

# Australian economy continues to expand

## Economic Research note

2 June 2010

- The Australian economy grew by 0.5%/qtr in Q1 2010, down from an upwardly revised 1.1%/qtr at the end of 2009. The annual pace of growth was little changed at a solid 2.7%/yr.
- Economic growth on the quarter was driven by further gains in public sector capex – which offset weakness in private sector capex – and a solid increase in household consumption.
- The terms of trade increased by a strong 4.2%/qtr, helping drive a 1.8%/qtr rise in real net national income. As this income continues to flow through the economy, solid growth could be expected in the year ahead from private sector capex, company profits and consumer spending.
- The RBA paused in its rate hike cycle yesterday, with obvious concerns over global financial markets, especially in Europe. A cash rate of 5% could still be expected by year-end, but with rate hike likely later in the year, rather than mid-year.

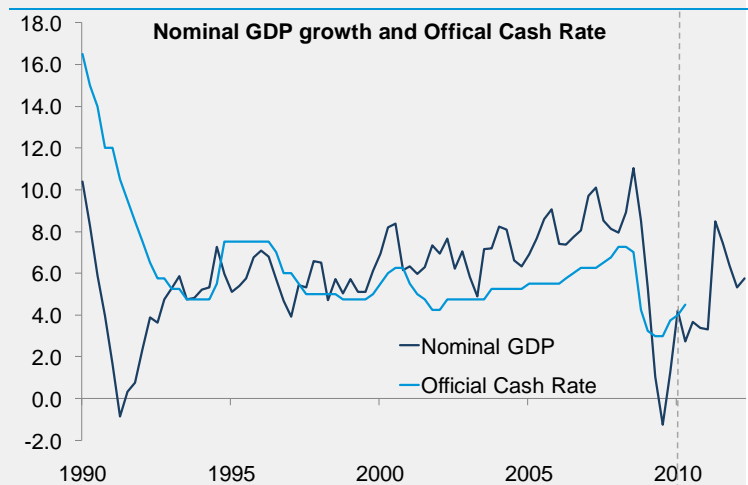
### Australian economy continues to expand:

The Australian economy grew by 0.5%/qtr in Q1 2010. While this was down from an upwardly revised pace of growth of 1.1%/qtr in Q4 2009 and with the annual pace of growth slipping marginally to 2.7%/yr from a revised 2.8%/yr, it still represents a solid outcome.

Economic growth on the quarter was driven by a surge in public capital spending, which added 0.7% to growth, with household consumer spending also contributing a solid 0.3%. This was offset by a decline in private sector capex (-0.6% growth) and a -0.5% points contribution from net exports (see below for further details on the contributions to growth).

Importantly, Australia's terms of trade rose by a further 4.2%/qtr in Q1 2010, helping to support a strong increase of 1.8%/qtr in real net disposable income. It is this increase in national income that is expected to continue to flow through the economy in the year(s) ahead, helping to drive private sector capex, profits and consumption and support the RBA's monetary policy tightening cycle (see below for further details on the RBA after yesterday's "pause" in rates).

### Australian nominal GDP and cash rate:



Source: ABS, RBA and Commonwealth Treasury

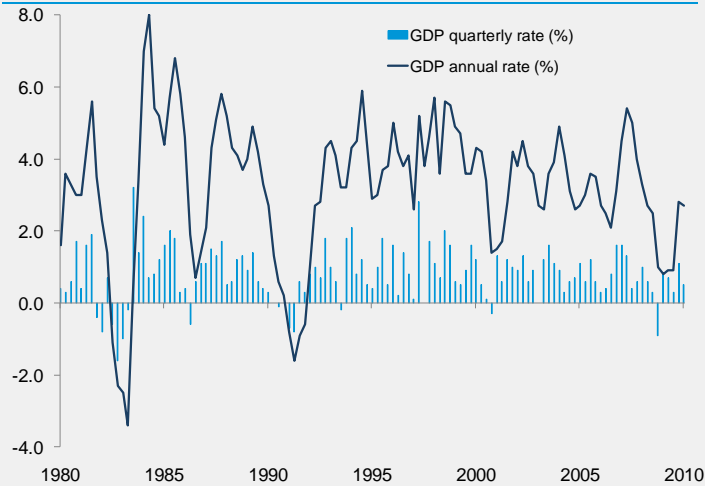


**Stephen Halmarick**  
Head of Investments Research

**Belinda Allen**  
Analyst, Investment Markets Research

**James White**  
Analyst,  
Investment Markets Research

**Australia qtrly and annual economic growth rates:**



Source: ABS

**Other highlights:**

Other highlights from the Q1 2010 national accounts include:

- On an industry basis, the strongest gains over Q1 2010 were in Transport, postal and warehousing (+0.2% contribution), Financial and insurance services (+0.2%) and professional, scientific and technical services (+0.2%). Mining, Construction and Administrative and support services each contributed +0.1% to GDP.
- These positive contributions were offset by declines in Agriculture, forestry and fishing (-0.1% contribution), Accommodation and food services (-0.1%), while the statistical discrepancy detracted 0.2% from growth.
- For Q1 2010 the rise in inventories amounted to \$A1,203m, the largest contribution since Q3 2008 and compares to \$A418m in Q4 2009, and large destocking in Q4 2008 to Q2 2009. These gains in inventories were most evident in wholesale trade and in the public sector, while both manufacturing and retail trade saw destocking of inventories.
- Compensation per employee rose 1.7%/qtr in Q1 2010, with the share of total factor income accounted for by wages continuing to fall and now sits at 53.4% from a peak of 54.8% in Q2 2009.
- This was due to gains in gross operating surplus (other), which rose 2.7% in Q1 2010, and private gross operating surplus which rose 0.8%/qtr. But the profits share of total factor income ratio fell to 26.7%, from 26.9% in Q4 2009.
- The household savings ratio rose to 2.7% from 2.6% (revised up from 2.3%), but lower from the peak of 6.9% during the height of the GFC. But the Q1 2010 reading still remains well above the average of around 0.6% seen before the onset of

the GFC and the large negative rates seen in 2004 and 2005 at the height of the housing boom.

- It is positive to see the savings ratio remain at relatively high levels despite the recovery in household net wealth. As employment continues to rise we could see a release of precautionary savings and a pick-up in private consumption in the remainder of 2010, as households become more comfortable with the RBA tightening cycle.
- With regard to prices, the chain price index for household final consumption spending rose by 0.9%/qtr. Private gross fixed capital formation prices rose 0.1%/qtr on the quarter. Export prices rose 4.0%/qtr but remain down 17.3% over the past 12 months, while import prices were unchanged over the quarter.
- Looking at the states, NSW, Victoria and South Australia were the largest contributors to national growth for the quarter, with state final demand growth of 0.6%/qtr, 0.4%/qtr and 1.3%/qtr, respectively. The Northern Territory recorded growth of 2.5%/qtr.
- Queensland and Western Australia both contracted by 0.5%/qtr. Western Australia saw sharp falls in private gross fixed capital formation, but gains from public sector investment. Queensland experienced a similar story. It would be expected that these states are positive contributors as private investment picks up with elevated commodity prices and continued demand from Asia for natural resources.
- NSW benefited from very strong public sector investment (capital formation), a rise of 24.3%/qtr, likely driven by construction within the education sector as part of the Federal Government stimulus spending, while private investment fell after sharp gains in Q4 2009. In contrast the growth in Victoria was still evident despite a pull back in public and private capital formation, with private and public consumption seeing some strength, likely driven by the sharp gain in house prices over the past year.
- What is also interesting to note is despite the pull back in Western Australia, exports from the region were higher, rising 3.1%/qtr. In contrast imports fell 13.7% after strong gains in Q4 2009, likely on the back of equipment for infrastructure, mining and gas development works.

**RBA pauses in tightening cycle:**

At its meeting yesterday, the Board of the RBA decided to leave the cash rate unchanged at 4.5%. This pause in the tightening cycle was widely expected by markets.

In announcing the decision to leave rates on hold the RBA stated that "concerns about sovereign

creditworthiness in several European countries have been a focus of financial markets” and that “investors have generally displayed a good deal more caution.”

The RBA then notes that “the effects of these various forces on the world economy will need to remain under review”, but that “at this stage global growth is still expected to be at about trend pace in 2010.”

These comments obviously indicate a level of concern at the RBA that the pace of global economic growth may be less than previously expected, driven largely by events in Europe. The RBA does note, however, that economic growth in north America is “becoming more established”, while growth in Asia “has continued to be quite strong and may need to moderate in the year ahead.”

On inflation, the RBA stated that the annual pace of price increase “appears likely to be in the upper half of the target zone over the next year.” As we state above, the RBA also noted that “with the high level of the terms of trade expected to add to incomes and demand, output growth over the year ahead is likely to be about trend.”

The RBA now sees the level of monetary policy consistent with having interest rates to borrowers at about their average levels of the past decade. As a result of this and the uncertainties in Europe, the RBA stated that the setting of monetary policy is “appropriate for the near term”.

The RBA is, however, expected to resume its tightening cycle in the months ahead, with a 5.0% cash rate still likely by year-end. This outlook will require, however, some signs of stability in global markets and, especially, in Europe and a change in the mix of growth in Australia away from public sector capex to private sector capex and more household consumption. As this may yet take some time, further rate hikes are now more likely to occur later in 2010, rather than around mid-year.

### For further information

Stephen Halmarick	Head of Investment Markets Research	+61 2 9303 3030	shalmarick@colonialfirststate.com.au
Belinda Allen	Analyst, Investment Markets Research	+61 2 9303 3110	ballen@colonialfirststate.com.au
James White	Analyst, Investment Markets Research	+61 2 9303 2645	jwhite@colonialfirststate.com.au

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