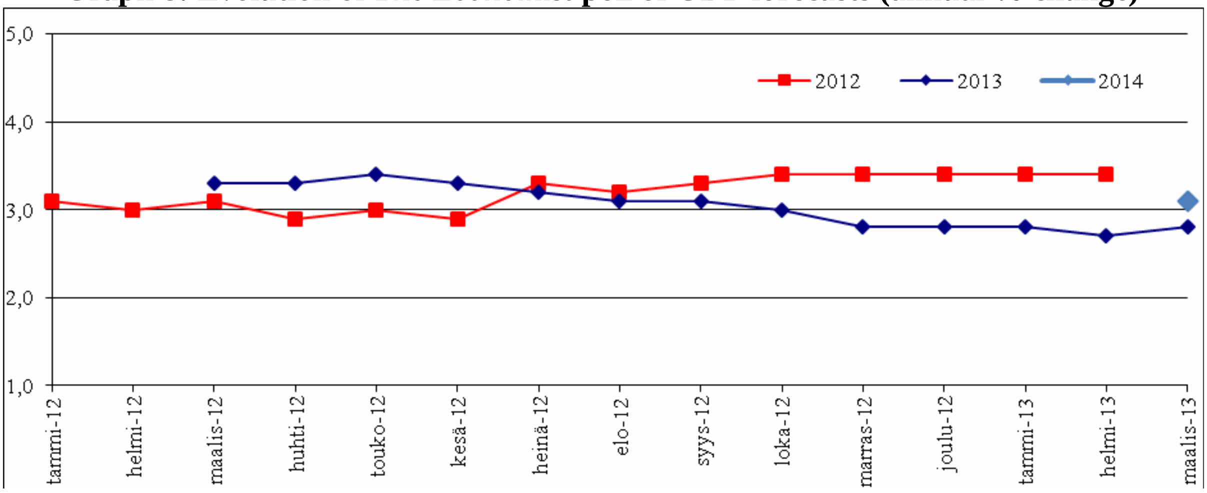
Treasurer Wayne Swan confirmed on 20 December that it was unlikely the budget would achieve the $1.1 billion surplus in 2012-13 (as forecast in October's MYEFO), citing "dramatically lower tax revenue" in the first four months of this current financial year (July-October). Although Mr Swan stressed the importance of Government economic responsibility in supporting jobs, the announcement represents a significant political backdown from a promise he first made in the May 2010 budget.

Since then there has been further speculation on the ability of the Government to achieve budget surpluses in the outlook years faced with falling terms of trade and nominal income growth and in the absence of further austerity measures.

OUTLOOK

The *Economist* March poll of GDP forecasts (9/3) continues to put Australia as one of the strongest economies of all the developed countries covered. The poll suggests that for 2013 the Australian economy will grow by 2.8% (up from 2.7% in the February forecasts with a range of +2.3% to +3.6%); and for 2014 it is forecast to grow by 3.1% (first forecast with a range of +2.4% to +3.8%). Inflation is forecast at +2.6% for 2013 (down from 2.7%) and +2.7% for 2013. The current account deficit is forecast to be -3.8% of GDP (down from -4.6%) for 2013, and -3.7% in 2014.

Graph 8: Evolution of *The Economist* poll of GDP forecasts (annual % change)



The RBA in its latest quarterly statement on monetary policy (8/2 – see Graph 8) slightly downgraded its outlook, with GDP growth now expected to be below trend at around 2½% over 2013 before picking up to just under 3% over 2014. The soft outlook reflects a number of factors: mining investment expected to peak; fiscal consolidation and the high level of the $A. *The Australian Financial Review* quarterly survey of forecasts (7/1) showed downward revisions in growth for 2013 to 2.7% (*cf* 3.0% in October) and downward revisions for 2012-13 to 3.0% (*cf* 3.2%). Alongside its latest Global Economic Prospects report (18/1) the World Bank has forecast the Australian economy to grow by 3.4% in 2012 and by 3.5% in 2013.

Prepared by: John Tuckwell and Ben Slatter