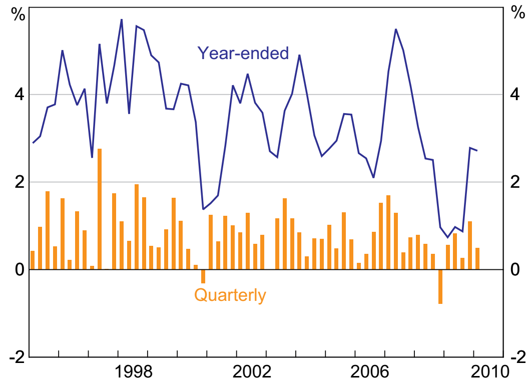
Domestic Economic Conditions

The Australian economy continued to expand at a solid pace over the first half of 2010. The economy is benefiting from elevated commodity prices and high levels of public investment. Employment growth has been strong and confidence remains generally positive. Over the period ahead, some rebalancing of growth is expected, with public investment likely to decline as stimulus projects are completed, while private demand is expected to strengthen. The outlook for investment in the resources sector remains especially positive and the high level of the terms of trade is boosting incomes and demand.

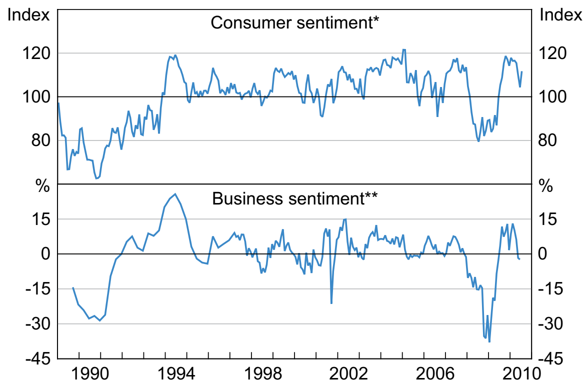
The latest available GDP data show that real GDP increased by 0.5 per cent in the March quarter, to be 2.7 per cent higher over the year (Graph 35, Table 7). The level of output in Australia is now 2.5 per cent above that in the September quarter of 2008, whereas for most other advanced economies, the level of output remains around or below its earlier peak. As discussed in previous *Statements,* the share of investment in GDP in Australia remains much higher than in other advanced economies and Australia's exports have performed relatively well. Looking forward, timely indicators of economic activity, including measures of consumer and business confidence and information from the Bank's liaison program, are consistent with continued growth in economic activity (Graph 36).

Graph 35
GDP Growth



Source: ABS

Graph 36
Sentiment Indicators



* Average of Roy Morgan Consumer Confidence Rating and Westpac-Melbourne Institute Consumer Sentiment Index; average since 1980 = 100
** Net balance; deviation from average since 1989
Sources: Melbourne Institute and Westpac; NAB; RBA; Roy Morgan Research

Table 7: Demand and Output Growth
Per cent

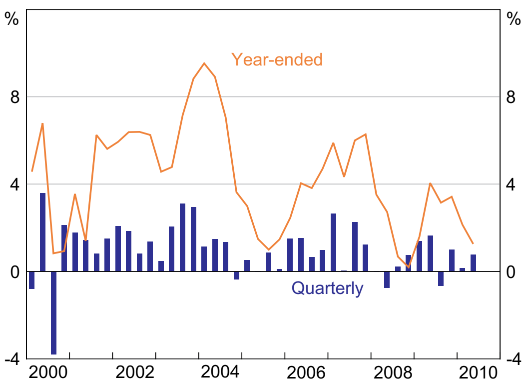
	March quarter 2010	Year to March quarter 2010
Domestic final demand	0.6	4.4
– Private demand	–0.4	2.0
– Public demand	3.8	12.9
GNE	0.8	5.7
Net exports[(a)]	–0.5	–2.7
Statistical discrepancy[(a)]	0.2	–0.4
GDP	0.5	2.7

(a) Contribution to GDP growth
Source: ABS

Household Sector

Household spending appears to have grown at a moderate pace through the first half of 2010. While this partly reflects the unwinding of the boost to spending that occurred in late 2008 and early 2009 as a result of the stimulus payments, it also appears that many households are taking a more cautious approach to their finances than was the case over much of the past decade and a half. In the June quarter this year, the volume of retail sales increased by 0.8 per cent, after rising by just 0.1 per cent in the March quarter (Graph 37). Other components of household consumption – particularly motor vehicles and services – have been stronger than retail sales. Total consumption rose by 0.6 per cent in the March quarter, to be 3.1 per cent higher over the year, while motor vehicle sales to households rose by more than 10 per cent in the June quarter, although they eased in July. The level of motor vehicles sales has recovered the 20 per cent fall that occurred in 2008 and the first half of 2009.

Graph 37
Real Retail Sales Growth



Source: ABS

Household income and confidence have been supported by the improvement in labour market conditions and the recovery in household wealth. Household net worth is estimated to be more than 20 per cent higher than the trough in early 2009, although it was little changed in the June quarter, reflecting softer growth in housing prices and a decline in equity prices. Measures of consumer sentiment continue to be above long-run average levels, with consumers appearing to be optimistic about future economic conditions. Despite this, the increased cautiousness of the household sector means that the household saving rate remains above its decade average (Graph 38). The increase in mortgage rates to around average levels has also resulted in households using more of their income to service debt; the ratio of household interest payments to disposable income has increased by around 2½ percentage points over the past year, although it remains well below its peak in September

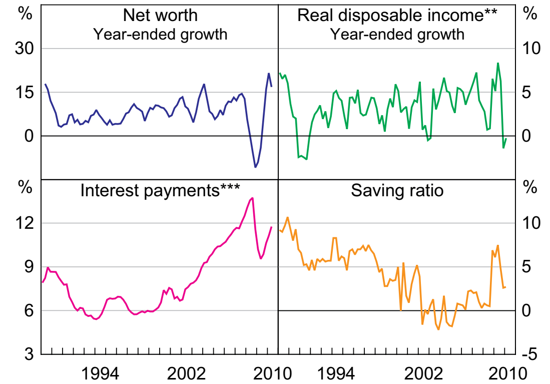
2008. However, this is likely to overstate somewhat the increase in overall payments on mortgages, given that some households left their payments unchanged as interest rates fell in late 2008 and early 2009 and will not have been as affected by the subsequent rise in interest rates.

The housing construction sector has been in a modest upswing since mid 2009, although recent data for building approvals indicate a slowing in momentum (Graph 39). Private building approvals rose by close to 50 per cent over 2009, boosted by the higher federal and state government grants to first-home buyers and the very low level of interest rates. However, with those factors being largely unwound more recently, private building approvals have fallen by 9 per cent over the first half of 2010, although a significant fall in approvals for houses has been partly offset by a gradual recovery in approvals for apartments. Overall, despite strong demand for housing from a rapidly growing population and a boost to activity from the construction of new homes under the Federal Government's Social Housing Initiative, the pick-up in homebuilding has been moderate by historical standards, with the number of building approvals currently below peaks seen in the late 1980s, mid 1990s and early 2000s when both the level and rate of growth of the population were lower than is now the case.

In the established housing market, conditions have eased in the June quarter. Data from RP Data-Rismark suggest that monthly growth in housing prices slowed in April and May and that prices fell in June (Graph 40). The cooling in the housing market is also apparent in a slowing in quarterly average price growth (Table 8). Auction clearance rates, which are timely indicators of housing market conditions, have also fallen over recent months from near historic highs to around average levels (Graph 41). The moderation in housing price growth has been relatively broad-based across capital cities and regional

Graph 38

Household Financial Indicators*

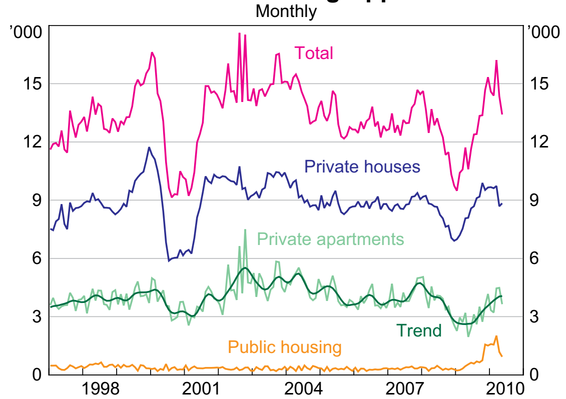


* Net worth and saving ratio include unincorporated enterprises; RBA estimate of net worth for June quarter 2010
** Income is after interest payments and smoothed with a two-quarter moving average between March quarter 2000 and March quarter 2002
*** Per cent of household disposable income before the deduction of interest payments; RBA estimate for June quarter 2010
Sources: ABS; RBA

Graph 39

Residential Building Approvals

Monthly

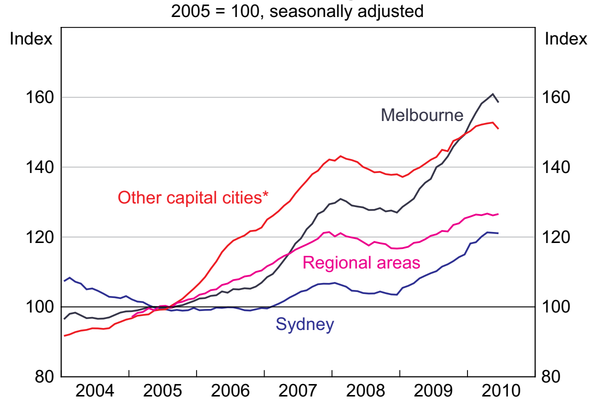


Source: ABS

Graph 40

National Housing Prices

2005 = 100, seasonally adjusted



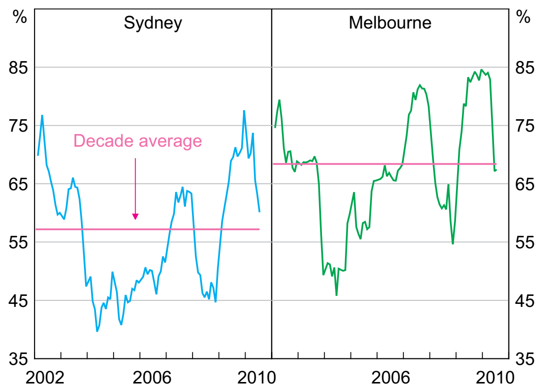
* Includes Adelaide, Brisbane, Canberra and Perth
Sources: RBA; RP Data-Rismark

Table 8: National Housing Price Growth
Per cent

	March quarter 2010	June quarter 2010	Year to June quarter 2010	Trough-to-latest
Capital cities				
ABS[(a)]	4.2	3.1	18.4	23.4
APM	3.7	2.5	15.2	19.2
RP Data-Rismark	4.5	1.4	12.2	17.3
Regional areas				
APM	0.7	0.5	9.4	11.9
RP Data-Rismark[(a)]	1.6	0.3	5.9	8.5

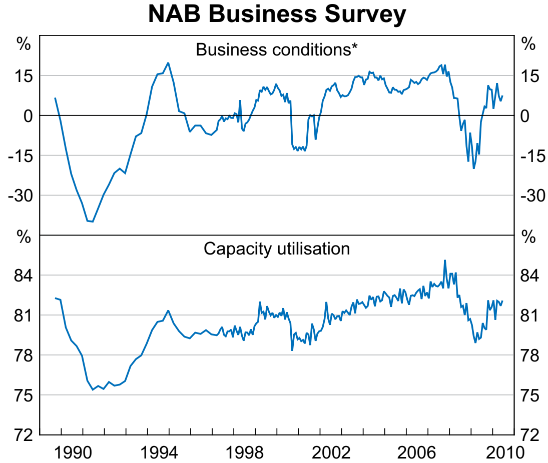
(a) Detached houses only
Sources: ABS; APM; RBA; RP Data-Rismark

Graph 41
Auction Clearance Rates*



* Seasonally adjusted; RBA estimate for Sydney for July 2010
Sources: APM; RBA; REIV; RP Data-Rismark

Graph 42
NAB Business Survey



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

areas, with signs that the previous strong growth in Melbourne house prices has eased (Graph 40).

The slowing in housing price growth is broadly consistent with recent developments in housing finance, with housing loan approvals having fallen by around 15 per cent from their September 2009 peak. The decline has been driven by a fall in owner-occupier loan approvals likely reflecting higher mortgage rates and a fall in turnover in lower-priced suburbs following the expiration of the boost to federal grants to first-home buyers. In contrast, investor loan approvals have been trending steadily higher over the past year, although as a share of total approvals they remain well below the peaks reached over 2002–03, when very strong investor demand was contributing to overheating in some property markets. Loan approvals have been strongest in Victoria, consistent with the stronger housing market conditions in that state.

Business Sector

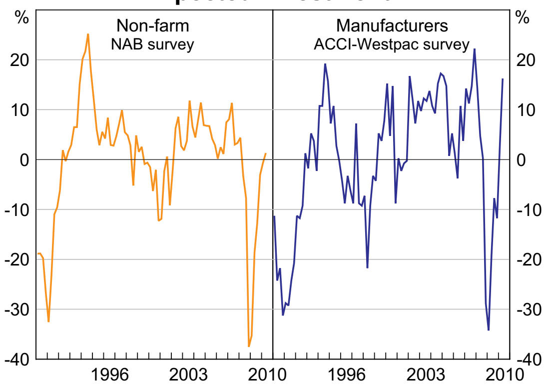
Conditions in the business sector remain reasonably favourable, although there is considerable variation across industries. Business surveys generally report that through to the middle of the year, conditions and capacity utilisation have remained at, or above, average levels (Graph 42). While the pattern of recent data on business investment has been affected by the timing of tax incentives in 2009, there are signs that private investment, outside of that related to the fiscal stimulus building program, is now starting to pick up. Investment is being underpinned by solid internal funding for businesses; survey measures of business profits remain at above-average levels, with the large increases in bulk commodity contract prices likely to have provided a boost to mining profits in the June quarter. Consistent with this, the value of capital imports has risen recently to be 4 per cent higher in the June quarter.

Measures of investment intentions are positive (Graph 43), particularly for the resources sector. The capital expenditure (Capex) survey's second estimate of firms' spending plans in 2010/11 points to a significant rise in buildings and structures investment, led by the mining sector. In particular, with work on the $43 billion Gorgon LNG project having commenced in late 2009, there is a significant pipeline of engineering work yet to be done (Graph 44). Further out, there are a number of significant projects in the advanced stages of planning, including additional LNG projects on the North-West Shelf off the coast of Western Australia and coal-seam methane projects in Queensland. More generally, the positive medium-term outlook for China and other trading partners in Asia suggests that strong demand for a number of Australia's commodities will continue to support a high level of engineering investment activity in the period ahead. Mining investment is underpinning total business investment, which, notwithstanding a modest fall recently, is currently at 16 per cent of GDP – a very high level compared both with history and other advanced countries (Graph 45).

In contrast to the mining sector, private non-residential building activity remains weak (Graph 46). Outside of public spending on private schools, the value of non-residential building approvals has remained at a low level since early 2009. While in recent quarters there have been further declines in approvals for industrial, retail & wholesale sector developments, there appears to be a tentative recovery in approvals for office

Graph 43

Expected Investment*



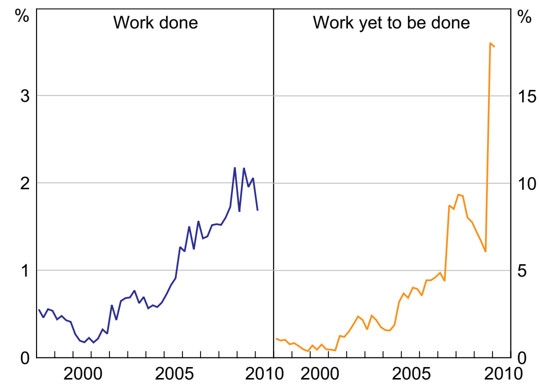
* Net balance; deviation from long-run average since: 1989 for NAB, 1961 for ACCI-Westpac

Sources: ACCI-Westpac; NAB

Graph 44

Mining Sector – Engineering Construction

Per cent of nominal GDP

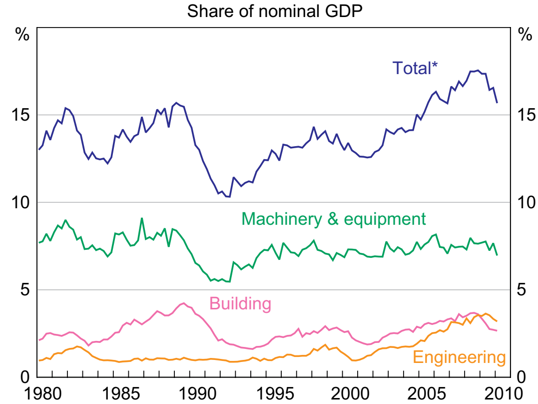


Source: ABS

Graph 45

Business Investment

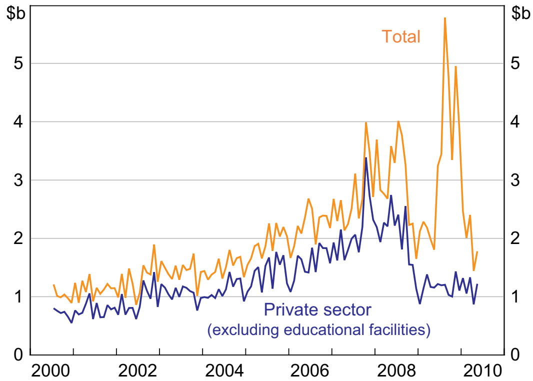
Share of nominal GDP



* Adjusted for second-hand asset transfers between the private and other sectors

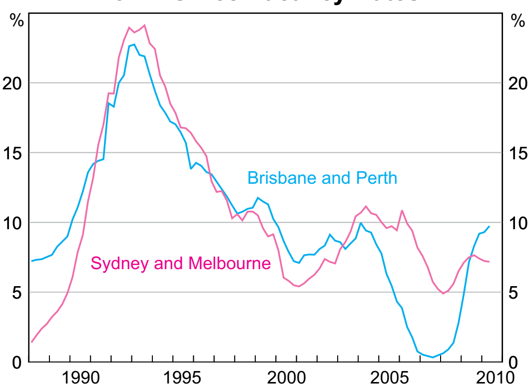
Source: ABS

Graph 46
Non-residential Building Approvals
Current prices, monthly



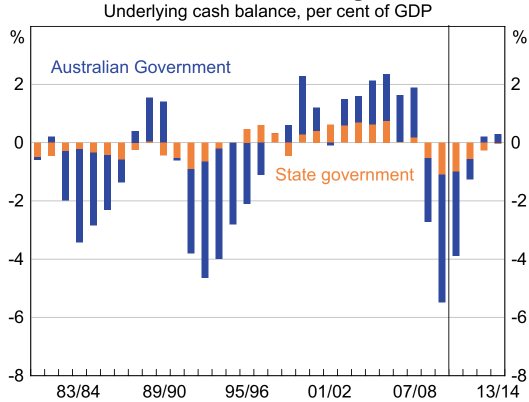
Source: ABS

Graph 47
CBD Office Vacancy Rates



Sources: Jones Lang LaSalle; Property Council of Australia; RBA

Graph 48
General Government Budget Balance
Underlying cash balance, per cent of GDP



Sources: ABS; Australian Treasury; state Treasuries

developments. Demand for office space looks to have picked up in most CBD markets, although conditions in Brisbane and Perth remain soft (Graph 47). 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. Liaison suggests that access to funding for most commercial property developer firms remains relatively tight.

Government Budgets

Australian Government and state budgets released since the start of May indicate a gradual reduction in deficits after the significant stimulus that occurred in 2008/09 and 2009/10. In total, the general government (federal plus states) deficit is budgeted to narrow from 5.5 per cent of GDP in 2009/10 to 3.9 per cent in 2010/11, before moving to a small surplus in 2013/14 (Graph 48). The narrowing of the deficit reflects the phasing out of fiscal stimulus and rising government receipts as growth picks up. Total capital expenditure by the state public sector (including both public trading enterprises and the general government sector) is expected to remain high in 2010/11 after rising strongly in 2009/10.

Farm Sector

Farm production is estimated to have increased slightly in 2009/10, with a modest increase in crop production partly offset by a small fall in livestock production. The outlook for the farm sector in 2010/11 appears largely favourable, with an improvement in seasonal conditions. Most cropping regions in the eastern states received average or above-average rainfall in the first half of 2010, and have enjoyed a good start to the season. The Southern Oscillation Index has been positive since April, consistent with the early stages of a La Niña weather pattern, which would normally suggest higher-than-average rainfall in most parts of eastern Australia in the remainder of 2010. However, cropping regions in Western Australia have tended to receive significantly below-average rainfall in the first half of 2010, and the outlook there is weaker. Overall, ABARE estimates that the area planted to wheat has fallen by 2 per cent this year to 13.5 million hectares, but that higher yields will see production increase by 2 per cent to 22.1 million tonnes.

Water inflows to the Murray-Darling basin returned to long-run average levels in the first half of 2010. Water storage levels have picked up in the eastern states since the beginning of the year, most notably in New South Wales and Queensland, and remain at high levels in Western Australia.

External Sector

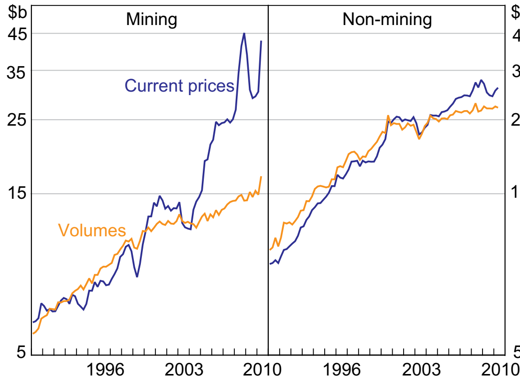
The large increases in bulk commodity contract prices have provided a significant boost to export revenue (Graph 49). As a consequence, the trade balance is estimated to have moved from a deficit of 1.0 per cent of GDP in the March quarter to a surplus of around 2 per cent of GDP in the June quarter, and the current account deficit to have narrowed. The significant increases in contract prices are also estimated to have led to a sharp rise in the terms of trade in the June quarter, back to around their peak in late 2008 (Graph 50).

Export volumes are estimated to have recorded very strong growth in the June quarter, to be around 6 per cent higher over the year, largely reflecting growth in resource exports. Coal exports recovered from weather-related supply disruptions (rising by around 16 per cent in the June quarter), while iron ore export volumes rose more modestly (up 3 per cent), with growth constrained by available port capacity. Gold exports increased sharply in the quarter to be 20 per cent higher, reflecting both an increase in domestic production capacity and higher re-exports. Strong demand for Australia's resource commodities in recent years has supported significant investment in resource projects by mining companies to boost capacity. Further investment in the resources sector – particularly for iron ore, coal and LNG – is expected to underpin strong growth in export volumes as capacity expands further.

Graph 49

Exports*

Log scale



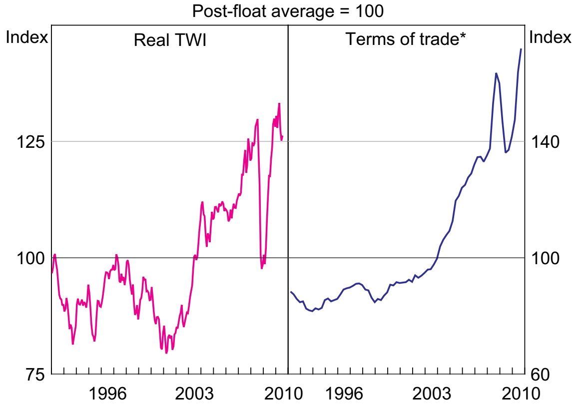
* Volumes data re-referenced to 2003/04 prices; RBA estimate for the June quarter 2010

Sources: ABS; RBA

Graph 50

Real Exchange Rate and Terms of Trade

Post-float average = 100



* RBA estimates for June and September quarters 2010

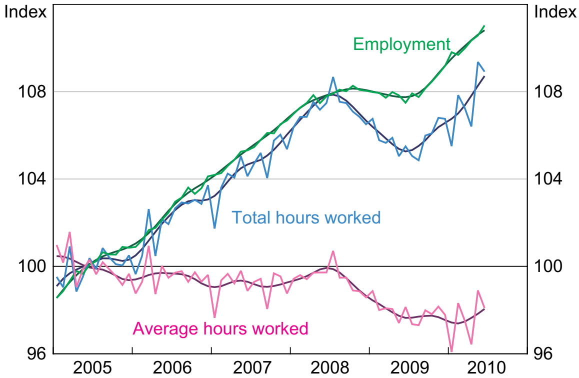
Sources: ABS; RBA; Thomson Reuters

Outside of resources, exports have been more subdued. Non-commodity exports fell slightly in the June quarter, with manufactures and services exports remaining below their pre-crisis peak. Weakness in manufactures exports has been broad-based. Travel-related service exports appear to have fallen in the June quarter, which has contributed to recent weakness in service exports. While global demand is improving, the relatively high value of the Australian dollar (currently around 25 per cent above its post-float average in real terms) may dampen growth for these other export categories (Graph 50).

Graph 51

Employment and Hours Worked

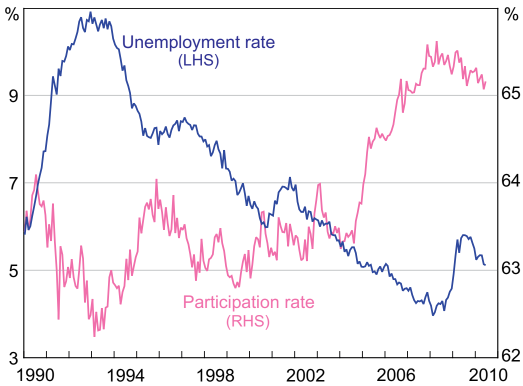
2005 = 100*



* Smoothed line is a 13-period Henderson trend
Sources: ABS; RBA

Graph 52

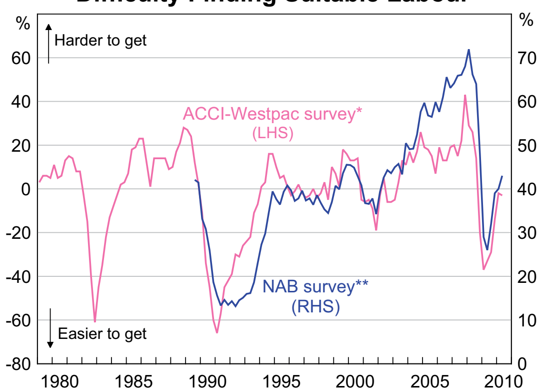
Labour Force



Source: ABS

Graph 53

Difficulty Finding Suitable Labour



* Net balance of firms finding it harder to get labour than three months ago
** Per cent of firms indicating that availability of suitable labour is a constraint on output
Sources: ACCI-Westpac; NAB

Import volumes are estimated to have increased by around 3½ per cent in the June quarter, with strong growth across the major components. Imports have now recovered the 15 per cent decline that occurred in late 2008 and early 2009, and are expected to grow at a solid pace going forward, underpinned by growth in domestic demand.

Labour Market

Conditions in the labour market have continued to improve. Employment increased by 0.7 per cent in the June quarter, to be 3¼ per cent above its trough in mid 2009 (Graph 51). Most of the growth in recent months has been in full-time employment, which has surpassed its previous peak in 2008. Employment growth has become more broad-based recently, with particularly strong growth in Western Australia and Queensland, following the earlier strength in Victoria. Growth has also broadened across industries, with solid employment gains in services industries, as well as in mining and construction.

The strong employment growth has seen the unemployment rate continue to edge lower, reaching 5.1 per cent in June, around ¾ percentage point below the peak in the recent downturn (Graph 52). Most states have recorded a decline in the unemployment rate over the past year, with the unemployment rate lowest in Western Australia. There are also signs that average hours worked have started to pick up, after declining during the recent labour market downturn.

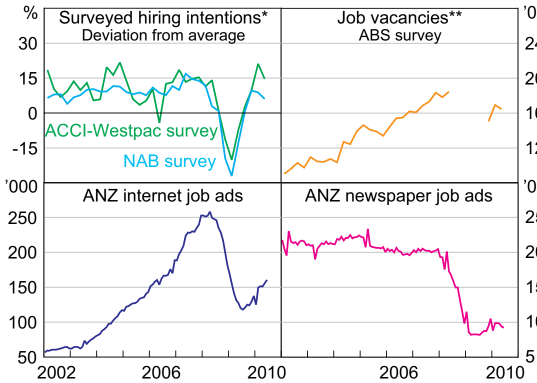
Notwithstanding this improvement in the labour market, business surveys and the Bank's liaison suggest that most firms are not encountering significant difficulty in sourcing suitable labour, except in mining-related industries where there have been reports of emerging skills shortages (Graph 53). While the decline in the participation rate during 2009 was modest relative to previous labour market downturns, it remains ¼–½ percentage point below its recent peak. Further, the decline in the participation rate was associated with a pick-up in the number of 'discouraged job seekers', which includes those who wanted to work but gave up looking due to labour market conditions. This group tends to have a relatively high probability of re-entering the labour force as the labour market improves. More generally, the supply of labour continues to grow robustly, driven by strong growth in the working-age population.

Forward-looking indicators of labour demand suggest that demand is likely to remain solid in coming months, despite some measures easing a little recently (Graph 54). Business survey measures of hiring intentions are at above-average levels. While job vacancies declined slightly over the three months to May according to the ABS survey, this followed a large increase over the previous three months. The ANZ measure of job advertisements has continued to grow, albeit at a slower pace in recent months; aggregate job advertisements in June were more than 30 per cent higher than a year earlier.

The growth in employment and total hours worked since mid 2009 has been strong relative to that in output, with the result that estimated growth in labour productivity has been relatively weak. One partial explanation for the relatively strong employment growth over this period is the subdued growth in real wages in 2009, which is likely to have contributed to hiring. Another possibility is that firms in some sectors may have recommenced hiring at an earlier-than-normal stage in the recovery, prompted by the widespread shortages of skilled labour experienced prior to the recent downturn. More generally, growth in productivity has been subdued for a number of years, particularly relative to the high-productivity period in the 1990s. This slowdown is difficult to explain fully, although lags between investment in the resources sector and new production coming on line may be part of the answer, as is the mining of more input-intensive resources that has become profitable due to elevated commodity prices. Another factor is the higher level of investment in the utilities sector to replace ageing infrastructure and improve the reliability of service. Given the current historically strong growth rates in both capital and labour, a return to average growth rates of productivity would lift estimates of potential output growth (Graph 55).

Graph 54

Labour Market Indicators



* Expectations for following quarter, net balance

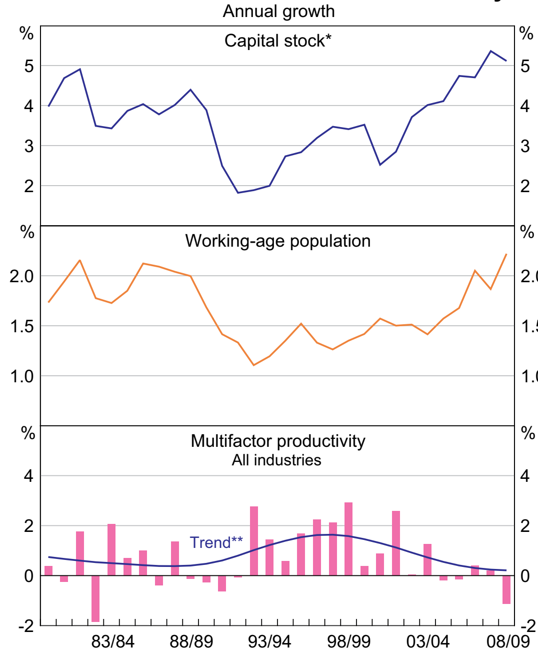
** This series was discontinued by the ABS after May 2008 and subsequently reinstated for the November 2009 reference period

Sources: ABS; ACCI-Westpac; ANZ; NAB; RBA

Graph 55

Factors of Production and Productivity

Annual growth



* Excluding livestock & orchards and private dwelling investment

** Estimated using a Hodrick-Prescott filter, $\lambda = 50$

Sources: ABS; RBA