



## Australia's latest economic problem?

July 2014

Australia's economy pleasantly surprised most analysts when it grew at its fastest pace in two years over the March quarter, to sustain an expansion that dates to the last quarter of 1991.<sup>[1]</sup>

Increased export sales, more household spending and greater investment in dwellings drove an economic expansion of 1.1% in the March quarter, a report in June showed. Over the 12 months to March this year, Australia's economy expanded 3.5%, a respectable pace at any time.<sup>[2]</sup>

The spurt in exports came largely from the mining sector even though the prices of some materials such as iron ore have dropped on lower demand from China. Mining exports are rising because all the investment in the mining sector over the past decade expanded production enough to compensate for falling prices. Low interest rates explain the increases in housing investment and consumer spending.

The Reserve Bank of Australia looks set to hold the cash rate at a record low 2.5% for a while yet as inflation appears tame. The boost in mining capacity, including the onset of sales from new LNG plants, points to higher export sales. This means these two favourable conditions will be in place to help the economy expand in coming quarters. Further help for the economy is that unemployment is still low, holding at 5.8% in May, which is not far off levels regarded as full-employment. Rising housing prices and ever-climbing stock markets are making people feel wealthier. The economic news from the rest of the world is largely the same as it was at the start of the year. What could go wrong?

Well, something has. Retailers such as Pacific Brands, the maker of Bonds clothing and Sheridan bed linen, the Reject Shop, which operates discount stores, and Super Retail, which owns leisure specialty stores such as Rebel, in June issued warnings that sales have dropped so much in recent weeks that their earnings will be hit. It's not just the big companies that are complaining. Anecdotal evidence suggests that smaller retailers around the country are finding that consumers have become tightfisted.

Some retailers are citing warmer-than-usual weather on the east coast for their predicament. (The way life works we don't tend to hear from the retailers that benefited from the hotter May.) But many, if not nearly all, of the stressed retailers are blaming something else; the federal government budget brought down in May.

The mixture of touted spending cuts, tax increases, mooted charges for visiting a doctor and possibly higher tertiary education fees, the political brawl over fairness, inequality, allegations of broken promises and a budget emergency seems to have spooked people.

Other evidence that the budget made people jumpy was a large plunge in the consumer confidence pulse that is taken each month by Westpac Banking and the Melbourne Institute. The

index they compile by surveying people fell 6.8% in May from April to 92.9, the lowest since August 2011 where 100 is the neutral level. Bill Evans, Westpac's chief economist, said the people's responses to the questionnaire were "clearly indicating an unfavourable response to the recent federal budget".<sup>[3]</sup> Ominously, there was no rebound in June, even if the index did edge up to 0.2%, for June's result still leaves the index floundering 6.6% lower than April's level and 15.6% below the post-election high in November last year.<sup>[4]</sup>

The Reserve Bank added to concerns about declining consumer demand when it said in June that "growth of the nominal value of sales had slowed over the three months to April, and the bank's retail liaison suggested that growth had moderated further in May."<sup>[5]</sup> (Retail liaison is the central bank's jargon for its discussions with retailers.)

The budget, as a document for managing the economy over the next 12 months, carried to punch against economic growth because few of its higher charges, increased taxes and spending cuts take immediate effect. But the thought of likely future stress on household budgets has dampened people's willingness to spend as robustly as before.

Consumer sentiment has plunged for a variety of reasons in the past without damaging the economy. People can still spend when they are worried about the outlook or move on from these doubts and confidence bounces back. Retail sales are only a partial guide to consumer spending as they only amounts to about 20% to 25% of GDP. Perhaps household spending outside the retail sector – on items from school fees to medical bills that comprise about 25% to 30% of output – has picked up. (Total household consumption sits at about 50% of GDP. The breakdown between sales at retail stores and other consumer spending is murky.)

The danger is, though, that if retail spending is sluggish and consumer sentiment is poor then economic growth will be hampered. For it's hard for exports, business investment or government spending to compensate for the shortfall in consumer spending.

It's a while off before we find out how the economy performed for the just-ended June quarter. The verdict on the evidence so far mustered is unlikely to pleasantly surprise.

Financial information comes from Bloomberg unless stated otherwise.

<sup>[1]</sup> Australia's economy contracted from the December quarter of 1990 to the June quarter of 1991. The economy recorded zero growth in the September quarter of 1991 and has expanded every quarter since then, on chain-volume measures. Source: Australian Bureau of Statistics. 5206.0 - Australian National Accounts: National Income, Expenditure and Product, Dec 2013. Time series spreadsheets.  
<http://www.abs.gov.au/AUSSTATS/abs@.nsf/DetailsPage/5206.0Dec%202013?OpenDocument>

<sup>[2]</sup> Australian Bureau of Statistics. Release 5206.0. "Australian national accounts: national income, expenditure and product." 4 June 2014.

<sup>[3]</sup> Westpac Banking. Release. "Consumer sentiment plummets – adverse response to budget." 21 May 2014.

<sup>[4]</sup> Westpac Banking. Release. "Consumer sentiment stabilises after sharp fall post budget." 11 June 2014.

[5] Reserve Bank of Australia. "Minutes of the monetary policy meeting of the Reserve Bank board. Sydney – 3 June 2014." Released 17 June 2014. <http://www.rba.gov.au/monetary-policy/rba-board-minutes/2014/03062014.html>