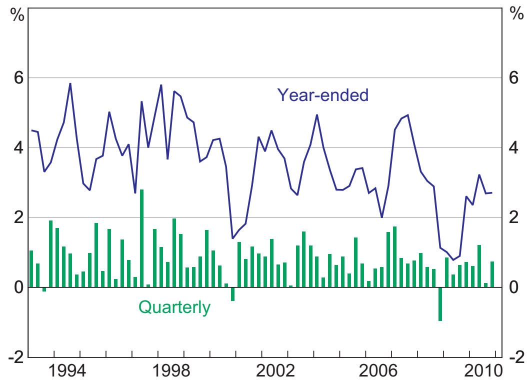
3. Domestic Economic Conditions

Growth in domestic demand appears to have been solid over recent months, although growth in aggregate production has been significantly affected by the extreme weather conditions in late 2010 and early 2011. The labour market remains strong and recent surveys suggest that business conditions in the overall economy remain positive. The terms of trade are at a record high, which is providing a significant boost to national income at a time when there is a large pipeline of mining investment to be undertaken. Growth in household consumption and borrowing, however, remains relatively subdued, as households continue to save a higher share of income than was the case over the past two decades.

The latest available data for real GDP show growth of 2.7 per cent over the year to December, with nominal income up by 8.8 per cent over the year mainly due to the rise in the terms of trade (Graph 3.1, Table 3.1). More recently, there has been a large decline in output of the mining sector due to the wet weather, which has increased the likelihood of a fall in GDP in the March quarter. Coal production, in particular, has been significantly affected, and the resumption of activity in flooded mines is taking longer than was initially expected (see 'Box B: An Update on the Impact of the Natural Disasters in Queensland'). Production levels should, however, recover over the months ahead, providing a boost to GDP growth in the June and September quarters.

Graph 3.1
GDP Growth



Source: ABS

Table 3.1: Demand and Output Growth
Per cent

	December quarter 2010	Year to December quarter 2010
Domestic final demand	0.3	2.7
– Private demand	0.2	1.6
– Public demand	0.7	6.0
Change in inventories[(a)]	0.8	0.4
GNE	1.1	3.1
Net exports[(a)]	0.0	–0.7
GDP	0.7	2.7
Nominal GDP	1.2	8.8

(a) Contribution to GDP growth
Source: ABS

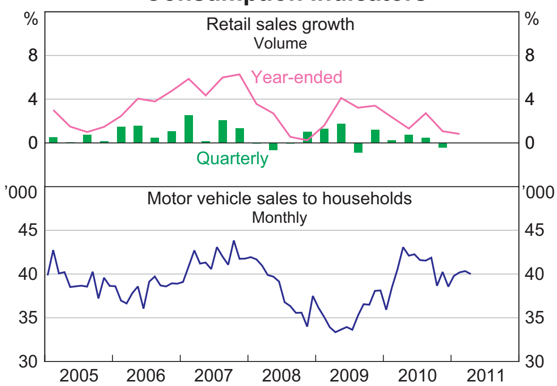
Household Sector

Growth in both household consumption and borrowing remains below the average of the past two decades. The volume of retail sales was flat in the March quarter to be 0.8 per cent higher over the year (Graph 3.2). Retail sales growth in Queensland was stronger than in the rest of the economy in the quarter, driven by sales of household goods, consistent with the replacement of flood-damaged consumer durables. Sales of motor vehicles to households have been somewhat stronger in the first four months of 2011 than in late 2010.

Real household disposable income grew by around 4½ per cent in 2010 – compared with 20-year average growth of 3¼ per cent – driven by strong labour market outcomes (Graph 3.3). Household net worth increased by 4½ per cent in 2010 and is estimated to have increased by ½ per cent in the March quarter (Graph 3.4). As a ratio to current income, however, household wealth is below the levels of much of the past decade. The household saving ratio remains around 10 per cent, which is its highest level since the late 1980s.

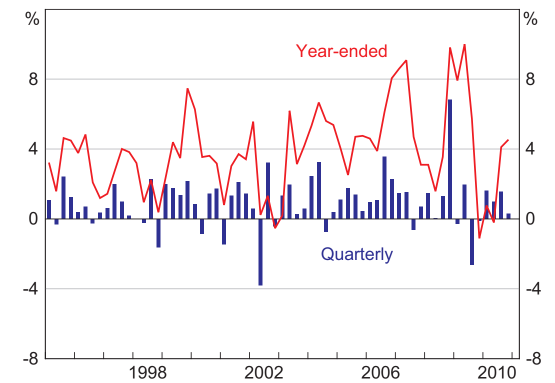
Consumer surveys suggest households continue to be quite optimistic about future economic conditions for Australia as a whole, although they are not as optimistic about their own finances (Graph 3.5). Higher prices for utilities and fuel and higher mortgage interest rates, amongst other things, appear to be weighing on households. In addition, the loss of household wealth during the global financial crisis is likely to have prompted some households to increase their saving to rebuild wealth and consolidate balance sheets. This is being reflected in the marked slowing in the pace of growth

Graph 3.2
Consumption Indicators



Sources: ABS; FCAI/VFACTS; RBA

Graph 3.3
Real Household Disposable Income Growth*



* Household sector includes unincorporated enterprises and is after interest payments; income level smoothed with a two-quarter moving average between March quarter 2000 and March quarter 2002

Sources: ABS; RBA

Graph 3.4
Household Debt, Net Worth and Saving

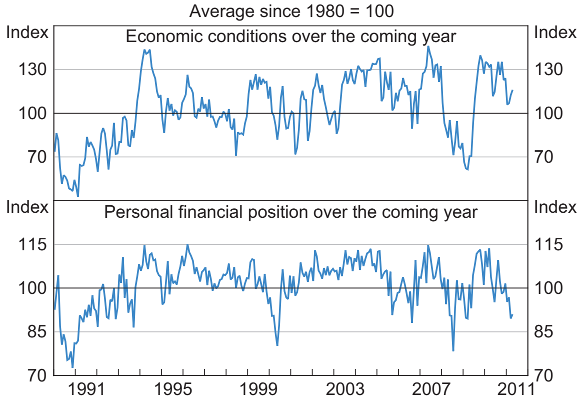
* Debt and income exclude unincorporated enterprises; income is before the deduction of interest payments

** Year-ended percentage change

*** Net of depreciation

Sources: ABS; APM; RBA

Graph 3.5
Consumer Sentiment
Average since 1980 = 100

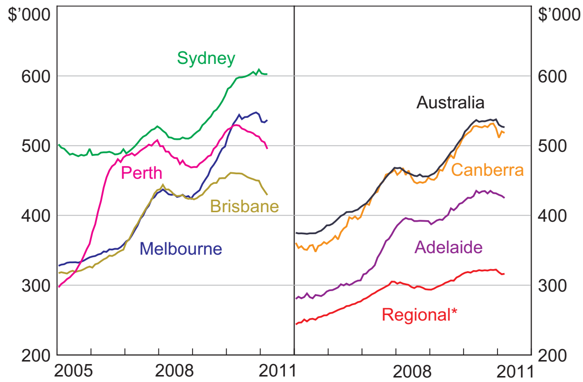


Source: Melbourne Institute and Westpac

in household credit, the stabilisation in the debt-to-income ratio; more households are now well ahead in their mortgage repayments and in paying down credit card debt. The slowing in debt accumulation is consistent with a return of household saving patterns to more traditional norms following the adjustment that took place in the 1990s and early 2000s in response to lower nominal interest rates, and innovation and increased competition in the financial system.

Consistent with the restraint in household spending, the housing market has cooled significantly since early 2010. Nationwide housing prices are estimated to have fallen by around 2 per cent in the March quarter to be slightly lower over the year (Table 3.2). Brisbane and Perth have been the weakest markets, with prices 4–6 per cent lower over the year, while prices in Sydney and Melbourne are broadly unchanged over the year (Graph 3.6). Auction clearance rates, which can provide a timely indicator of housing market conditions, are currently below decade-average levels in Sydney and Melbourne, while the total stock of dwellings listed for sale is relatively high compared with recent years, suggesting that properties are taking longer to sell. Demand for housing finance slowed in the early part of the year, following the increase in mortgage rates in November 2010 and flooding in Queensland and Victoria; loan approvals in February were down by 11 per cent over the year, with investor approvals down a little more than owner-occupier approvals.

Graph 3.6
Dwelling Prices



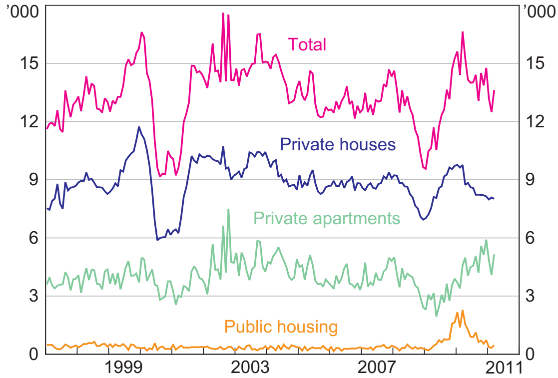
* Excluding apartments; measured as areas outside of capital cities in New South Wales, Queensland, South Australia, Victoria and Western Australia
Sources: RBA; RP Data-Rismark

Table 3.2 National Housing Price Growth
Per cent

	3 months to December 2010	3 months to March 2011	Year to March 2011
Capital cities			
ABS[(a) (b)]	0.8	–1.7	–0.2
APM	–0.8	–0.2	–0.6
RP Data-Rismark	0.3	–2.1	–0.6
Regional areas			
APM[(b)]	–1.0	–1.8	–3.1
RP Data-Rismark[(a)]	0.4	–1.8	–0.5

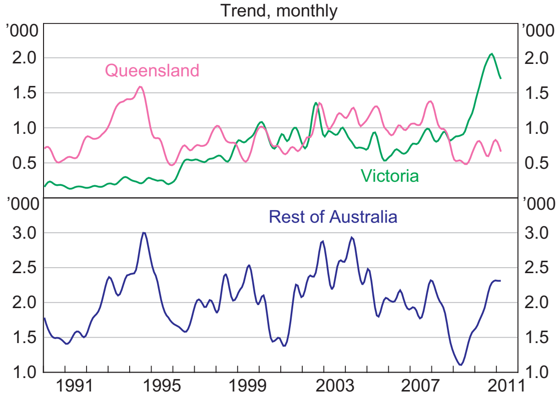
(a) Detached houses only
(b) Quarter-on-quarter growth rate
Sources: ABS; APM; RBA; RP Data-Rismark

Graph 3.7
Residential Building Approvals
Monthly



Source: ABS

Graph 3.8
Private Apartment Approvals
Trend, monthly



Sources: ABS; RBA

Indicators of dwelling investment have softened in early 2011, with disruptions owing to flooding having had some effect on the number of building approvals (Graph 3.7). This was particularly apparent for detached houses, with approvals in Queensland falling by 15 per cent in the March quarter; excluding Queensland, house approvals rose by 1 per cent in the quarter. Apartment approvals fell sharply in the quarter, with a sharp fall in Victoria following a very large run-up through late 2009 and in 2010 (Graph 3.8). Public residential approvals have also fallen further as the impetus from the Social and Defence Housing Initiative has faded. The recent flow of residential approvals implies around 140 000 completions a year, which is below the average level seen over the past two decades.

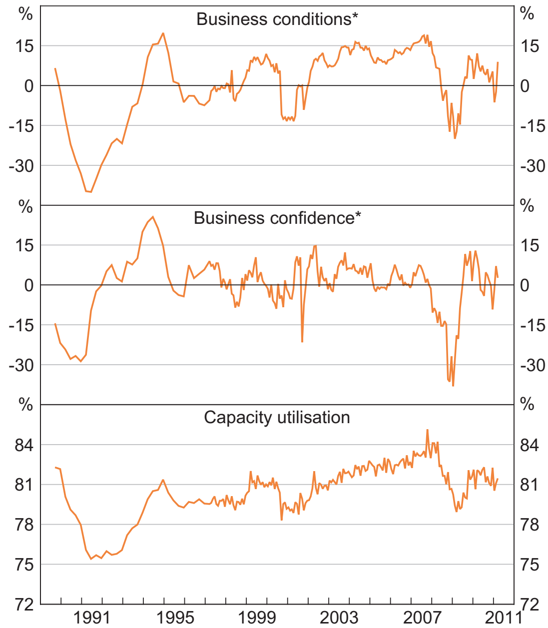
Business Sector

Overall measures of business conditions are around, or modestly above, average levels, although there is significant variation across sectors. Conditions deteriorated sharply in January due to the floods, but have since picked up, and measures of business confidence are at around average levels (Graph 3.9). Not surprisingly, these swings have been largest in Queensland; after the floods disrupted production in January, many businesses are now expecting that the reconstruction activity will boost demand over the months ahead.

Given the various factors currently shaping the Australian economic outlook, business conditions differ significantly across industries. Looking through the weather-related disruptions, the mining sector is growing strongly and the Bank's liaison suggests that engineering construction and service-sector firms exposed to mining and public infrastructure are experiencing strong demand. In contrast, subdued growth in household demand and the unwinding of the construction projects funded by the fiscal stimulus are weighing on firms in retailing and some parts of the building industry. The high Australian dollar also continues to provide a challenging environment for many trade-exposed businesses, including those in the tourism and manufacturing sectors.

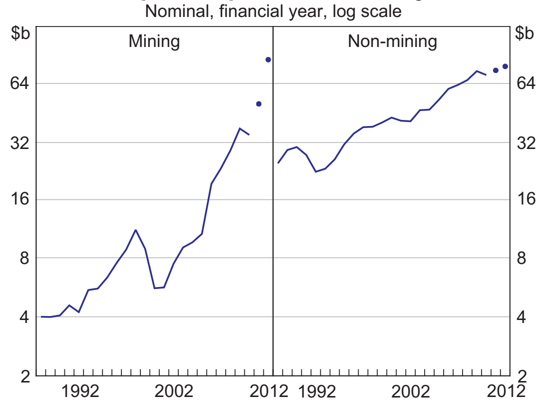
There is a large stock of mining construction in the pipeline, reflecting the high level of commodity prices and the robust outlook for growth in emerging economies in Asia. The ABS capital expenditure survey of firms' spending plans points to large increases in mining sector investment in 2010/11 and 2011/12 (Graph 3.10). A number of

Graph 3.9
NAB Business Survey



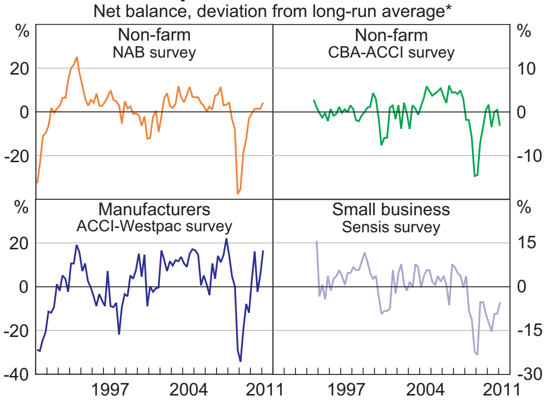
* Net balance; deviation from average since 1989
Sources: NAB; RBA

Graph 3.10
Capital Expenditure Survey*
Nominal, financial year, log scale



* 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

Graph 3.11
Expected Investment
Net balance, deviation from long-run average*

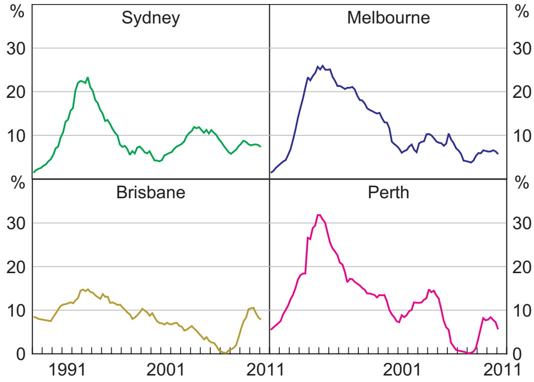


* Deviation from long-run average since 1961 for ACCI-Westpac, 1989 for NAB, 1994 for CBA-ACCI and Sensis
Sources: ACCI; CBA; NAB; RBA; Sensis; Westpac

large projects are already underway; the $43 billion Gorgon LNG project is advancing in the construction phase, while construction of the $14 billion Pluto project is now complete with production expected to commence later this year. In recent months, work has begun on two large coal-seam methane to LNG projects in Queensland (Gladstone LNG and Queensland Curtis LNG). Investment plans in the iron ore sector, which accounted for around 17 per cent of the value of exports in 2010, have also progressed significantly over the past year. Over the past six months, Rio Tinto, BHP Billiton and Fortescue Metals have committed to significant expansions in capacity, while other proposed projects, mainly in the Pilbara and Mid West regions of Western Australia are at various stages of planning and design. With this high level of activity in the mining sector, liaison is reporting a pick-up in competition for labour and other inputs, which could delay some projects.

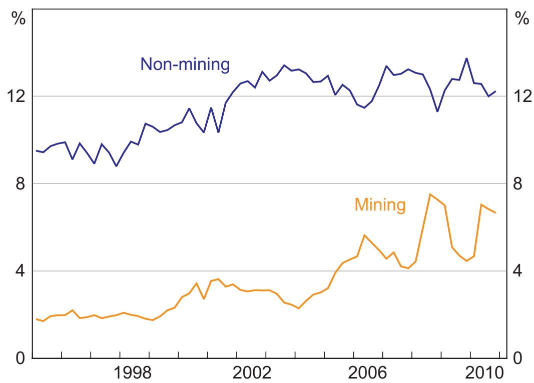
Outside the mining sector, the ABS capital expenditure survey points to modest growth in non-mining investment in 2010/11 and 2011/12. Surveys of investment intentions show a mixed picture, although on balance they suggest around average growth in non-mining investment (Graph 3.11). While the value of non-residential building approvals fell in the March quarter and is significantly lower than pre-downturn levels, the outlook for building appears to have improved. The

Graph 3.12
CBD Office Vacancy Rates



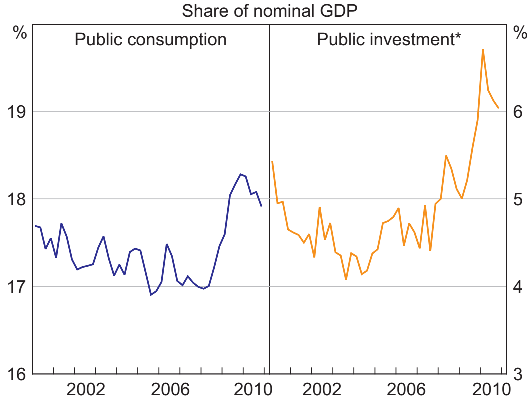
Source: Jones Lang LaSalle

Graph 3.13
Private Non-financial Corporation Profits*
Share of nominal GDP



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

Graph 3.14
Components of Public Demand
Share of nominal GDP



* Adjusted for second-hand asset transfers between the public and other sectors
Source: ABS

national CBD office vacancy rate has fallen slightly in recent quarters, and more significant falls are expected in Sydney and Melbourne over the next few years, given forecasts of solid increases in office demand and relatively moderate new additions in progress (Graph 3.12).

Company profits rose by around 1 per cent in the December quarter and by 13 per cent over the year. Mining profits fell slightly over the quarter and non-mining profits rose slightly, but in year-ended terms mining profits were up by over 60 per cent while non-mining profits were down by 3 per cent (Graph 3.13). Business balance sheets generally remain in sound shape and many firms are able to use internal sources to fund investment spending; the gearing ratio (the ratio of debt to assets) has continued to decline, to be slightly below its decade average (see also the 'Domestic Financial Markets' chapter).

Government Spending

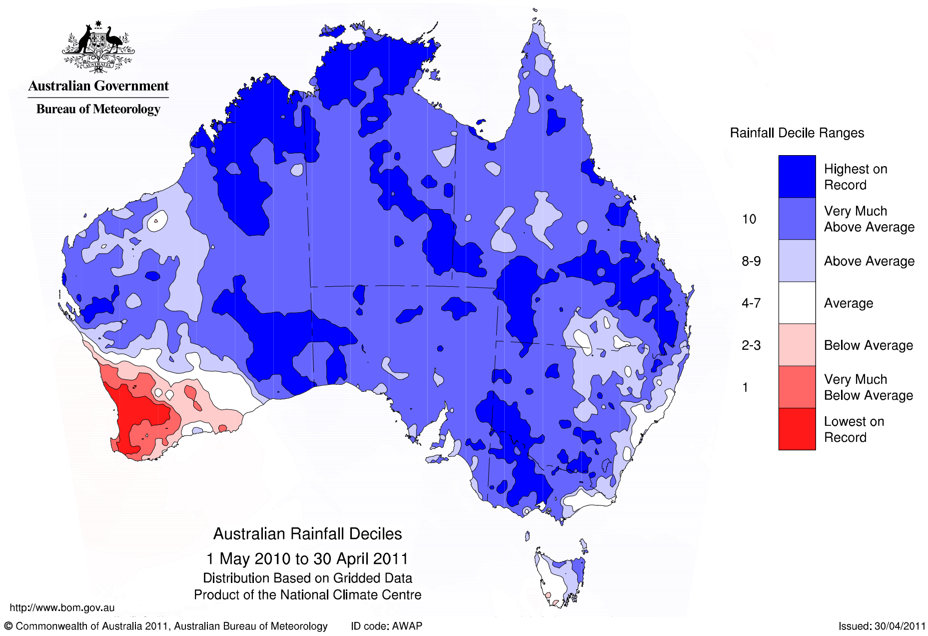
Public demand had been steadily increasing as a share of GDP since around 2005, due to government spending on infrastructure investment and the stimulus-related programs. More recently, however, public investment has been falling as fiscal stimulus projects such as the education-related construction under the Building the Education Revolution program are completed (Graph 3.14). More broadly, with the budget projected to return to surplus over the next few years, the impact of fiscal policy will be contractionary.

Farm Sector

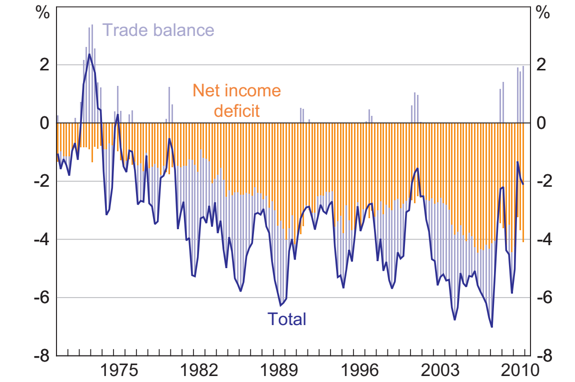
The latest forecasts from rural agencies suggest an increase in farm production of around 8 per cent in 2010/11, including a solid increase in the national wheat harvest to around 26 million tonnes in 2010 from 22 million tonnes in 2009. Offsetting the improvement in the wheat harvest, the flooding in early 2011 across the eastern states has resulted in crop losses in cereals, sugar, fruit and vegetables, cotton and grain sorghum, as well as a significant downgrading in crop quality.

Looking ahead, inflows into the Murray–Darling basin, which contains roughly 40 per cent of the nation's agricultural production, have been at all-time record levels in recent months and non-metropolitan water storages are at their highest levels in a decade. Accordingly, the Australian Bureau of Agricultural and Resource Economics and Sciences (ABARES) suggests that crop production over 2011/12 should benefit from the increased availability of irrigation water and improved subsoil moisture, with farm production expected to increase by 2½ per cent. Given that Australian agricultural exporters are receiving higher prices and anticipating favourable growing conditions, measures of rural confidence have returned to high levels in recent private sector surveys, following a number of years of well-below average readings. However, one notable area of divergence in rural conditions is in the south-west of Western Australia, where drought continues (Graph 3.15).

Graph 3.15
Australian Rainfall
1 May 2010 to 30 April 2011

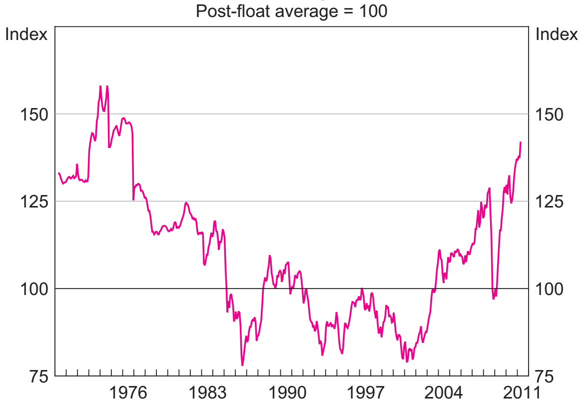


Graph 3.16
Current Account Balance*
Per cent of GDP



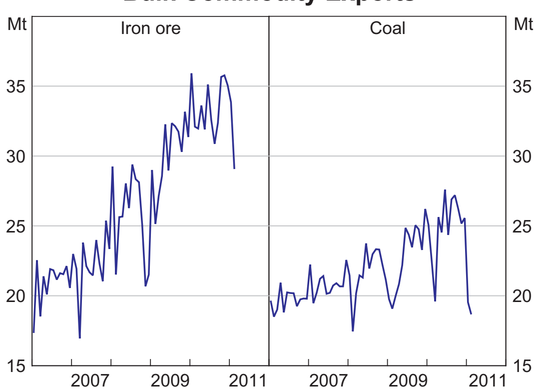
* Excluding RBA gold
Source: ABS

Graph 3.17
Real Exchange Rate*
Post-float average = 100



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

Graph 3.18
Bulk Commodity Exports



Source: ABS

External Sector

The large increases in bulk commodity contract prices have significantly boosted Australia's export revenues, with the trade balance in the December quarter recording its largest surplus as a share of GDP since the early 1970s (Graph 3.16). The current account deficit in the past three quarters averaged 1.8 per cent of GDP, well below the average deficit of 4½ per cent over the preceding decade. The significant increase in contract prices has also contributed to an estimated increase of around 20 per cent in Australia's terms of trade over the year to the March quarter, taking them to around 95 per cent above the average of the 1990s. The large rise in the terms of trade over recent years has led to a significant appreciation of the exchange rate, which in real terms is around the levels of the mid 1970s (Graph 3.17).

Export volumes in early 2011 have been affected by adverse weather events. Coal export volumes fell sharply in January and remained at low levels in February, with exports in the first two months of the quarter around 25 per cent lower than in the December quarter (Graph 3.18). Iron ore exports have been disrupted by a higher-than-usual frequency of cyclones and tropical lows, and were around 11 per cent lower in the first two months of the March quarter. Exports of both commodities are expected to bounce back sharply in coming months, while significant expansions to mine and infrastructure capacity are expected to provide a substantial boost to resource exports in coming years. At the time of writing, there were no data available on the effect of the Japanese earthquake on Australian exports to Japan, although a number of Japanese customers have declared *force majeure*. In 2010, Japan was Australia's second largest merchandise export destination, accounting for nearly one-half of thermal coal exports and one-fifth of iron ore export volumes.

Outside of resources, export growth has been subdued (Graph 3.19). Non-commodity exports fell slightly in the December quarter, with manufacturing and services exports remaining below their pre-crisis peaks. While global demand is strengthening, the relatively high value of the real exchange rate is restraining some non-resource export categories, including tourism. Non-resource export volumes are estimated to be largely flat in the March quarter.

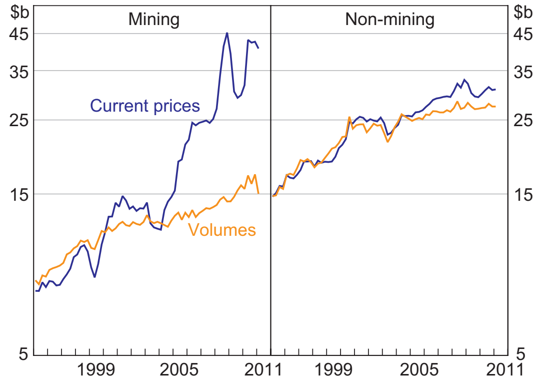
Import volumes are estimated to have grown by ½ per cent in the March quarter to be 7 per cent higher over the year. Imports are expected to grow at a solid pace going forward, due to expected growth in domestic final demand, especially in investment, and as the high exchange rate encourages spending on imports.

Labour Market

Labour market conditions have remained firm over recent months despite some moderation in the pace of headline employment growth from the very strong pace recorded during 2010. Growth in full-time employment has remained strong at around 4 per cent over the year, while part-time employment has been broadly flat after experiencing rapid growth during the initial stage of the recovery from the global slowdown (Graph 3.20). Consistent with the strength in full-time employment, total hours worked have increased more rapidly than employment over the past year, despite a temporary fall in January associated with the Queensland floods.

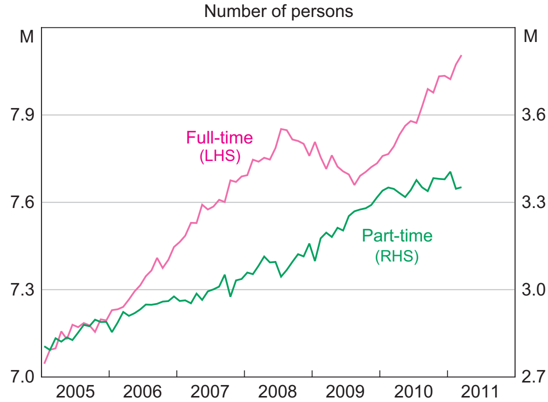
With strong growth in employment, the unemployment rate has drifted lower over the past year, to 4.9 per cent in March, around 1 percentage point below its 2009 peak. The participation rate has remained broadly unchanged over recent months after rising significantly in the June and September quarters of 2010 (Graph 3.21).

Graph 3.19
Exports*
Log scale



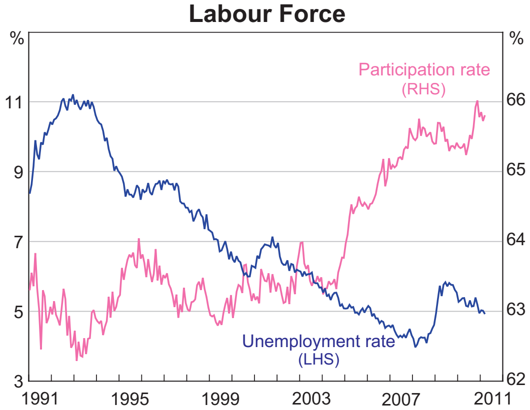
* Volumes data referenced to 2003/04 prices; RBA estimate for the March quarter 2011
Sources: ABS; RBA

Graph 3.20
Employment
Number of persons



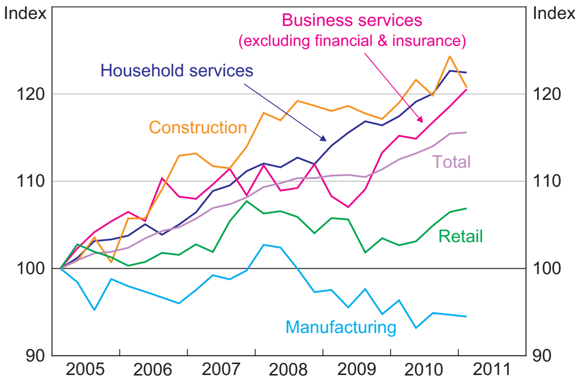
Source: ABS

Graph 3.21
Labour Force



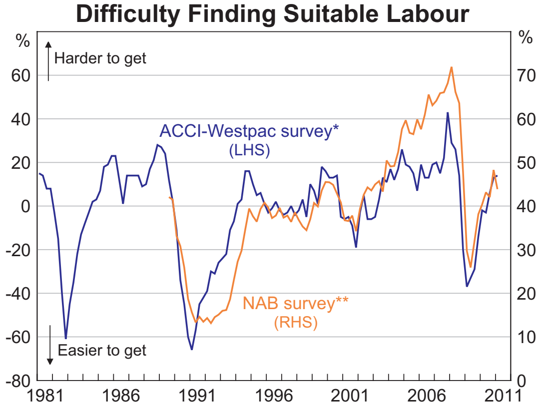
Source: ABS

Graph 3.22
Employment in Selected Industries
February 2005 = 100



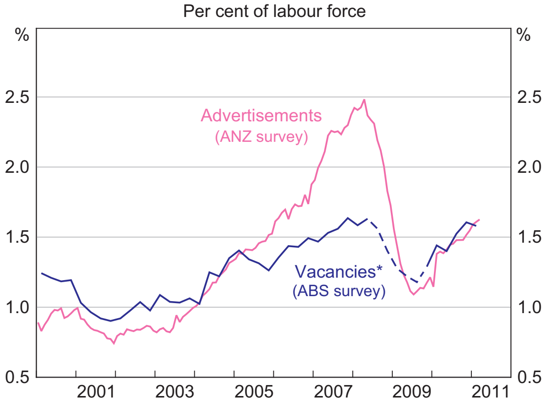
Source: ABS

Graph 3.23
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

Graph 3.24
Job Vacancies and Advertisements
Per cent of labour force



* Dashed line represents estimates for August 2008 to August 2009
Sources: ABS; ANZ

Employment growth over the past year has been relatively broad-based across industries, with notable strength in both business and household services (Graph 3.22). Some of the strength in business services employment, particularly in professional, scientific & technical services, is likely related to the expansion of the resources sector. Although construction employment eased in the March quarter, it remains at a relatively high level and is expected to grow strongly in the period ahead given the large pipeline of planned engineering activity in the resources sector. Direct employment in the mining and utilities industries, which account for relatively small shares of total employment (less than 2 per cent each), has grown by around 15 per cent over the past year.

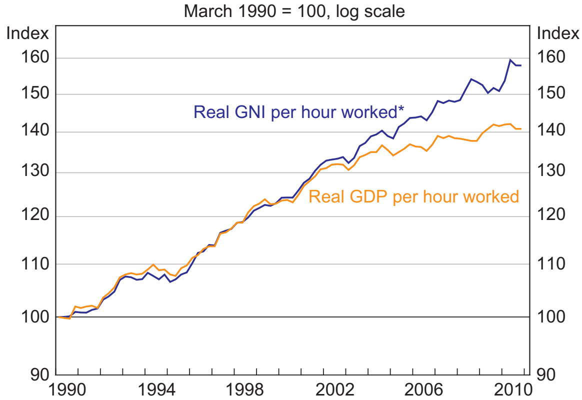
Despite relatively soft retail activity, employment in the retail sector has increased over the past year, although it remains slightly below the peak seen in 2007. Within manufacturing, employment in mining-related firms is receiving a boost from the expansion of the resources sector, while more trade-exposed parts of the sector are contracting under pressure from the high level of the exchange rate.

Consistent with the official data, business surveys and liaison indicate that labour market conditions have continued to gradually tighten, but at this stage skill shortages generally remain localised in mining-related industries and some other skilled occupations (Graph 3.23). Leading indicators of labour demand continue to point to solid employment growth, although at a more moderate pace than in the latter part of 2010. The ABS measure of vacancies fell slightly as a share of the labour force in the three months to February, but nevertheless is at a high level (Graph 3.24). More recent data from ANZ indicates that job advertisements increased further in March. At an industry level, the pick-up in vacancies as a proportion of industry employment has been most pronounced for those sectors generally reporting strong employment growth over the past year, particularly mining, construction and business services.

The growth in employment and total hours worked since mid 2010 has been strong relative to the observed increase in output, with the result that estimated growth in labour productivity has been weak. More generally, growth in productivity has been subdued for a number of years, particularly relative to the high productivity period in the 1990s (Graph 3.25). Over the past decade, output per hour worked has grown by an average of 1.2 per cent per year, compared with 2.1 per cent over the preceding decade. However, growth in real incomes over the past decade has been held up by the rise in the terms of trade over this period.

Graph 3.25

Productivity and Income



* Real GDP adjusted for the purchasing power of changes in the terms of trade and income accruing to foreigners

Source: ABS