

# Financial Insights

with Australian Unity Personal Financial Services

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## Positive signs for the Australian economy, but caution still warranted

By Macquarie's Global Economics Team

Despite policymakers retaining a positive outlook for the Australian economy, we find that there is little evidence of improving underlying momentum as we head into the second half of 2011.

In leaving the cash rate unchanged in July, the Reserve Bank retained a strong outlook for Australia's medium term growth prospects, but noted that "growth through 2011 is now unlikely to be as strong as earlier forecast".

This is not all that surprising given that at the mid-point of the year, there is very little evidence of accelerating growth. Indeed, most indicators of economic activity suggest a serious lack of momentum in domestic demand conditions. And, if this persists, it will become a lot more difficult for the RBA to justify any further tightening of monetary policy.

In the past few months, consensus expectations for growth in the Australian economy have been revised sharply lower. While the weaker than expected GDP result at the start of the year was a key factor behind these downgrades, there is also some recognition that economic activity will be more subdued in the back half of the year as well. As a result, the RBA has put through a downgrade to its growth forecasts for 2011, but policymakers have still retained a more upbeat assessment of economic growth over the medium term.

In our opinion, there are two key reasons why growth forecasts are higher amongst the RBA and Treasury compared to the broader market. First is the expectation that the benefits of the mining investment boom will flow through to other sectors of the economy, providing support to income and employment growth, and subsequently, consumer spending. And, second is the expectation that the large amount of planned mining investment spending comes through on time and as expected.

However, we are much more cautious on both these factors, especially given that the recent flow of data is pointing to a severe lack of momentum in economic activity heading into the second half of the year. This is particularly evident in the range of business surveys, including the NAB business survey, the Sensis small business survey and the Australian Industry Group Performance Indices.

A good example of both these issues can be found in the Performance of Construction Index (PCI), which has worsened over the first half of this year. This slowing could be expected in the residential and commercial sectors, given the impact of high interest rates, but it is interesting to note that construction in the engineering sector has also been slowing, according to the survey. New orders and employment for engineering construction have been consistently falling since February, which is at odds with the anticipated sharp uplift in Q2 mining sector investment that was assumed in the most recent capital expenditure survey.

We do not doubt that mining firms intend to increase capex significantly over the next 12 months, but we do have doubts on how all this investment can occur at the same time, given the well documented capacity constraints in the sector. And, given that Australia's economic growth is increasingly dependent on this business investment, any delays or disruptions to production will mean that output is weaker over that period of time.

The other issue that we have highlighted as a downside risk to the RBA's growth outlook is whether or not the benefits of the mining investment boom spread across to other sectors in the economy. Highlighting the RBA's perspective, in a recent speech, titled 'Economic conditions and prospects', the Reserve Bank Governor stated that "the impact of the resources sector expansion does get spread around, in more ways than might immediately be apparent".

In our opinion, however, we are seeing very little spill-over from the mining sector into the broader economy. Despite elevated expectations within the resources sector, overall business confidence has slowed due to weakness elsewhere – particularly amongst the manufacturers, builders, retailers and tourism operators. Moreover, small businesses are increasingly pessimistic in the face of subdued consumer demand.

Weaker business confidence has clearly had a dampening influence on labour market conditions, with employment growth and hiring intentions notably down in recent months. The RBA continues to focus on the low level of the unemployment rate as an indication of tight labour

market conditions, but this has been driven by weaker participation rather than strong employment growth over the past six months.

Moreover, another indication that the benefits of the mining boom are being confined to within that sector is that wages growth has remained modest outside of the resources and related industries

This is an important issue in terms of income growth for households who remain very cautious in regards to spending due to concerns around household finances. In this respect, the consumer confidence survey provides an interesting insight into the psyche of consumers at the moment. That is, they expect the economy to continue growing in the next 12 months, but at the same time, they anticipate a worsening in their personal finances. And, as we know, household spending is driven more by personal situation rather than expectations for the broader economy.

This has certainly become more apparent recently, with retail sales growth remaining weak.

So, what do these issues mean for the interest rate outlook? Certainly, the recent run of softer economic data appears to have taken some of the steam out of the RBA's bullish growth outlook and, as a result, could lessen the need for interest rates to rise in the near term. Moreover, it is not just domestic developments that are providing cause for concern, with the accompanying statement to the RBA's July Board meeting appearing to take on a more cautious view towards global growth as well.

The Board noted that the global economic expansion had slowed in the June quarter, causing some moderation in commodity prices and "a key question is whether this more moderate pace of growth will continue". This suggests that more evidence of a stronger recovery is needed for the Bank to be comfortable with the pace of growth – both domestically and offshore.

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