Colonial First State
Global Asset Management

RBA open-ended. Growth dominated by capex

Economic research note

7 December 2011

- In a move that is consistent with action by a number of central banks around the world, the RBA has taken the cash rate down a further 25bp to 4.25%.
- The decision comes on the back of a slower global economy and heightened concerns about the outlook, especially in the context of the ongoing European debt crisis.
- In an open-ended statement the RBA will continue to focus on fostering sustainable growth and low inflation, suggesting further easing in the new-year.
- Q3 11 GDP data showed the Australian economy growing at 2.5%/yr. Growth was driven by private sector capex, with some help from household consumption.
- Economic growth should average around 3%/yr in the year ahead, with downside risks from the deteriorating global economic environment, fiscal tightening but offset by the RBA's policy easing.
- Australia's 20 year run of solid economic growth looks set, therefore, to continue.

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RBA open-ended

At the Reserve Bank of Australia (RBA) Board meeting yesterday the decision was made to ease monetary policy by a further 25bp, taking the cash rate to 4.25%. This follows right on the heels of the November rate cut.

This decision must be seen in a global context, where central banks around the world have stepped up their action to support growth against clear signs of a slowing in economic momentum, largely stemming from the ongoing debt crisis in Europe.

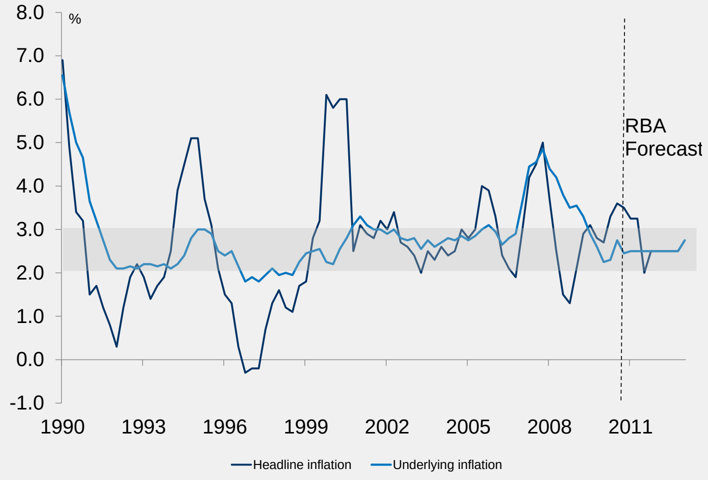
This global action has involved the co-ordinated provision of increased liquidity, at a lower cost, from the major central banks in the northern hemisphere, a reduction in the Reserve Requirement Ratio in China (ie. allowing the banks to lend more money) and interest rate cuts in other countries such as Brazil and Indonesia. In addition the ECB is expected to lower its key interest rate by 25bp, to 1.0%, when it meets tomorrow.

The back-to-back interest rate cuts from the RBA, therefore, form part of this global response to economic developments. Indeed, in announcing the easing the RBA noted that "the likelihood of a further material slowing in global growth has increased" and that this "has increased the scope for some easing in monetary policy in a number of countries."

The other striking element of the RBA statement on the easing is its open-ended nature. When easing in November the RBA clearly stated that they want to take monetary policy to a "more neutral" setting. In the statement yesterday there was no mention of whether monetary policy was now nearer "neutral" and indeed the RBA noted that in the future it will "continue to set policy as needed to foster sustainable growth and low inflation over time."

The implication here is clearly that the RBA remains worried about the downside risks – and justifiably so. With no meeting scheduled in January, the RBA now has around two months to assess the outlook for the global economy and the implications for Australia. **At this stage the outlook would suggest that further policy easing is likely in the new-year, perhaps as early as February.**

Australian inflation – within target



Source: ABS and RBA

Highlights of the RBA statement

In announcing yesterday's monetary policy easing, the RBA also highlighted the following:

- The uncertain situation in Europe, including a slow policy response from key leaders, financial market turbulence and precautionary behaviour by consumers and businesses "means that the likelihood of a further material slowing in global growth has increased".
- As a result commodity prices have fallen, and this has taken pressure off inflation rates and "this has increased the scope for some easing in monetary policy in a number of countries".
- In relation to Australia, the RBA highlighted that "output growth has been close to trend, with demand growth stronger than that".
- "The terms of trade have now peaked and will decline somewhat in the near term, but they remain very high." However "investment in the resources sector is picking up very strongly, with much more to come".
- On inflation the RBA has noted that "CPI inflation …is now starting to decline as production of key crops recovers" and "with labour market conditions now softer, the likelihood of a significant acceleration in labour costs outside the resources and related sectors in the near term has lessened".
- On interest rates, the RBA said that lending rates are around their average level of the past 15 years due to the reduction in the cash rate, however "term funding conditions for financial institutions have become more difficult".
- Overall the RBA left the statement open ended, stating "that the inflation outlook afforded scope for a modest reduction in the cash rate" and going forward "the Board will continue to set policy as needed to foster sustainable growth and low inflation over time".

Australian economy performs well

Q3 11 GDP data released today for Australia showed the economy doing relatively well – especially in a global context.

GDP growth for Q3 11 was slightly higher than expectations at 1.0%/qtr (consensus 0.8%). Upward revisions to past quarters (ie. Q2 11 1.4%, up from 1.2%) have helped take the annual pace of growth to 2.5%/yr, from a weather-effected low of 1.0%/yr in Q1 11.

Not surprisingly, the dominant source of growth over Q3 11 was private gross fixed capital formation, which increased by 6.0%/qtr and contributed +2.1%/pts to growth. Household spending was also a positive contributor, growing at 1.2%/qtr and contributing 0.7%/pts to growth.

On the negative side, the biggest subtraction from growth came from an inventories unwind (-0.8%/pts) and net exports (-0.6%/pts). As planned, the government sector was a negative for the economy, down 1.2%/qtr and contributing -0.2%/pts to growth.

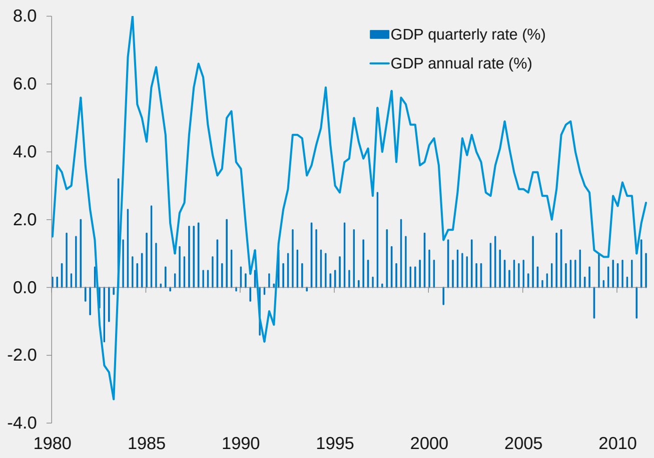
By industry the largest contributions to growth came, not surprisingly, from the construction (+5.0%/qtr and 0.4%/pts to growth) and mining (+3.7%/qtr and 0.3%/pts) sectors.

Going forward the pace of annual economic growth is expected to accelerate in early 2012, as the weather-effected -0.9%/qtr GDP number for Q1 11 drops out of the calculation. The RBA expects the annual growth rate to accelerate to 4.0%/yr at this time.

However, beyond that Australia's economic growth rate is expected to moderate, back down to around 3.0%-3.5%. The growing downside risks for the global economy will clearly imply downside risk for Australia in the year ahead, although with back-to-back rate cuts the RBA is helping shield the economy from some of these effects.

The bottom-line is, however, that in a global context, economic growth of around 3.0% for Australia will continue to place Australia at the top end of the expected growth for developed nations and continue Australia's 20 year run of solid economic performance.

Australian economic growth



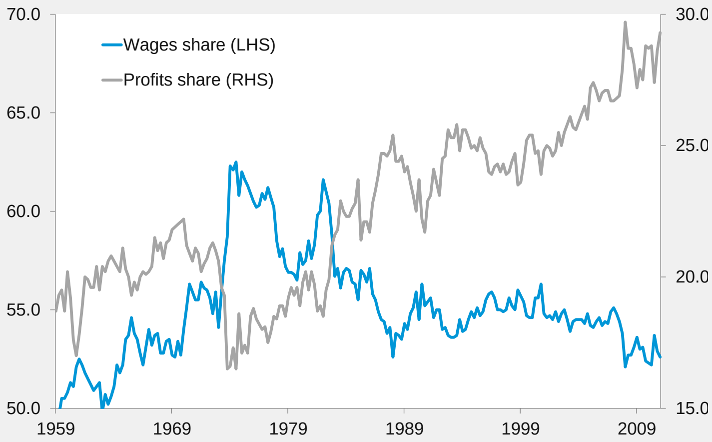
Source: Bloomberg

One area of interest in the GDP data for markets should be the ongoing surge in the profit share of the economy – at the expense of the wages share.

As shown in the chart below, the profit share of the economy has now risen to 29.3%, up from 28.6% in Q2 11 and the recent cyclical low of 23.5% in Q2 99. On the other hand, the wages share of the economy has fallen to 52.6% (from 52.9% in Q2 11) and down from a cyclical peak of 56.3% in Q2 2001.

The surge in the share of the economy accounted for by the mining sector is clearly a key driver here, adding weight to the two-speed nature of the economy.

Profit and wages share of the Australian economy



Source: ABS

Highlights of the GDP data

The main highlights of the GDP data for the quarter were:

- On an industry basis, most sectors contributed positively to growth, except administrative & support services, financial & insurance services & telecommunications which detracted 0.1%/pts and agriculture, fishing, forestry and transport and warehousing which detracted 0.2%/pts.
- The strongest sector was construction which contributed 0.4%/pts to GDP growth. Close behind was mining and manufacturing, contributing 0.3%/pts and 0.2%/pts respectively.
- The strong growth in construction and mining represents the sharp increase in engineering construction and the recovery of the mining sector following weather disruptions earlier in the year.
- On the expenditure side, private gross fixed capital formation added 2.1%/pts to GDP and household final consumption expenditure added 0.7%/pts. This was partially offset by inventories, which detracted 0.8%/pts and net exports, which detracted 0.6%/pts.
- The terms of trade remained strong, rising 2.7%/qtr, up 13.2% for the year. However this was down from the 5.8%/qtr increase in Q2 and, as the RBA said in the statement accompanying yesterday's rate cut, the terms of trade is now expected to have peaked.
- Compensation of employees rose 1.9%/qtr in Q3, to be up 7.5% for the year – which reflects a rise in average earnings of 1.6%. This suggests that proceeds from the higher terms-of-trade (up 2.7%/qtr) are flowing through into the broader economy, especially into the hands of households.
- Corporate profits rebounded sharply, up 10.7%/qtr, with the mining sector a key contributor.
- Household consumption increased by 1.2%/qtr with growth ranging from 0.1%/qtr in the ACT to 1.4%/qtr in Western Australia. The household saving ratio fell from 10.5% in the Q2 to 10.1% in Q3.
- On a state level, the strongest growth was in Western Australia which was up a very strong 8.4%/qtr and 16.4% for the year. Growth was also strong in Queensland, up 3.5%/qtr and 9.3% for the year. The strong growth in Queensland and Western Australia reflects the unprecedented number of mining and gas projects underway in region.
- South Australia and Victoria were the weakest states, with growth contracting over the quarter by -1.6% and -0.1% respectively. Unsurprisingly, the weakest states are those less exposed to the mining boom.

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