

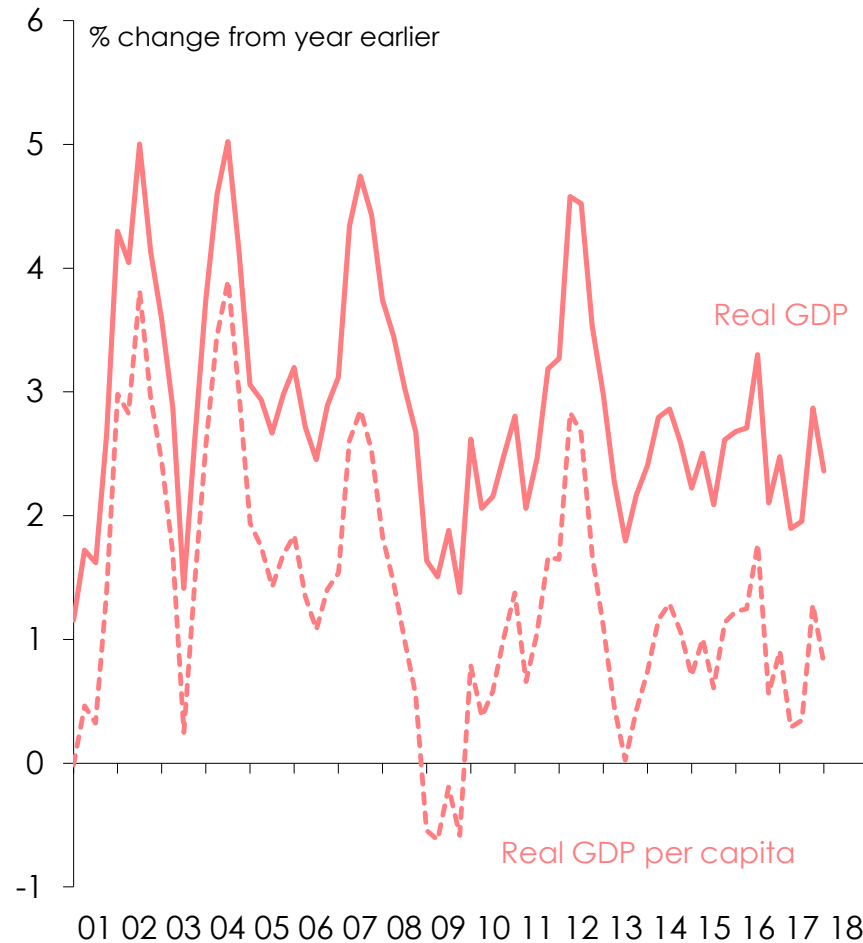
AUSTRALIA'S ECONOMIC HORIZON

PRESENTATION TO AUTOCARE 2018
HOSTED BY THE AUSTRALIAN AUTOMOTIVE AFTERCARE ASSOCIATION

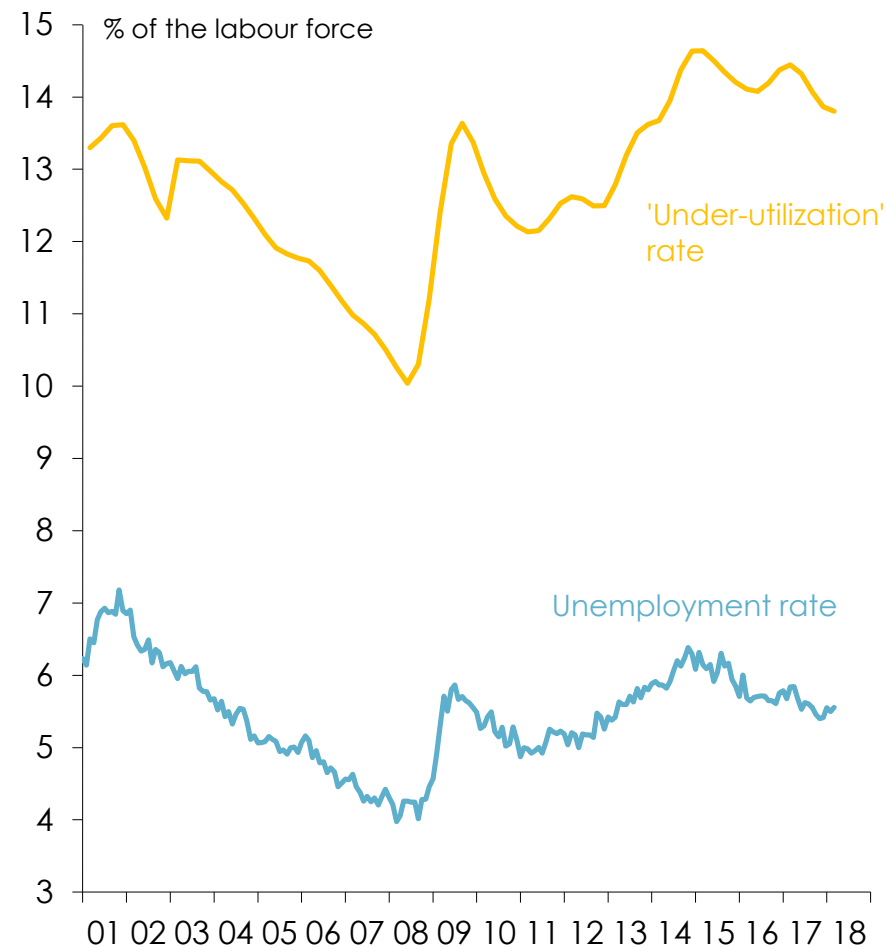
INTERNATIONAL CONVENTION CENTRE, SYDNEY – 4TH MAY 2018

Australian economic growth is still below trend, there is still a lot of spare capacity in the labour market and inflation is still (just) below-target

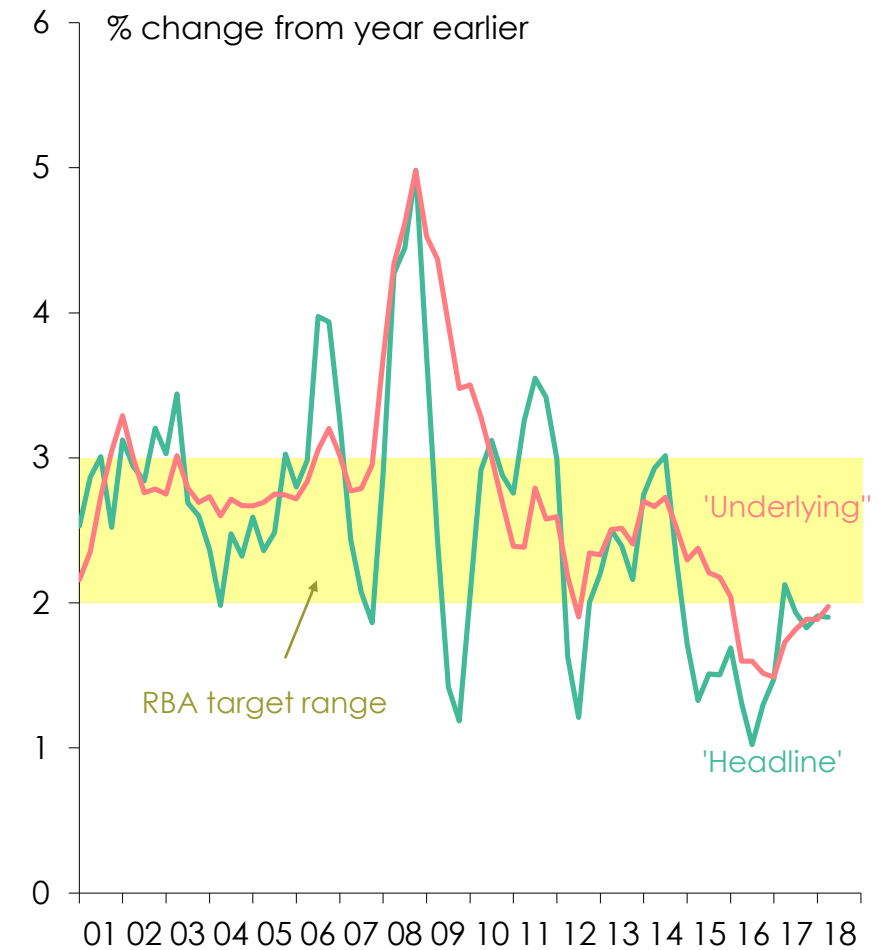
Economic growth



Unemployment and under-employment



Consumer prices

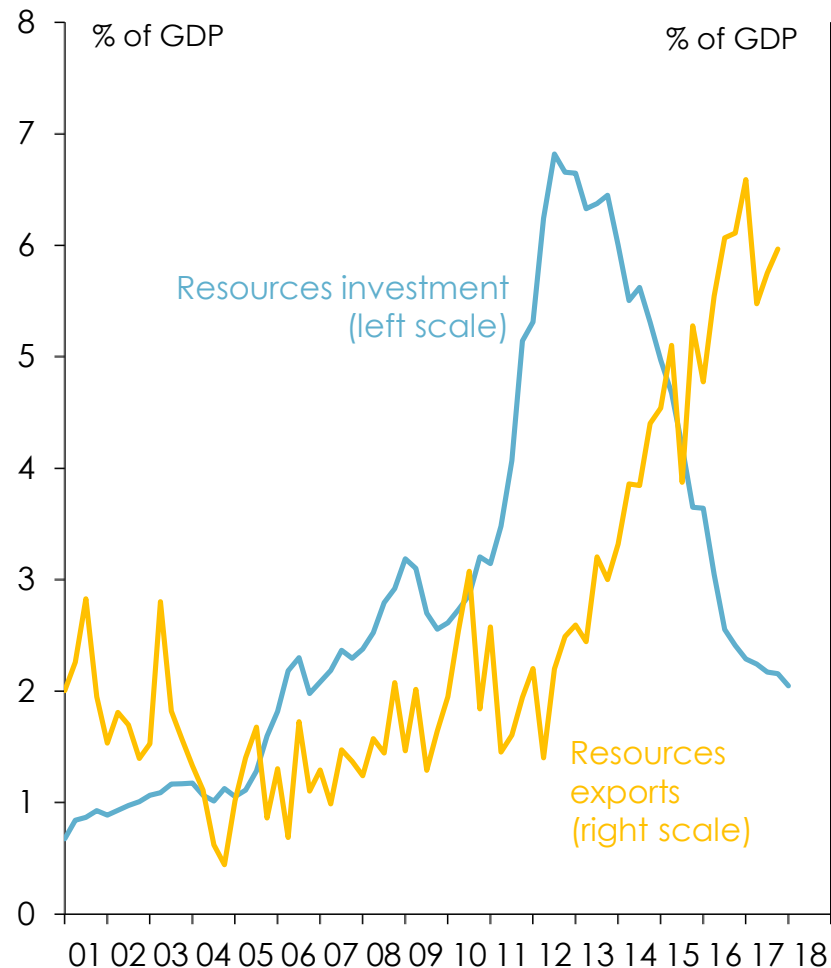


Note: The labour force 'under-utilization' rate includes people employed part-time who are willing and able to work longer hours (and weights them equally with people who are 'unemployed' in the conventional sense). 'Underlying' inflation abstracts from the impact of volatile items (typically items such as petrol, or fruit and vegetables) on the CPI.

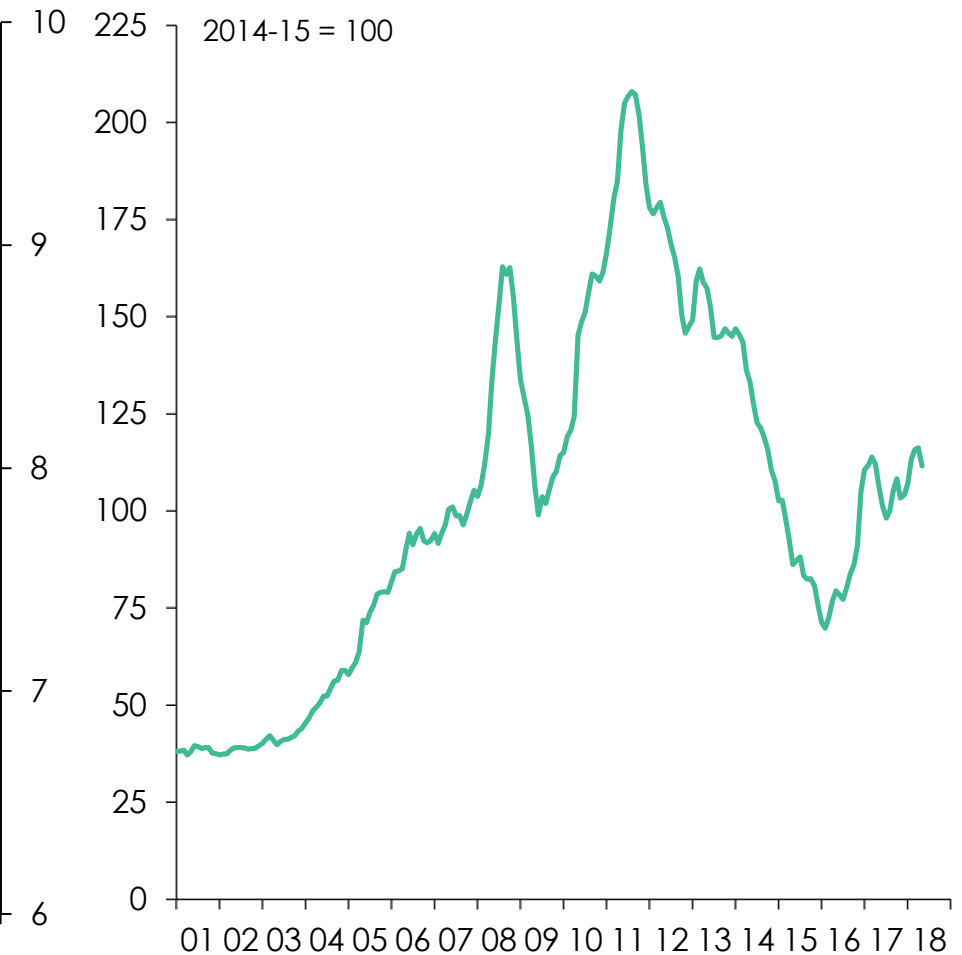
Source: Australian Bureau of Statistics.

The run-down in resources investment has largely been completed, and resources export prices are holding up better than expected

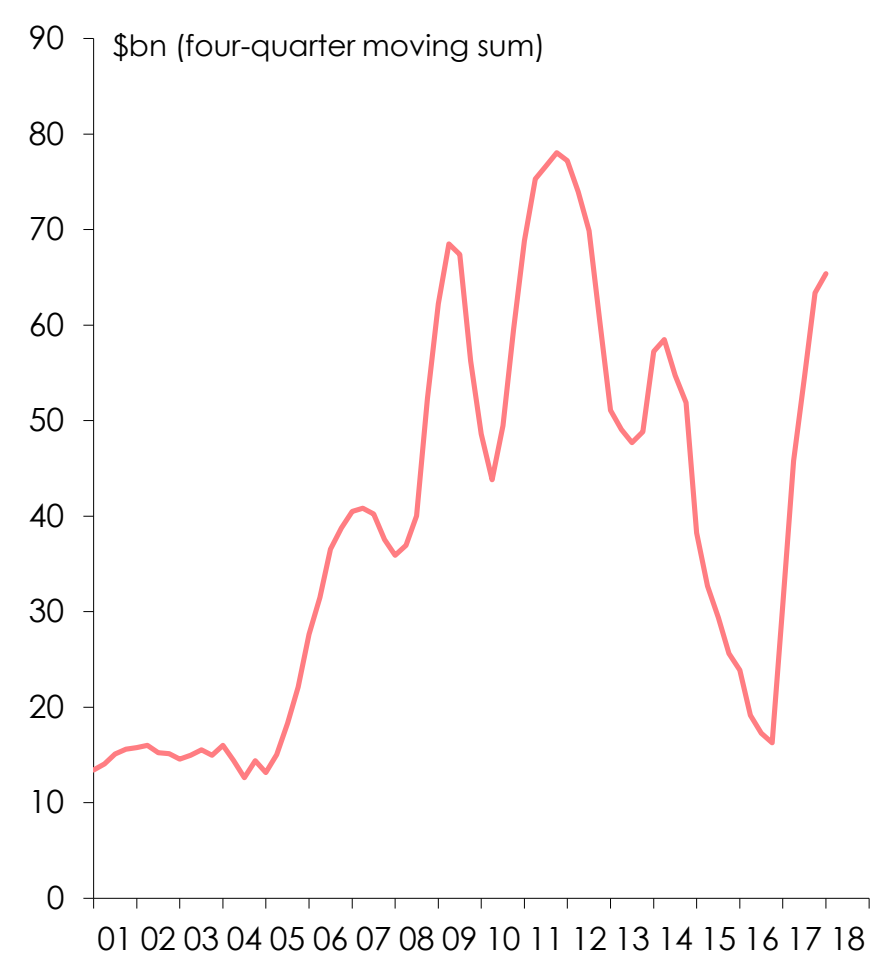
Resources sector capex and exports



Resources sector commodity prices



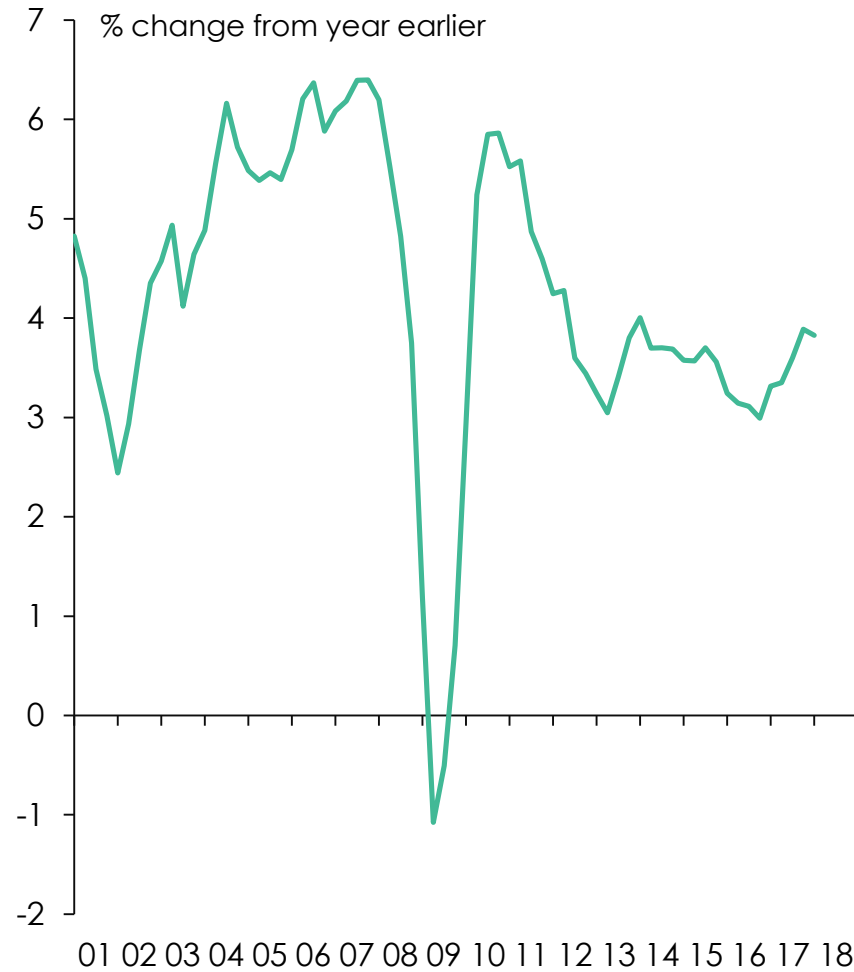
Mining industry pre-tax profits



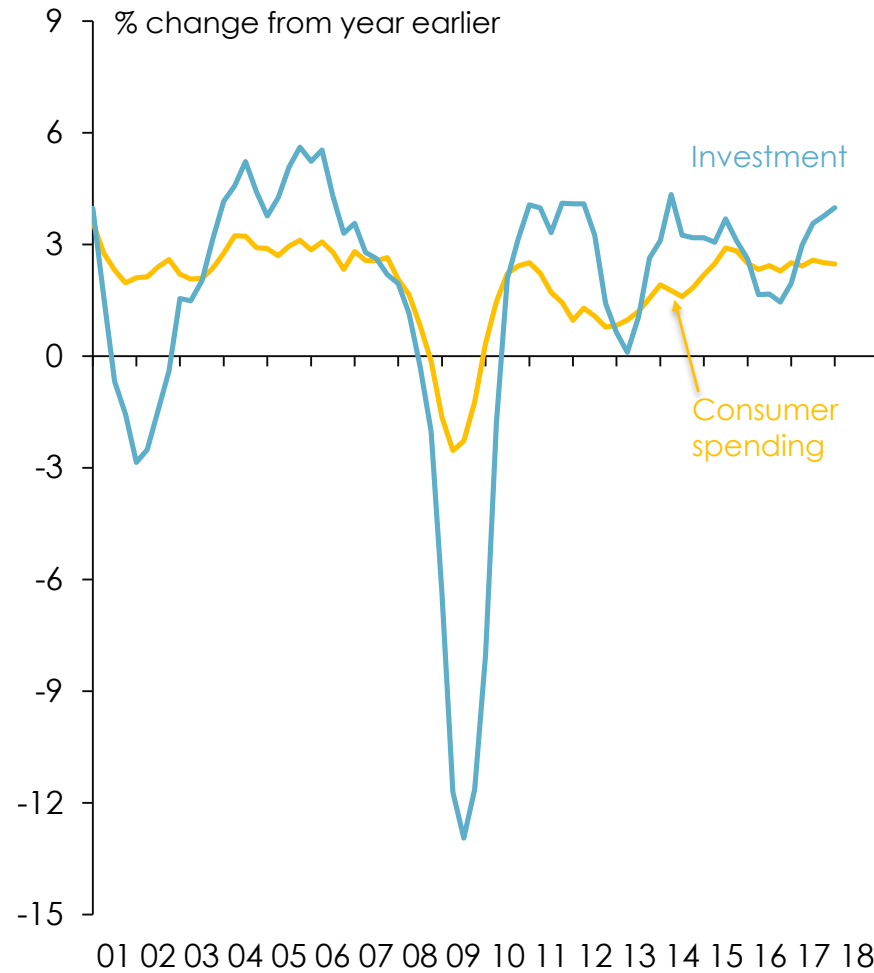
Note: Mining industry includes oil and gas extraction and production, but excludes metal manufacturing (eg aluminium or zinc smelting).
Source: Australian Bureau of Statistics.

The world economy has picked up since the beginning of last year, with business and consumer confidence the highest since the 1990s

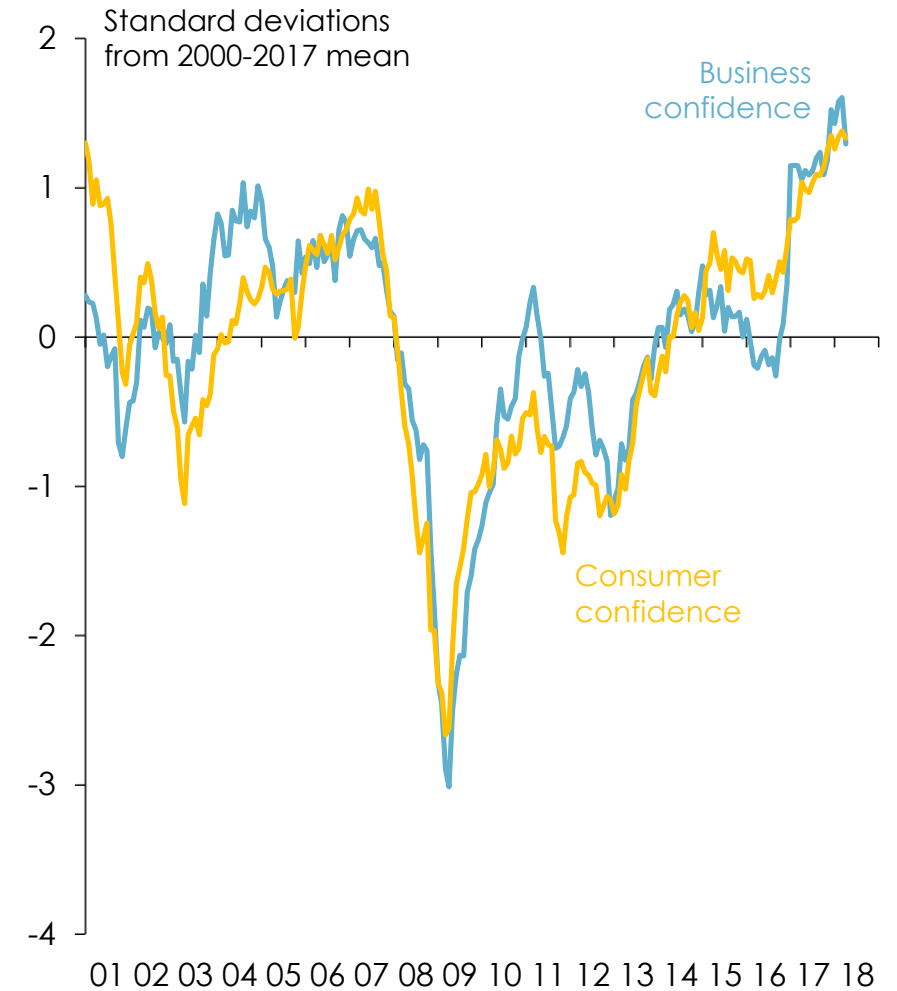
World economic growth



Major components of developed country growth



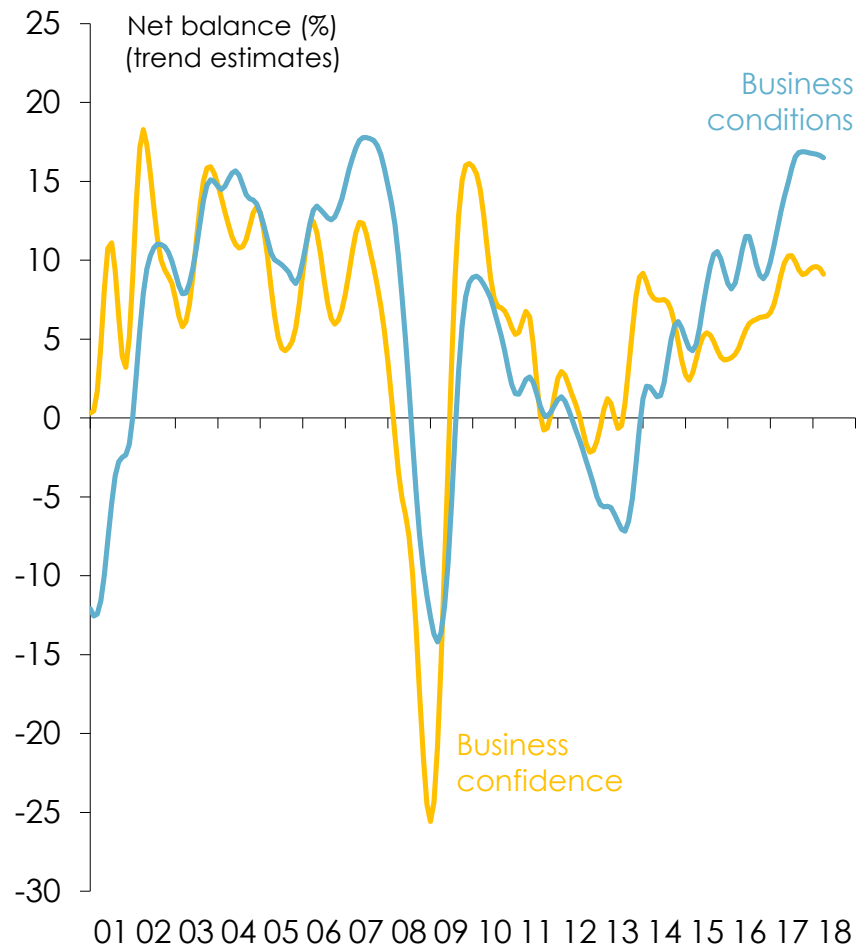
Advanced economies business & consumer confidence



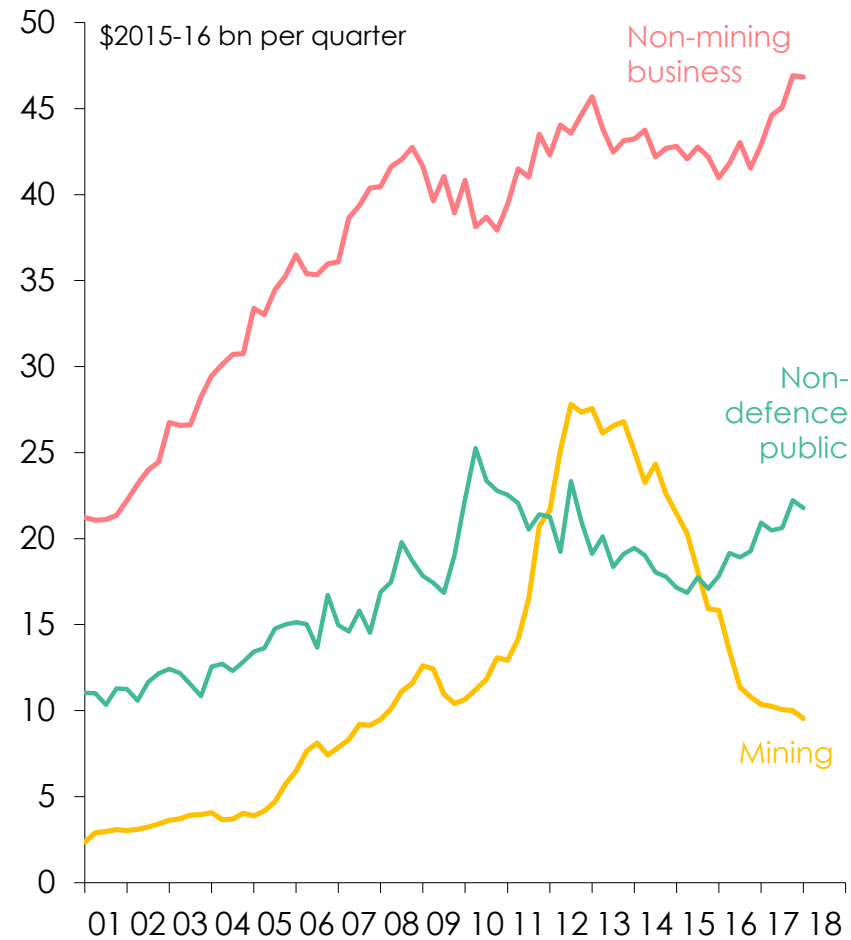
Sources: IMF; OECD; Eurostat; UK Office of National Statistics; Japan Economic & Social Research Institute; The Conference Board; Bank of Japan; US National Federation of Independent Businesses; Corinna Economic Advisory

Australian business conditions are clearly improving – and that is reflected in a long-awaited pick-up in non-mining investment

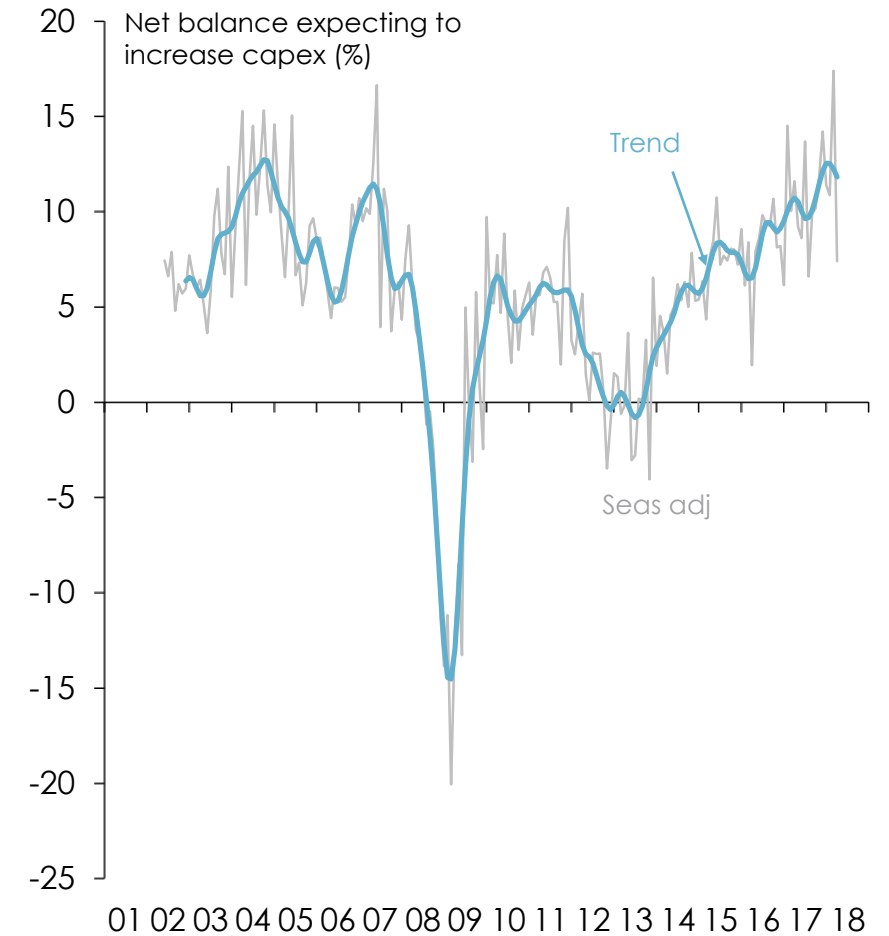
Business conditions and confidence



Non-residential investment – mining vs other sectors



Business survey capital expenditure expectations

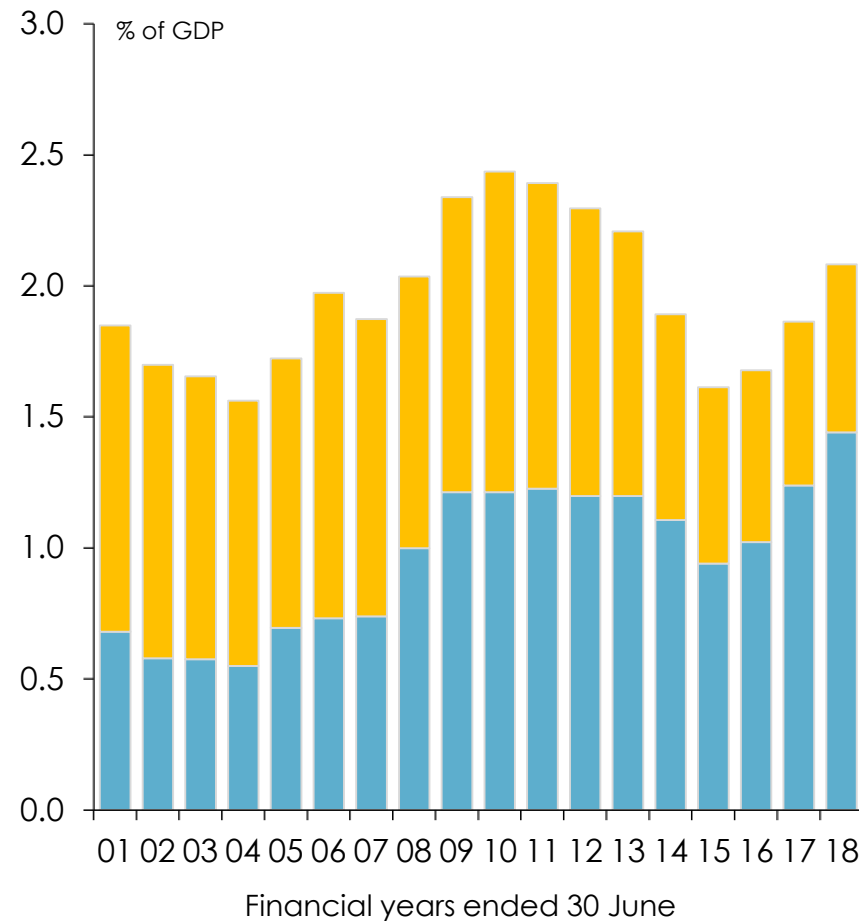


Sources: National Australia Bank; ABS.

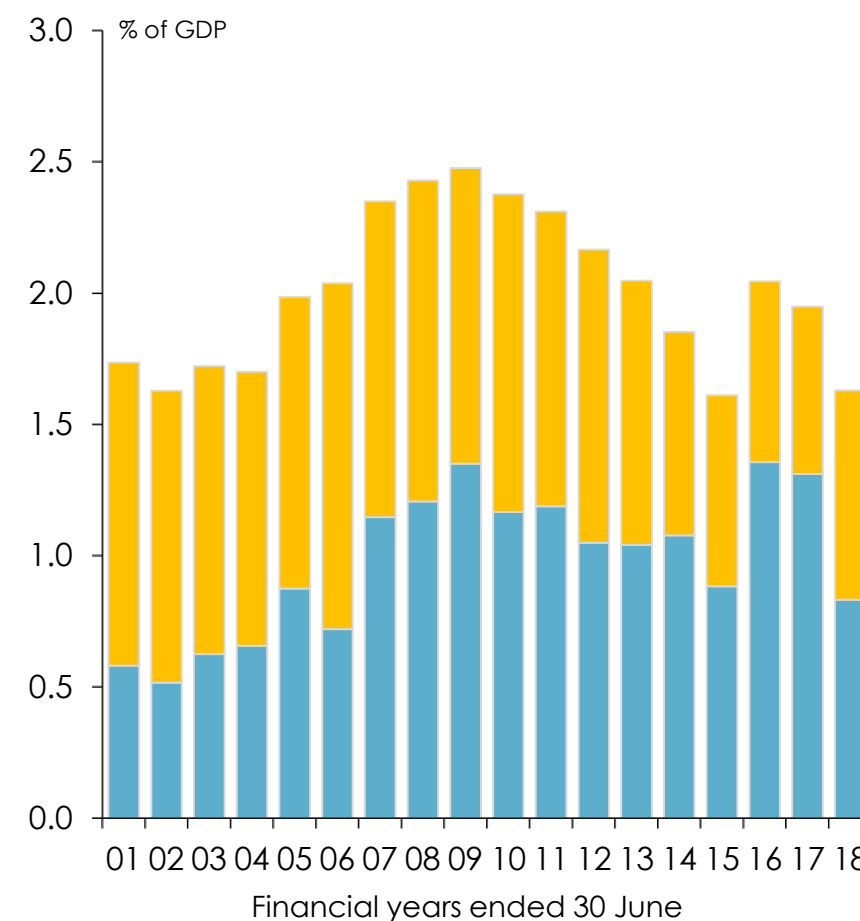
Higher levels of infrastructure investment spending are now beginning to provide some real impetus to economic growth

Indicators of engineering construction activity for the public sector

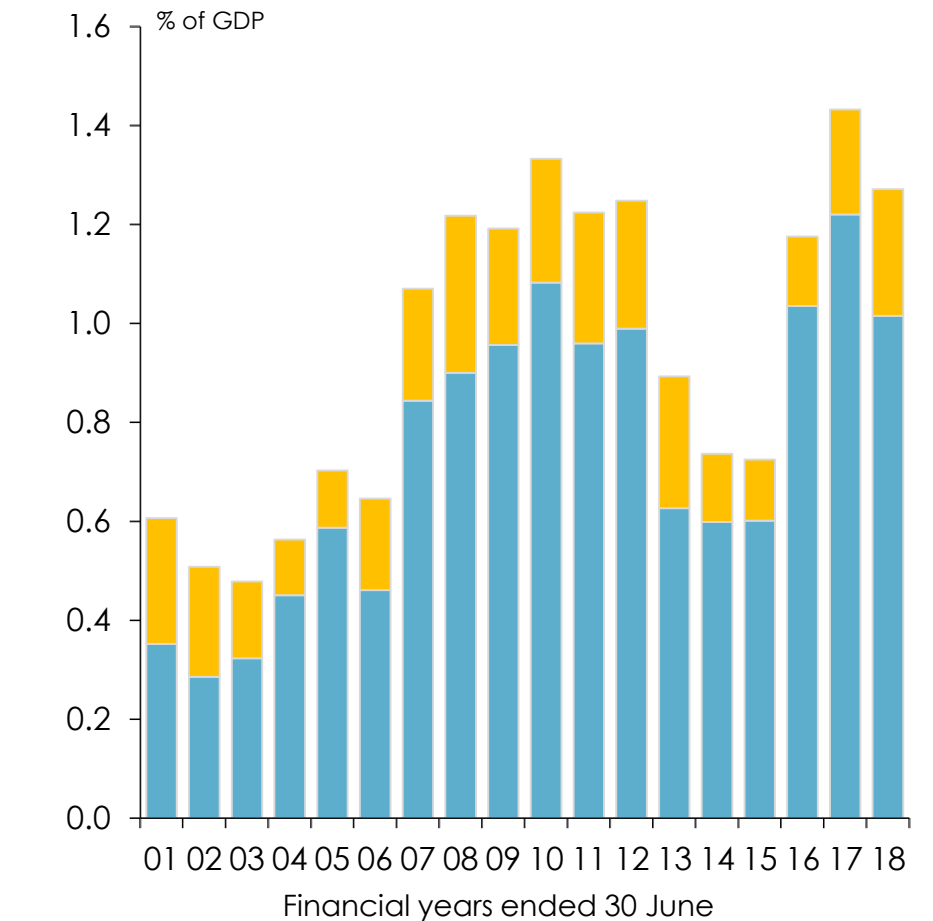
Value of work done



Commencements



Work yet to be done

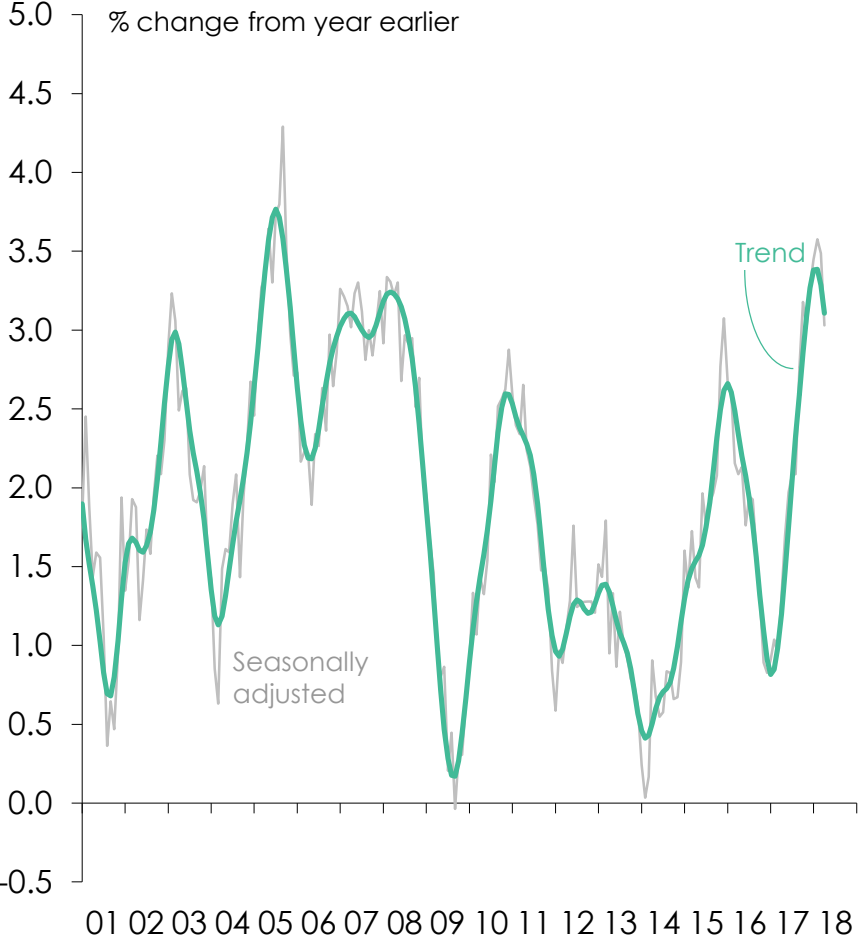


■ Work by the private sector for the public sector
 ■ Work by the public sector for the public sector

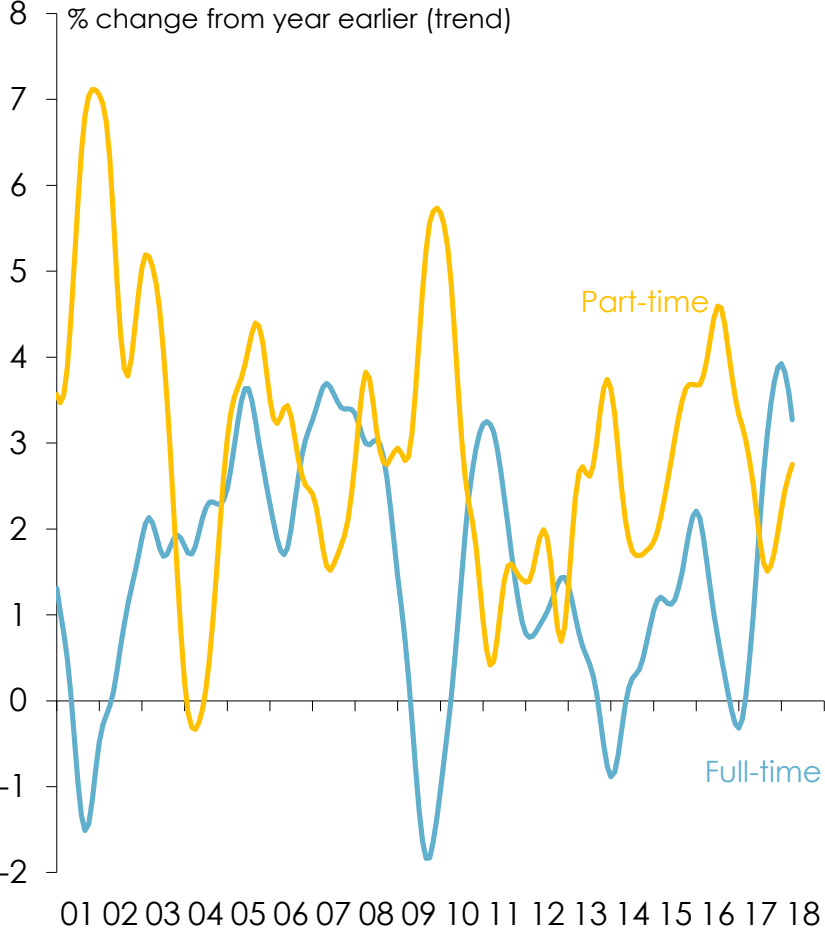
Source: ABS.

Employment growth has picked up – this time led by full-time employment – and seems likely to be sustained

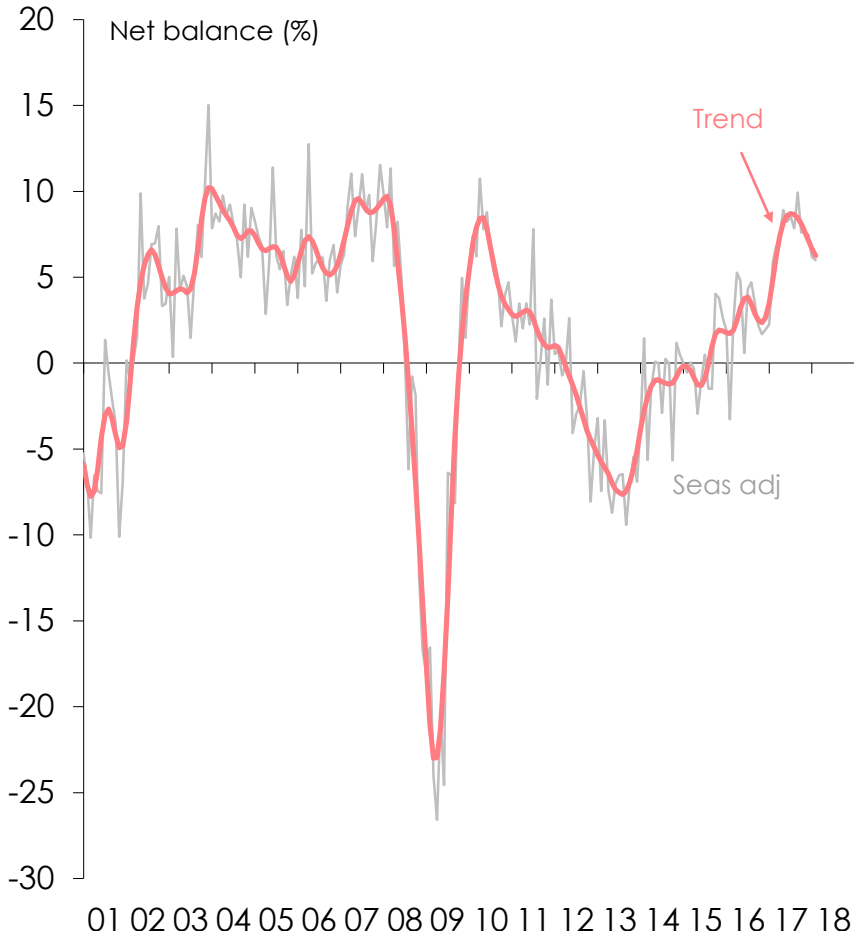
Employment growth



Full-time vs part-time employment



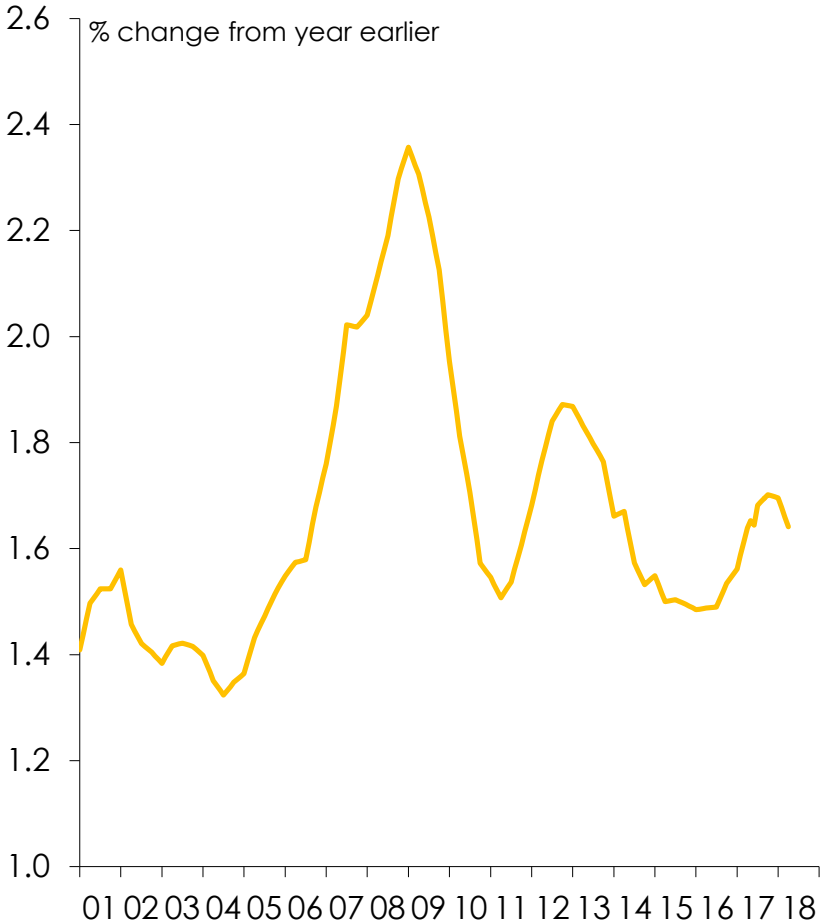
NAB business survey – employer hiring intentions



Sources: ABS; National Australia Bank.

But a large share of this employment growth is being absorbed by faster population growth and rising labour force participation

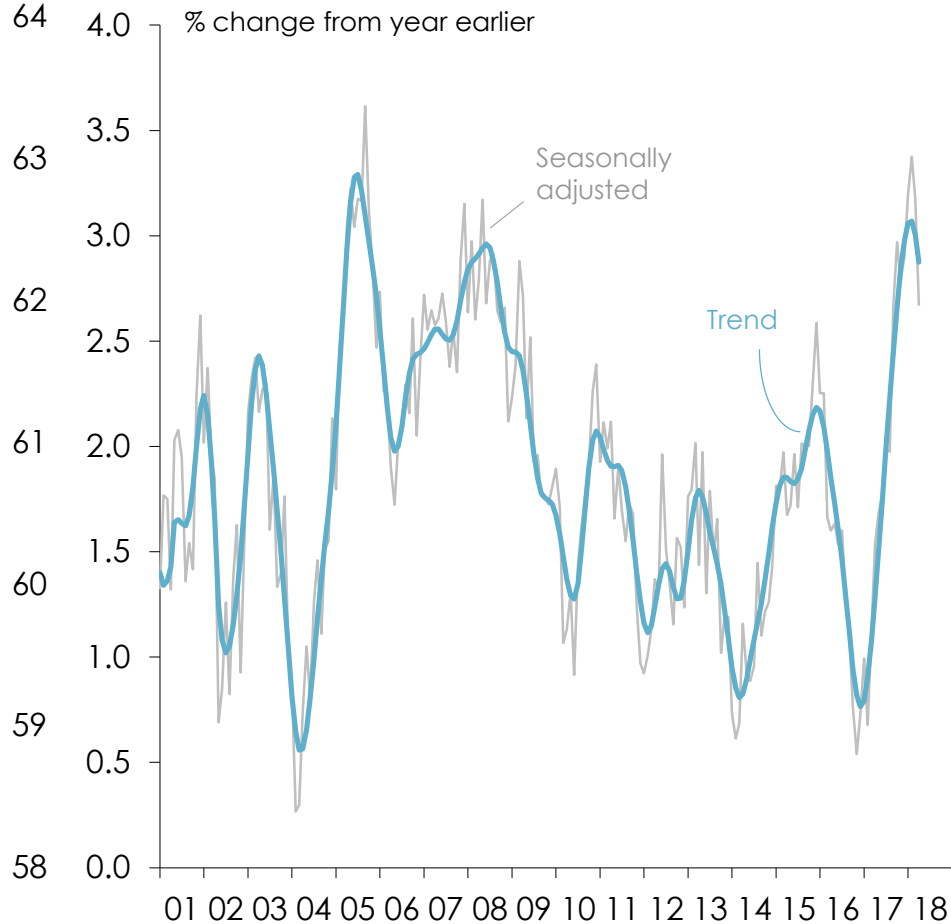
Civilian working age population growth



Labour force participation rate



Labour force growth

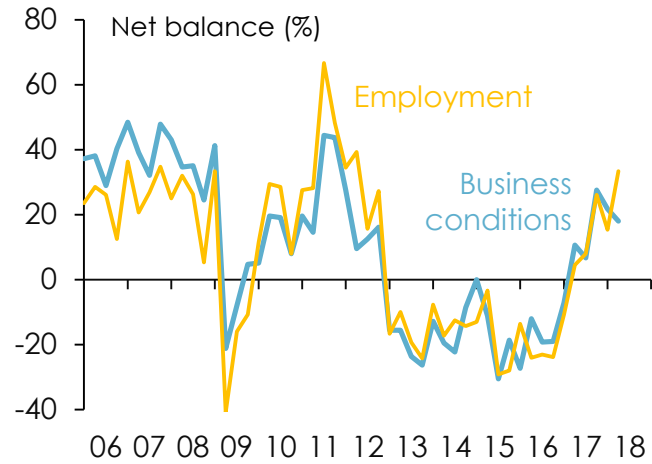


Source: ABS.

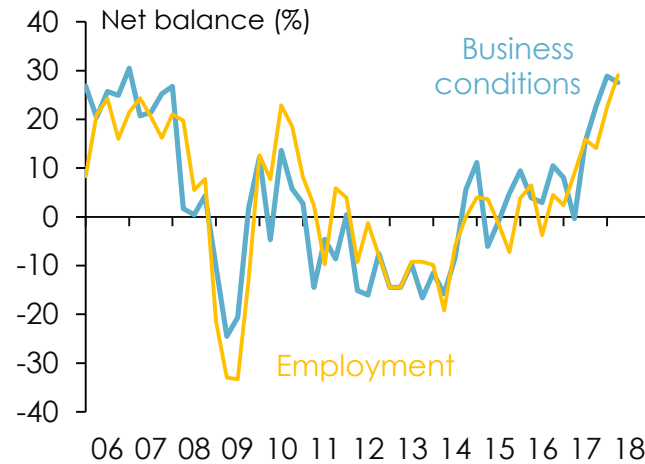
The improvement in business conditions and in employment is fairly broadly based

NAB quarterly survey – business conditions and employment by major industry group

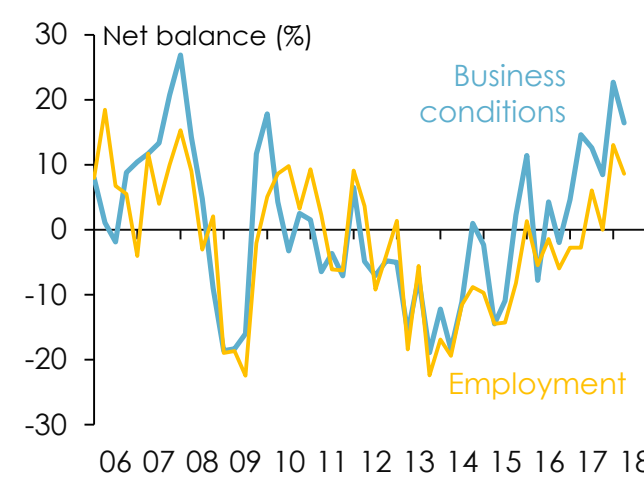
Mining



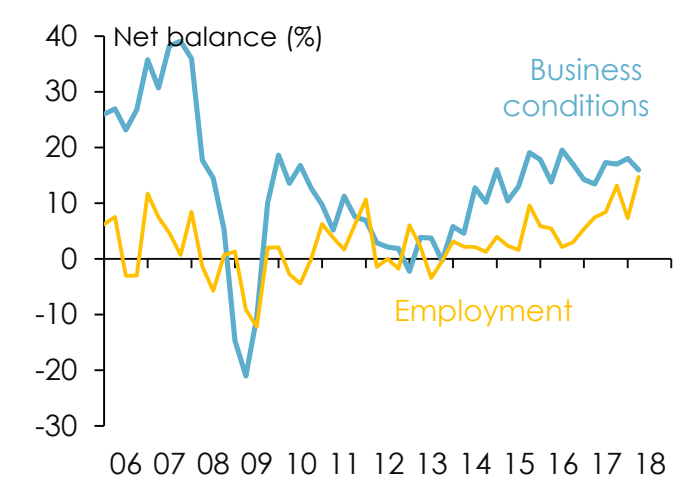
Construction



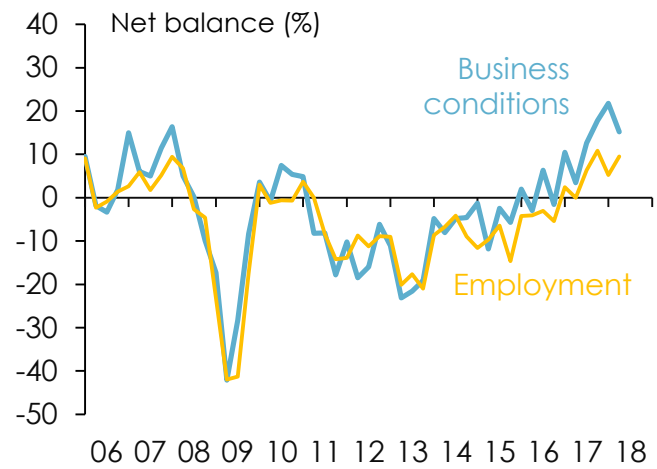
Wholesale trade



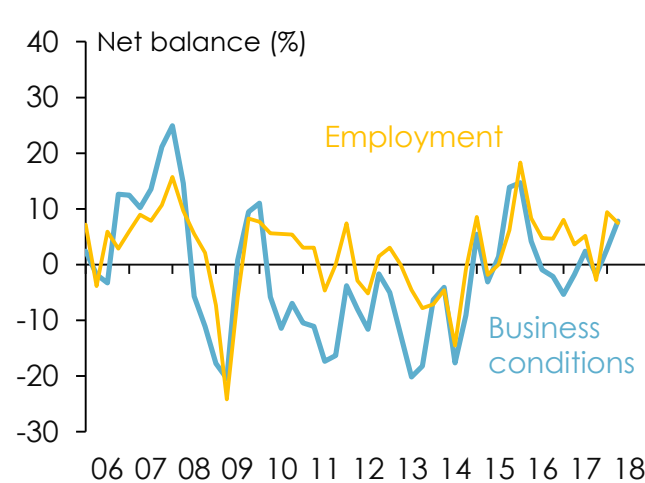
Finance



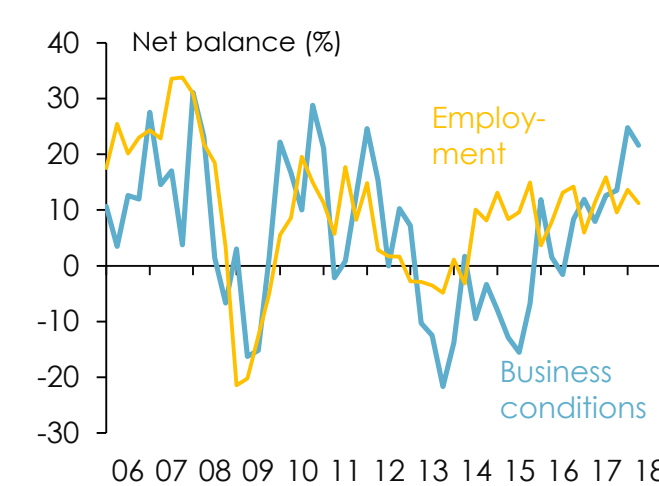
Manufacturing



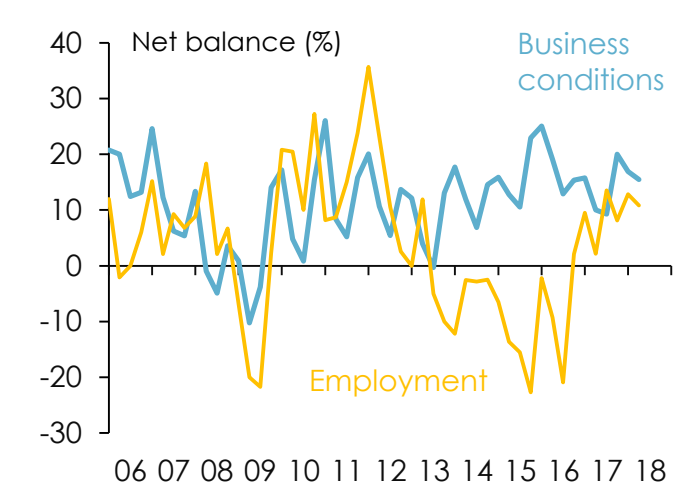
Transport



Retail trade



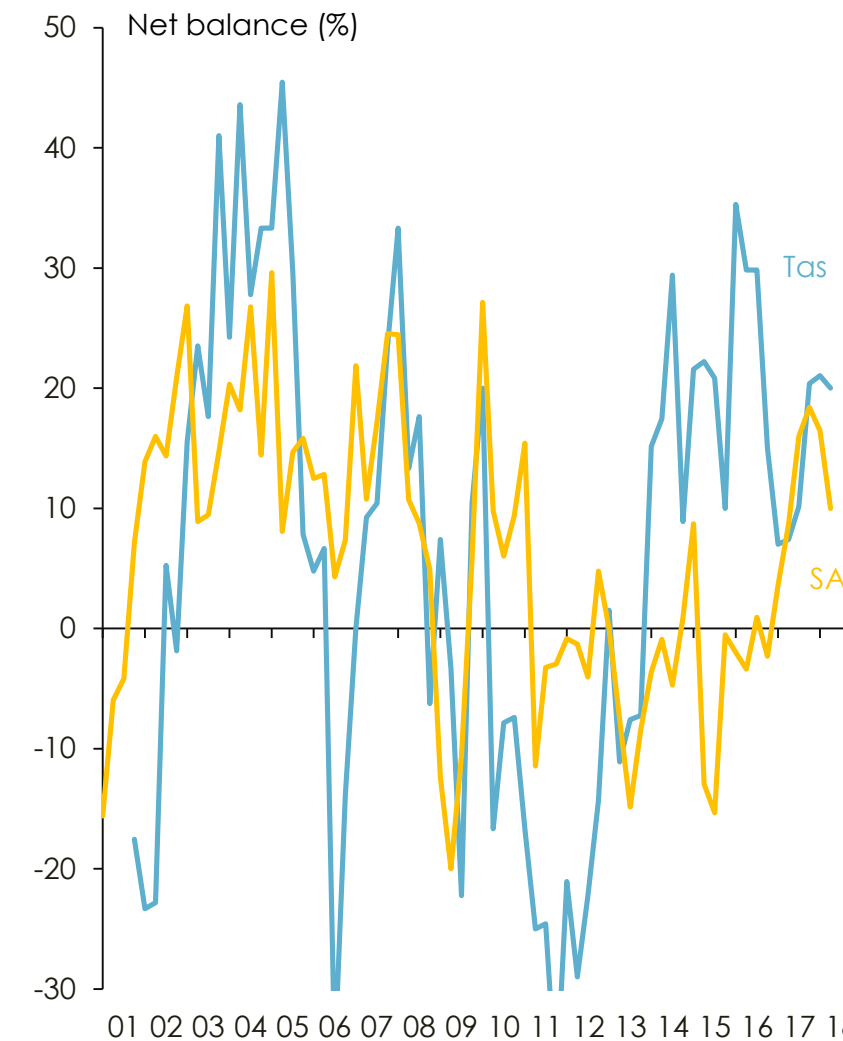
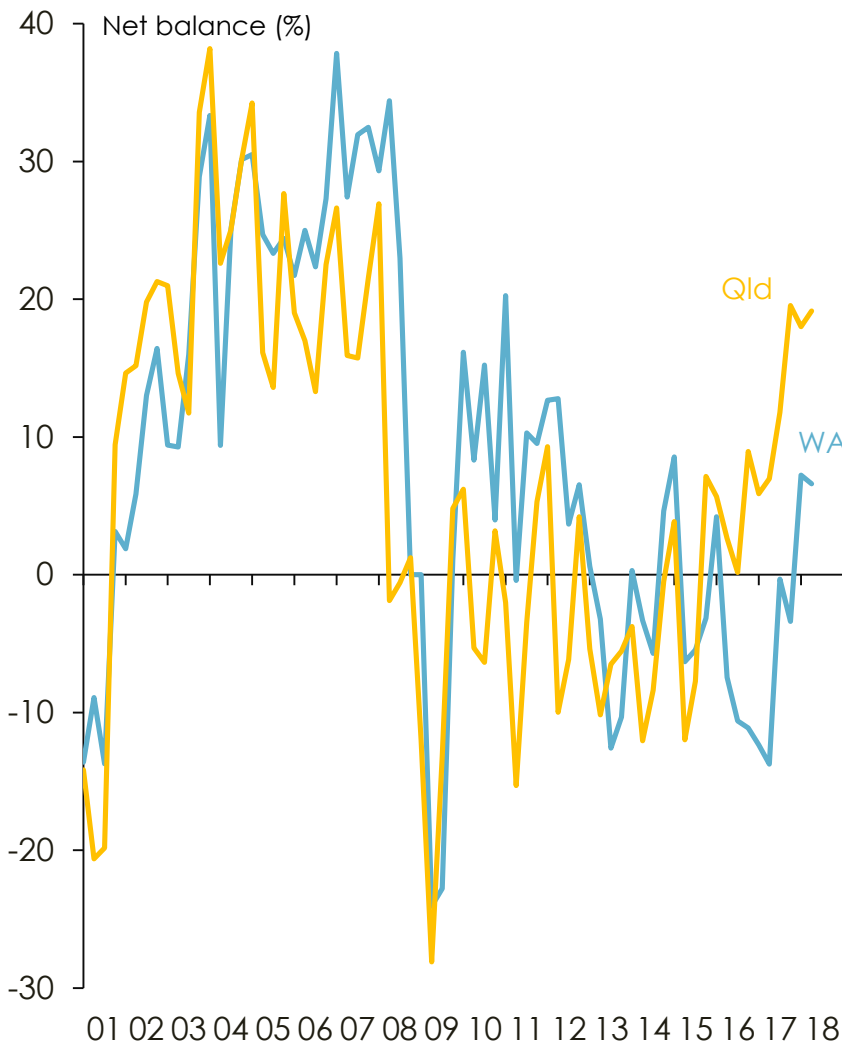
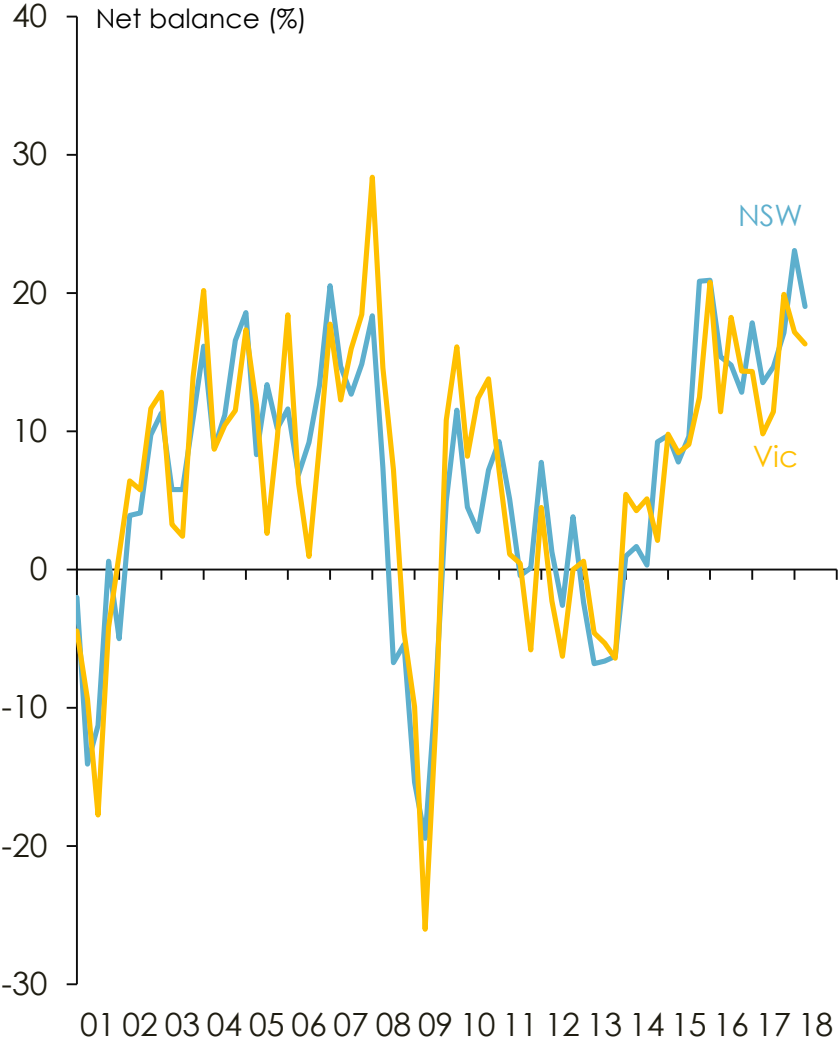
Recreation



Source: National Australia Bank.

Economic performance is becoming more even across Australia's states, in terms of business conditions ...

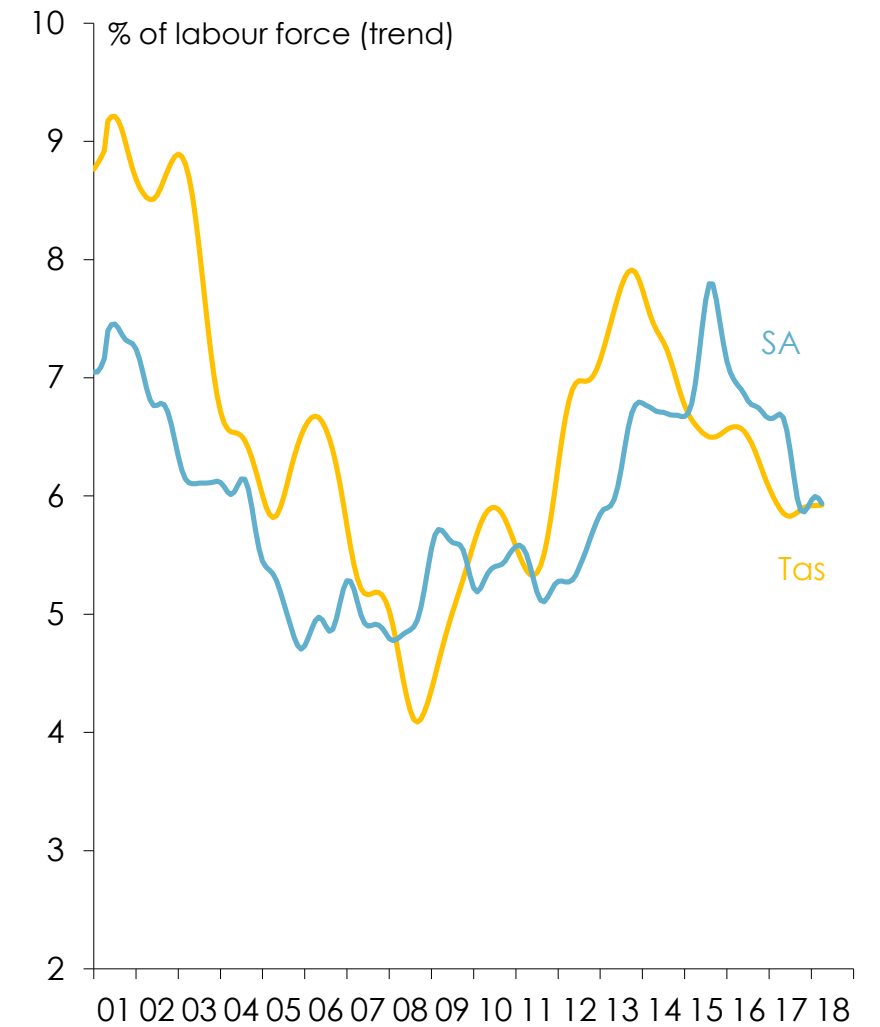
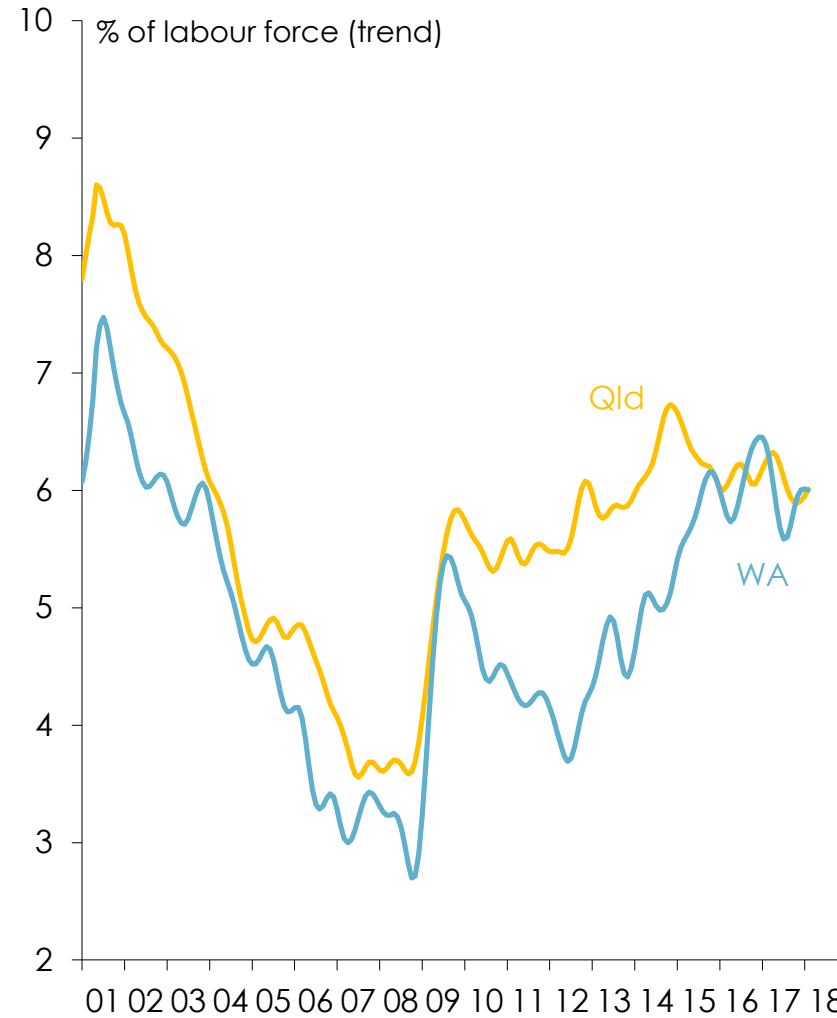
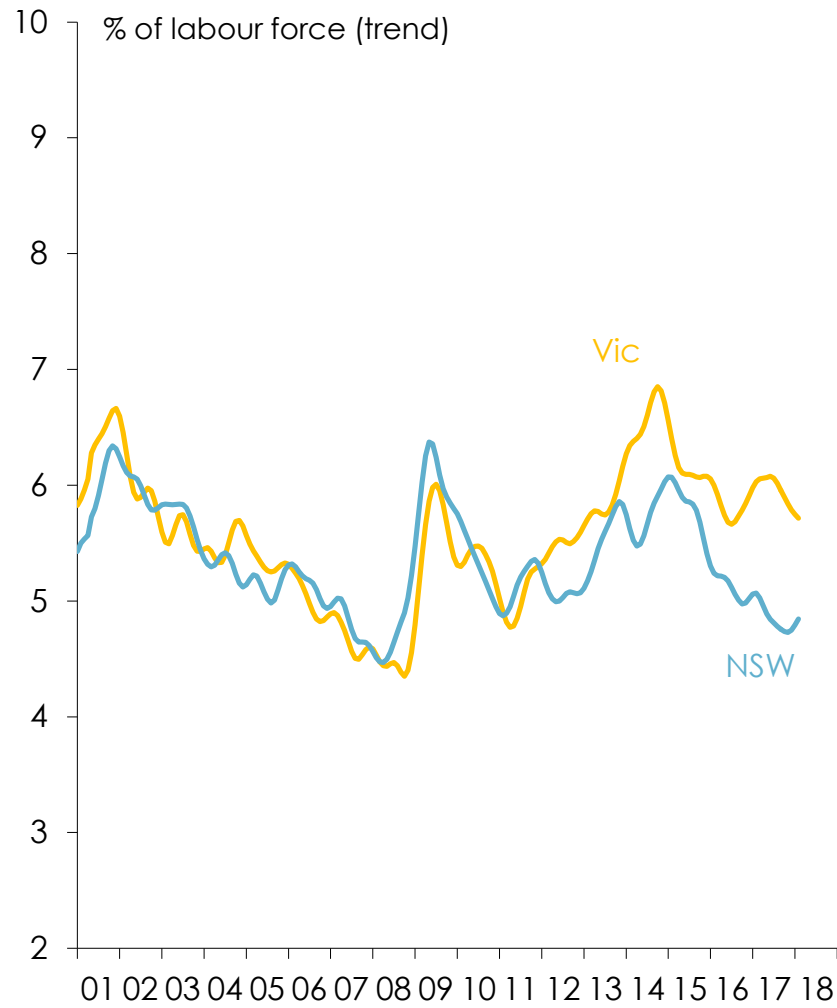
National Australia Bank quarterly business survey – business conditions, by State



Source: National Australia Bank.

... the state of the labour market ...

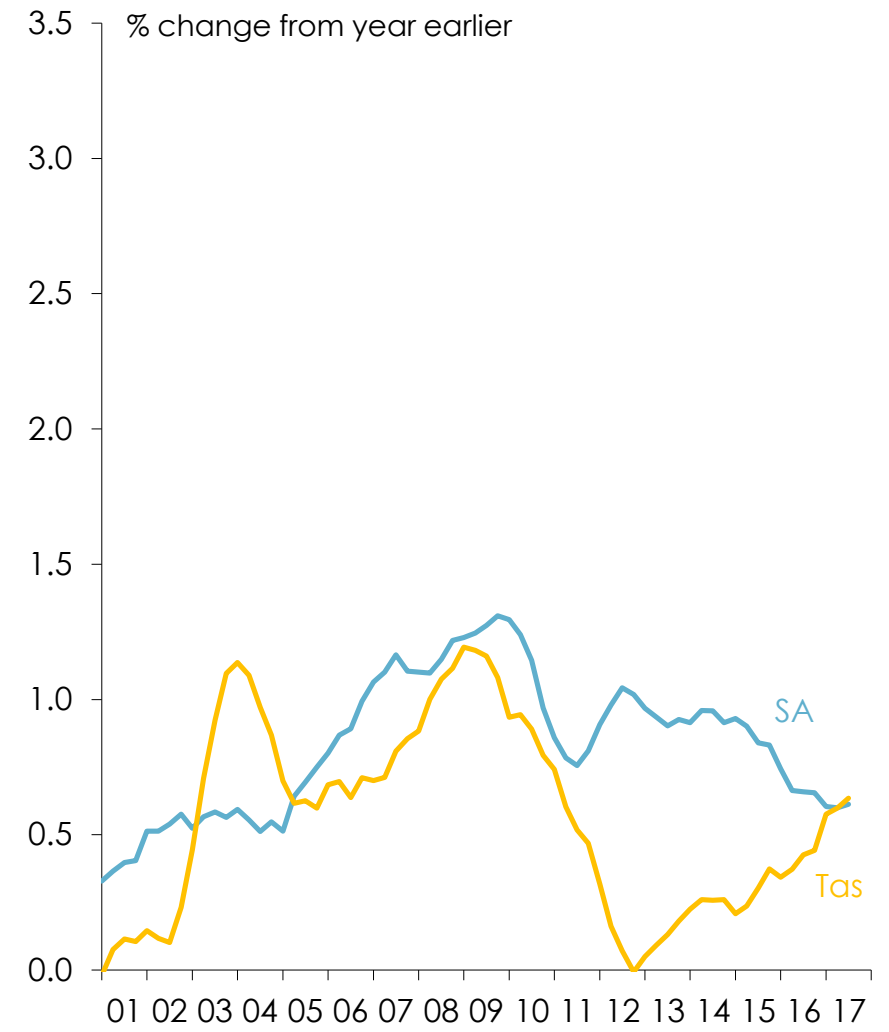
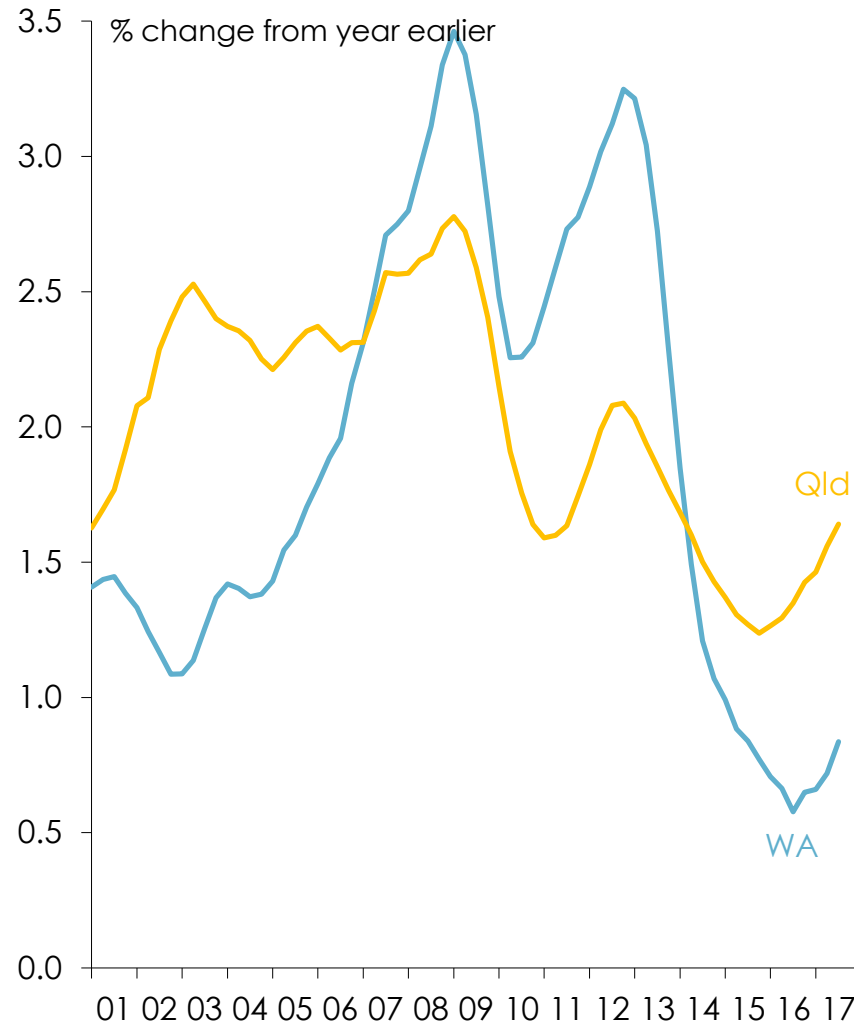
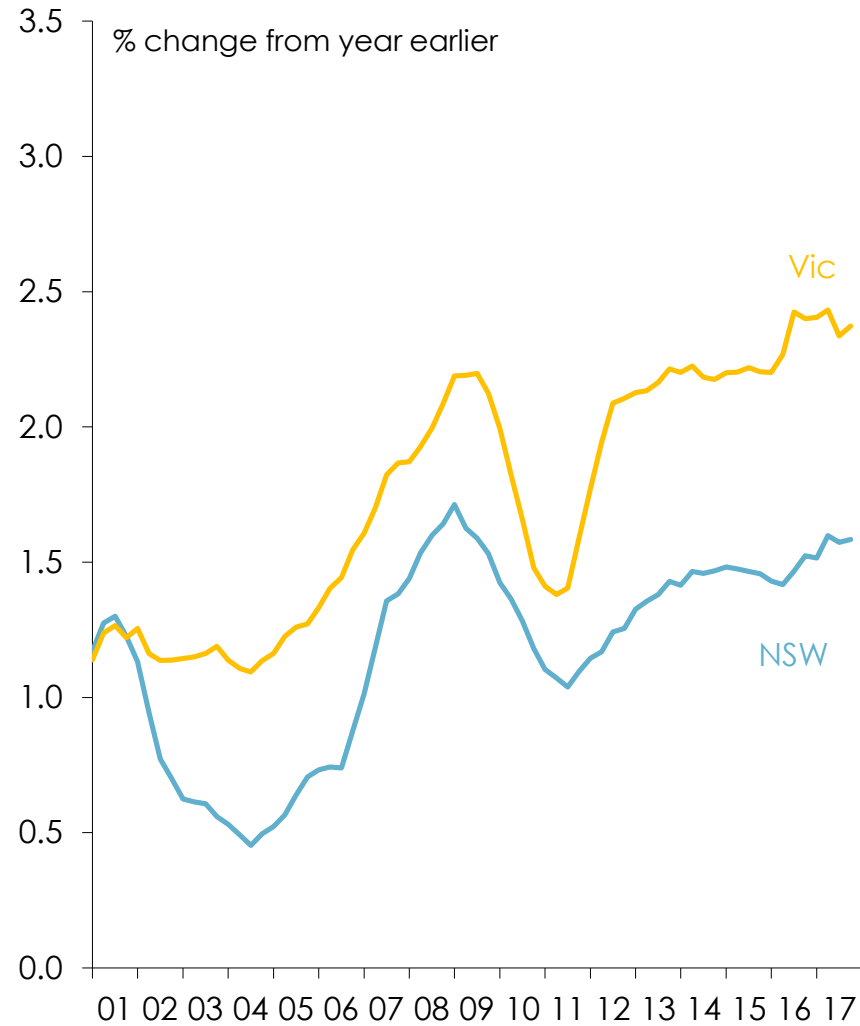
Unemployment rates, by State



Source: ABS.

... and even population growth

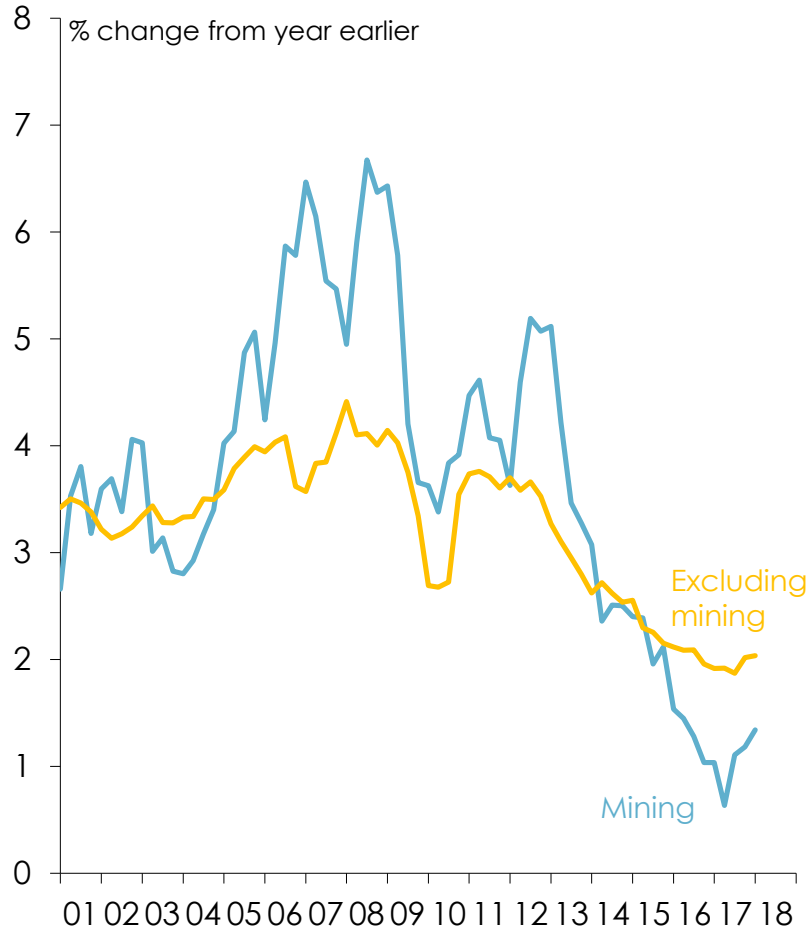
Population growth rates, by State



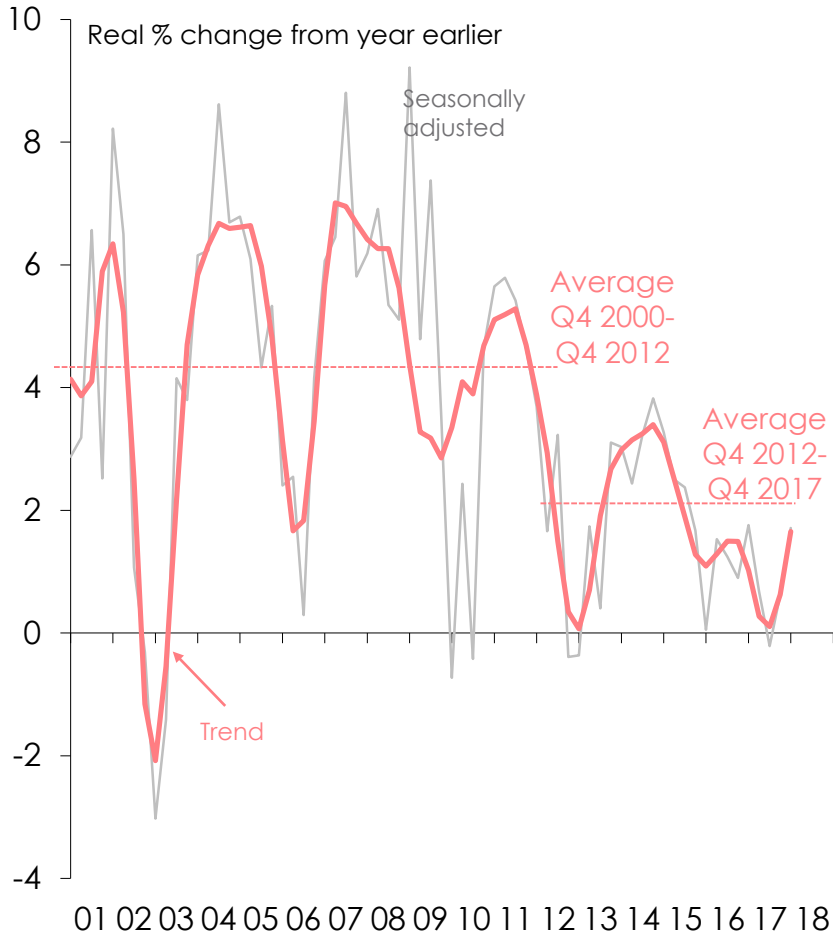
Source: ABS.

As in other 'advanced' economies however wages growth remains very sluggish, so household income and spending growth continue to be soft

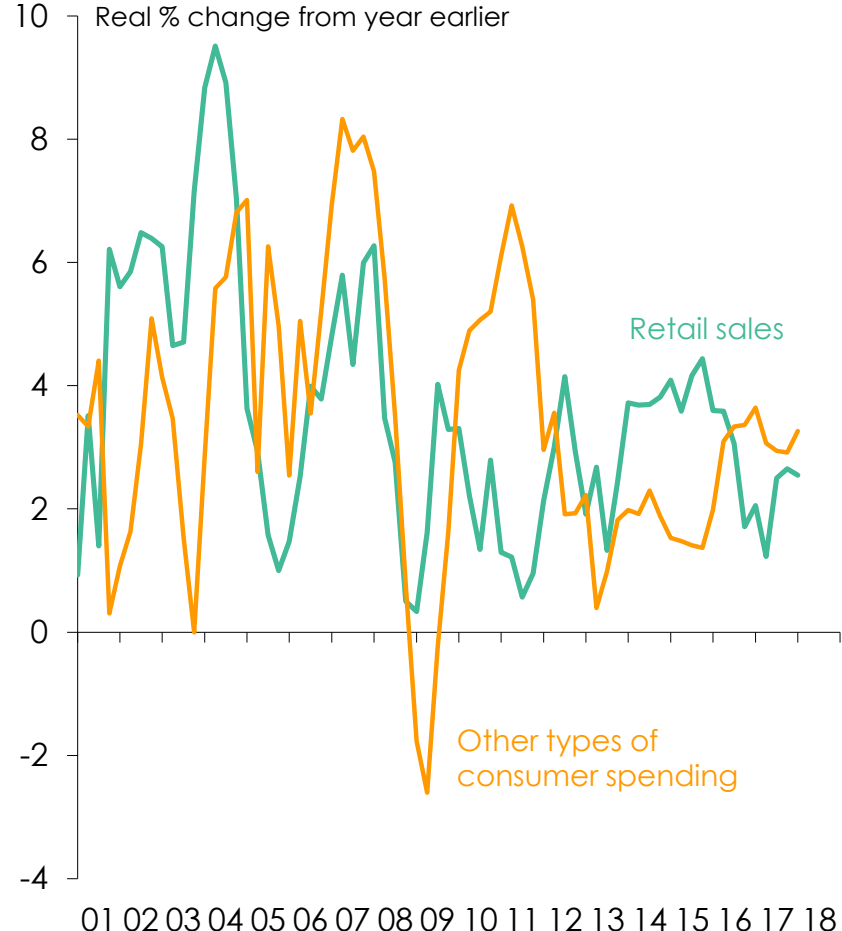
Wages growth



Household disposable income



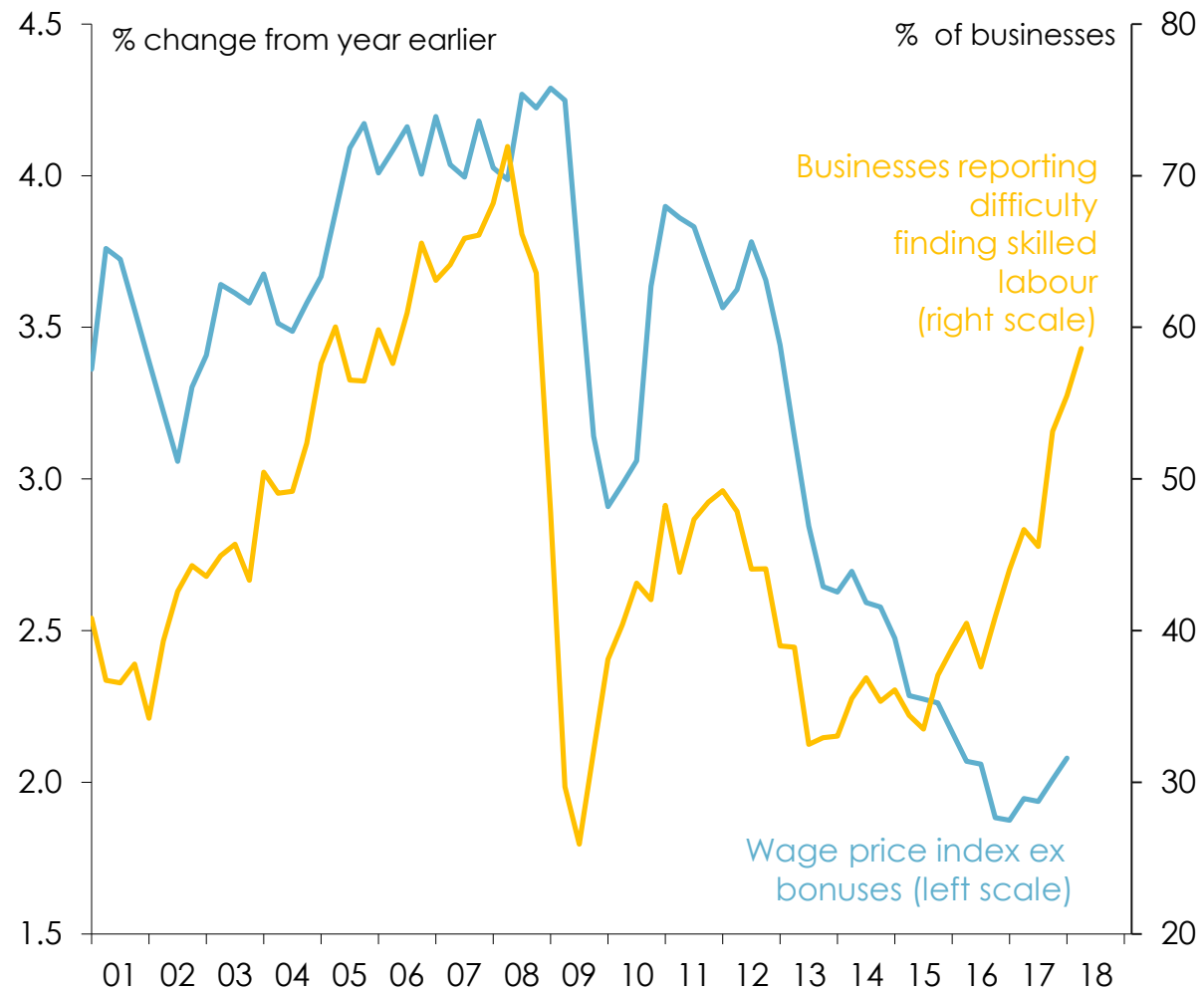
Household consumption expenditure



Source: ABS.

It is still likely to be some time before wages growth begins picking up

Skilled labour shortages and wages growth

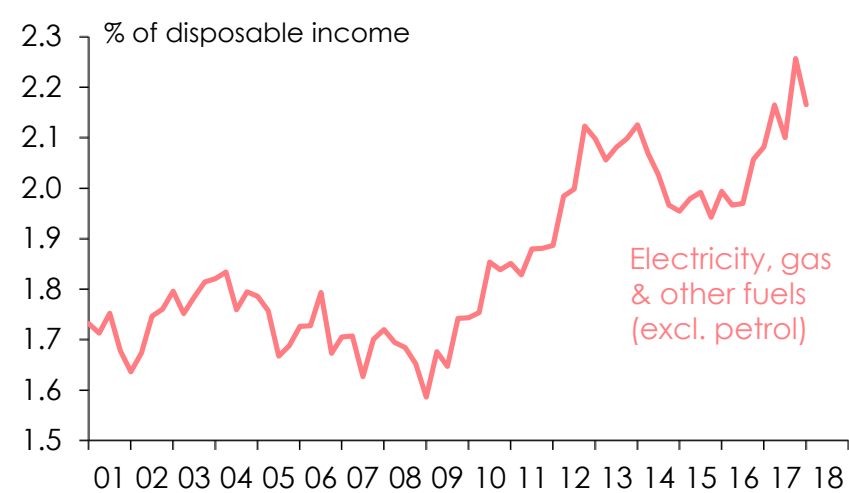
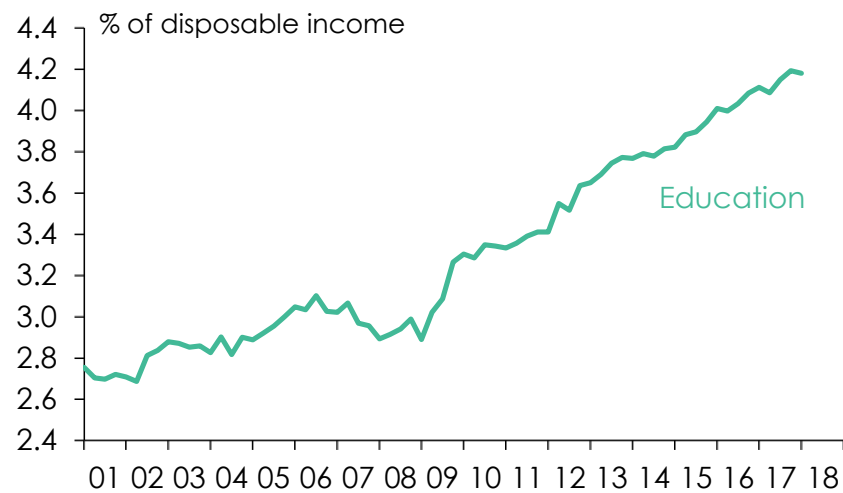
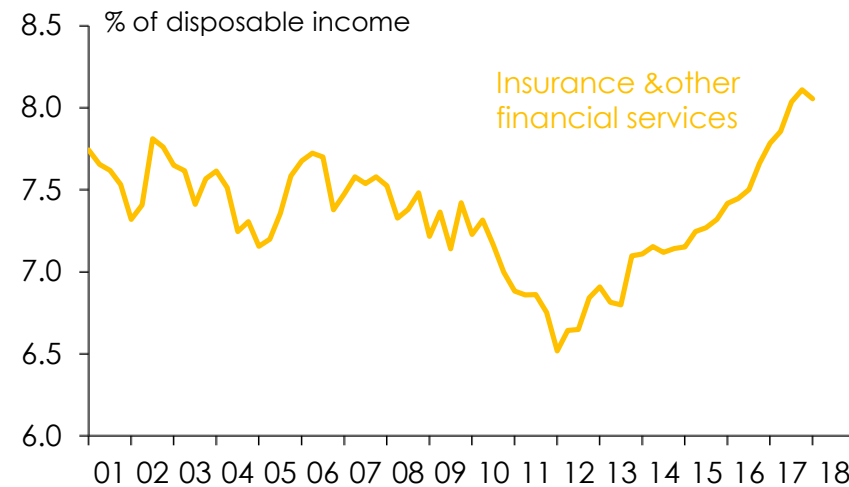
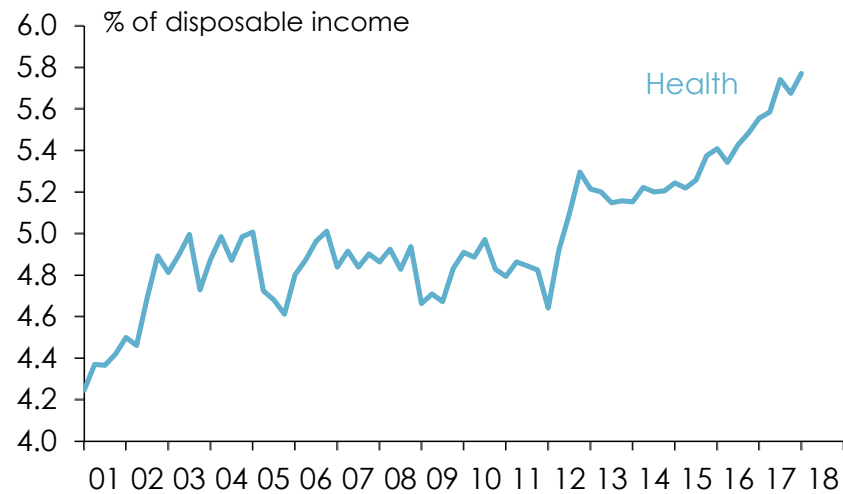


- ❑ **The proportion of businesses encountering ‘difficulties finding suitably skilled labour’ is now the highest since before the financial crisis**
 - which historically would have been consistent with wages growth of around 3-3½% pa
- ❑ **Contemporary experience in other advanced economies suggests that unemployment needs to be lower for longer than historically before wages growth begins to pick up**
- ❑ **“The latest data suggest that the rate of wages growth has now troughed, with a pick-up evident in the most recent quarter. A further lift is expected, but it is likely to be only gradual”**
 - RBA Governor Phillip Lowe, 11th April 2018

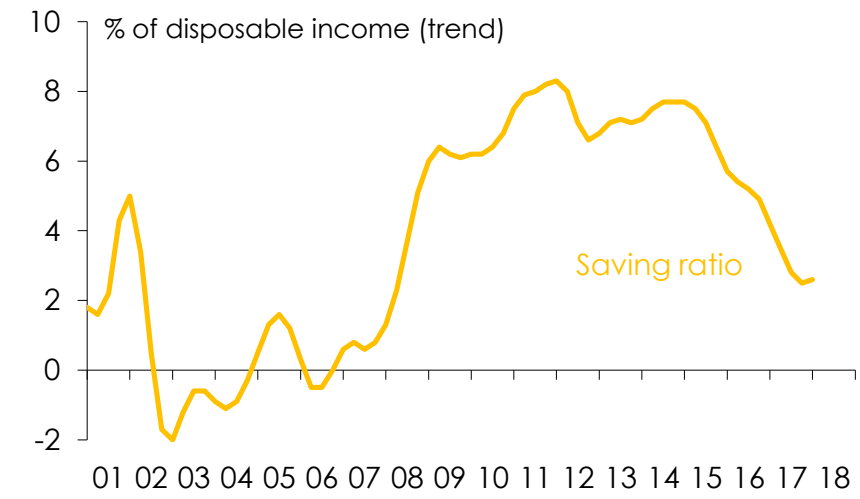
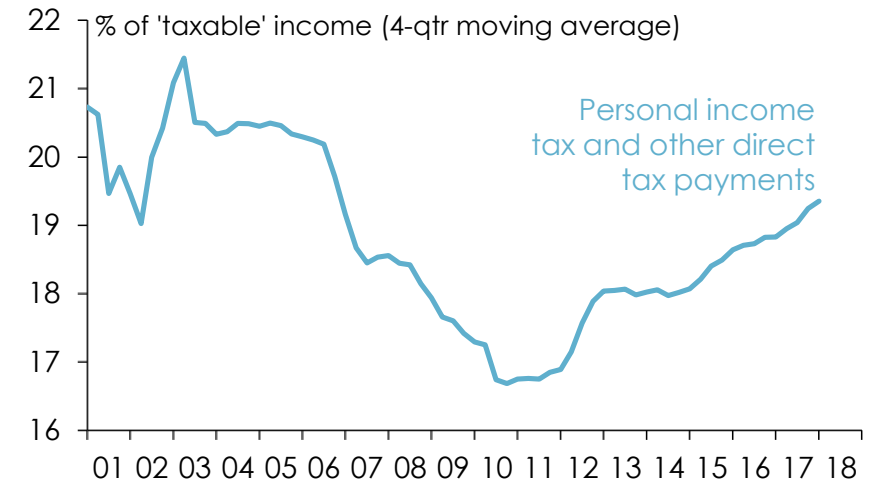
Sources: ABS; National Australia Bank Quarterly Business Survey.

Household budgets are also being squeezed by rising costs of some 'non-discretionary' items, and higher income tax payments

Selected categories of household consumption expenditure as a pc of disposable income



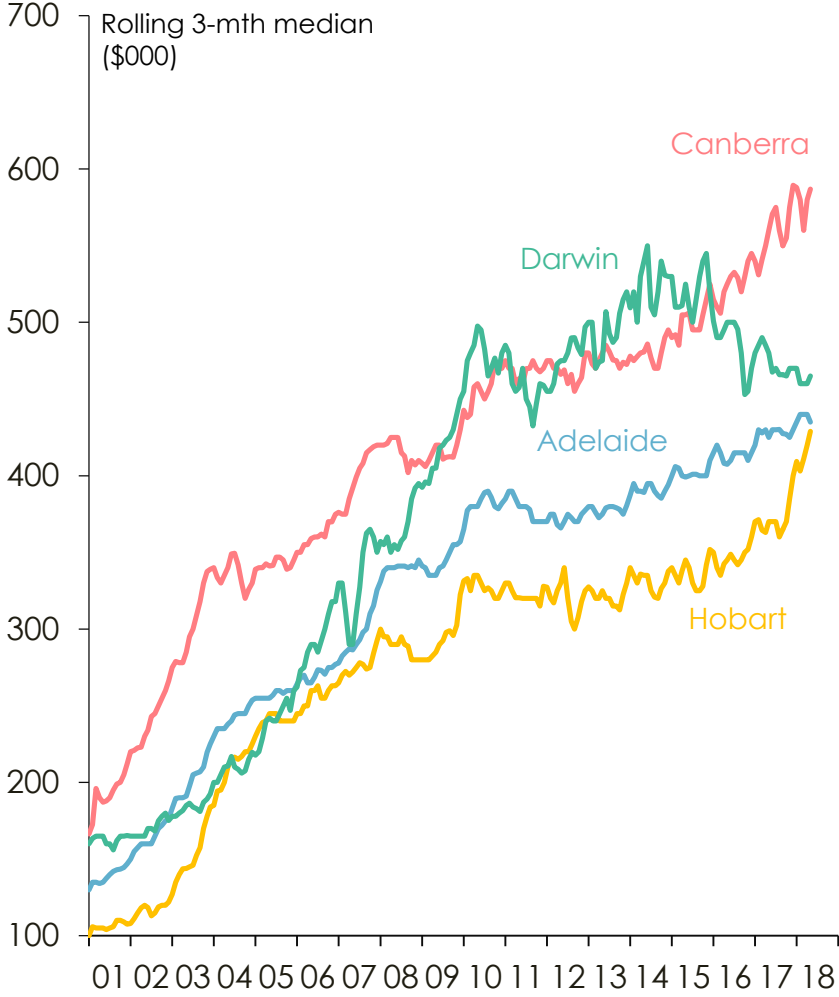
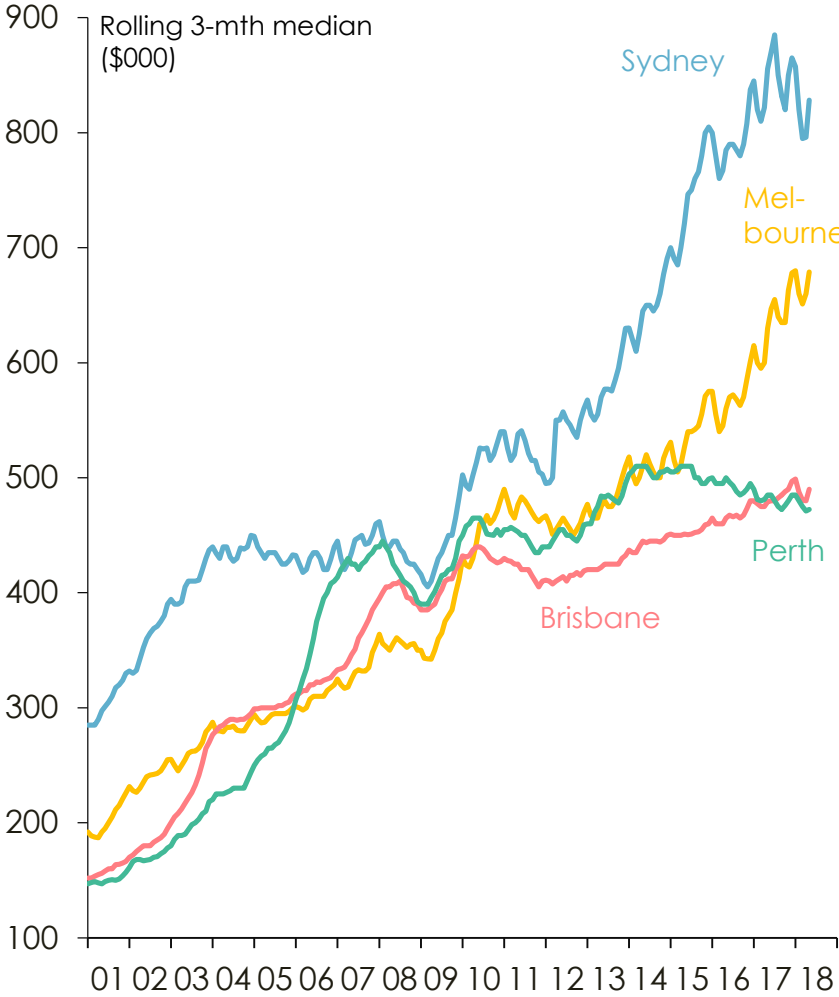
Household income tax and saving ratios



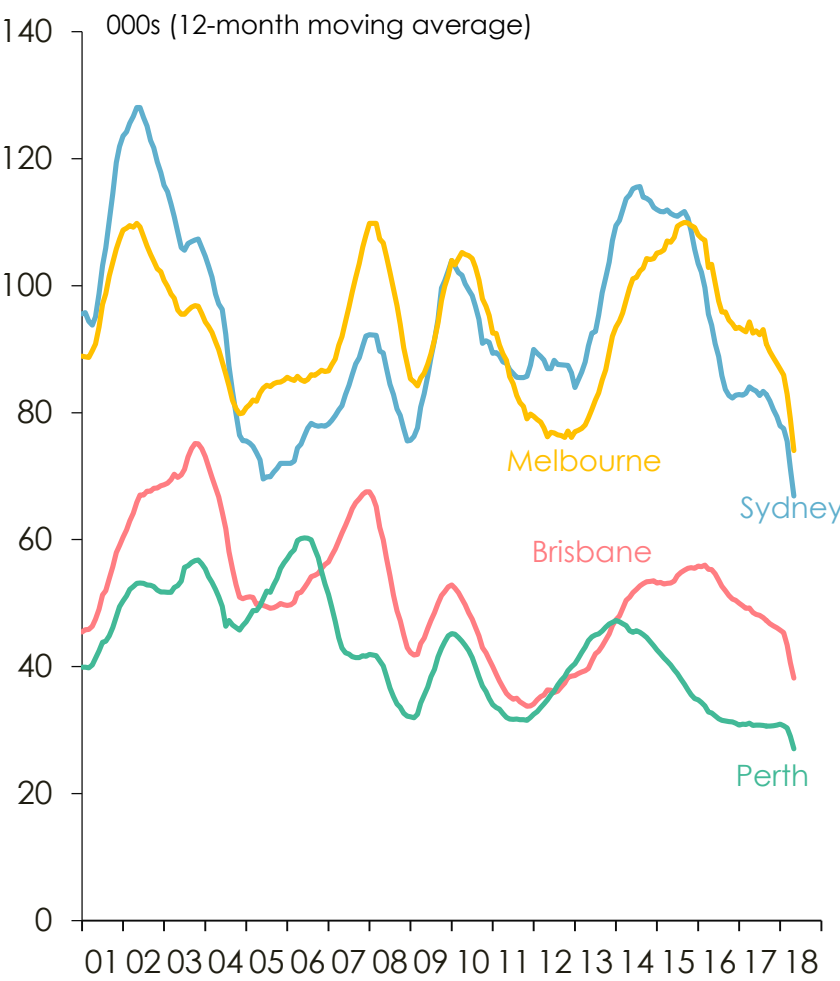
Source: ABS Note: 'taxable' income is gross household income excluding imputed items (dwelling rent, interest on superannuation and pension fund savings and workers' compensation premiums) and interest payments by unincorporated enterprises.

Capital city residential property markets appear in most cases to have peaked

Capital city median dwelling sale prices



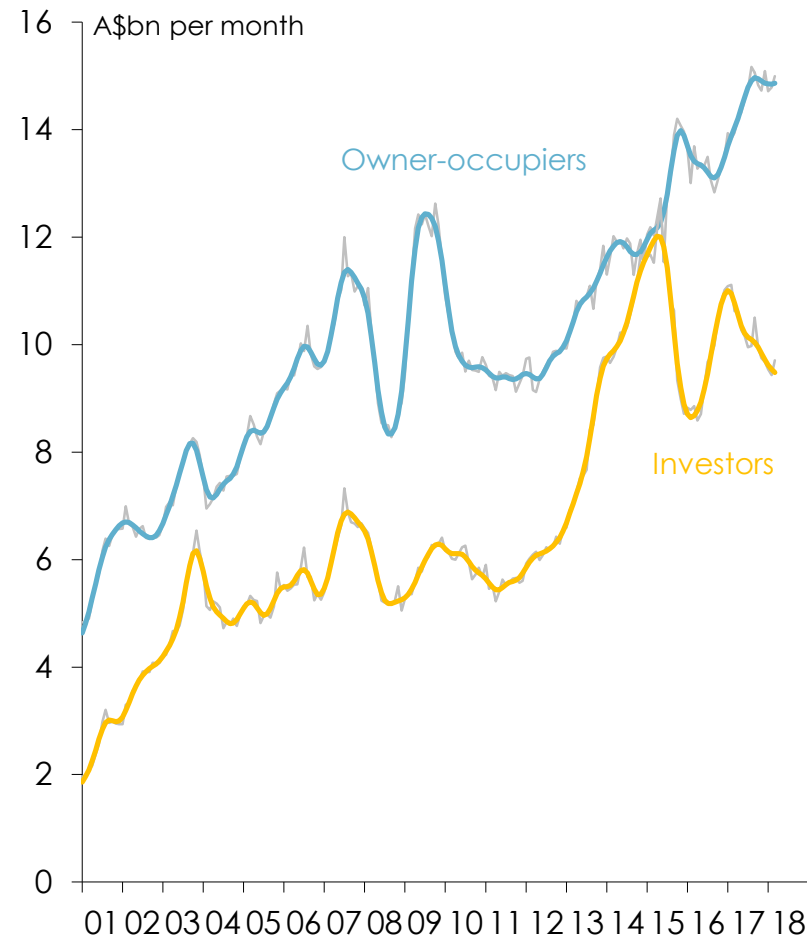
Sales volumes



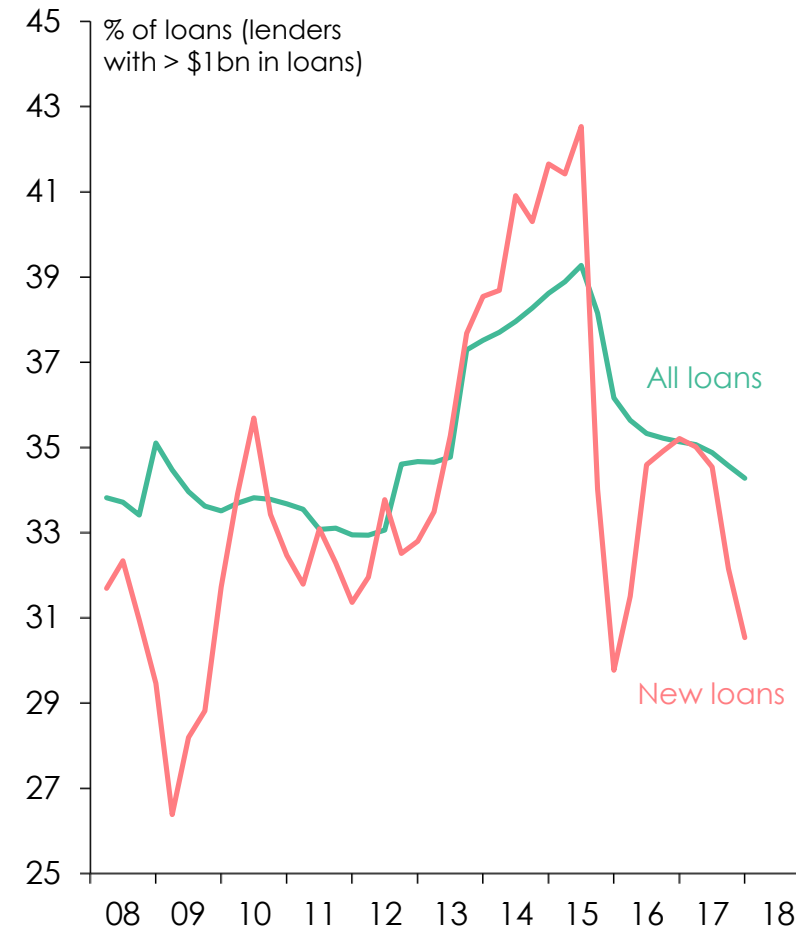
Source: CoreLogic.

The softening in property prices clearly owes something to 'macro-prudential' curbs on lending to investors (and to lower foreign investment)

Housing finance commitments



Lending to residential property investors



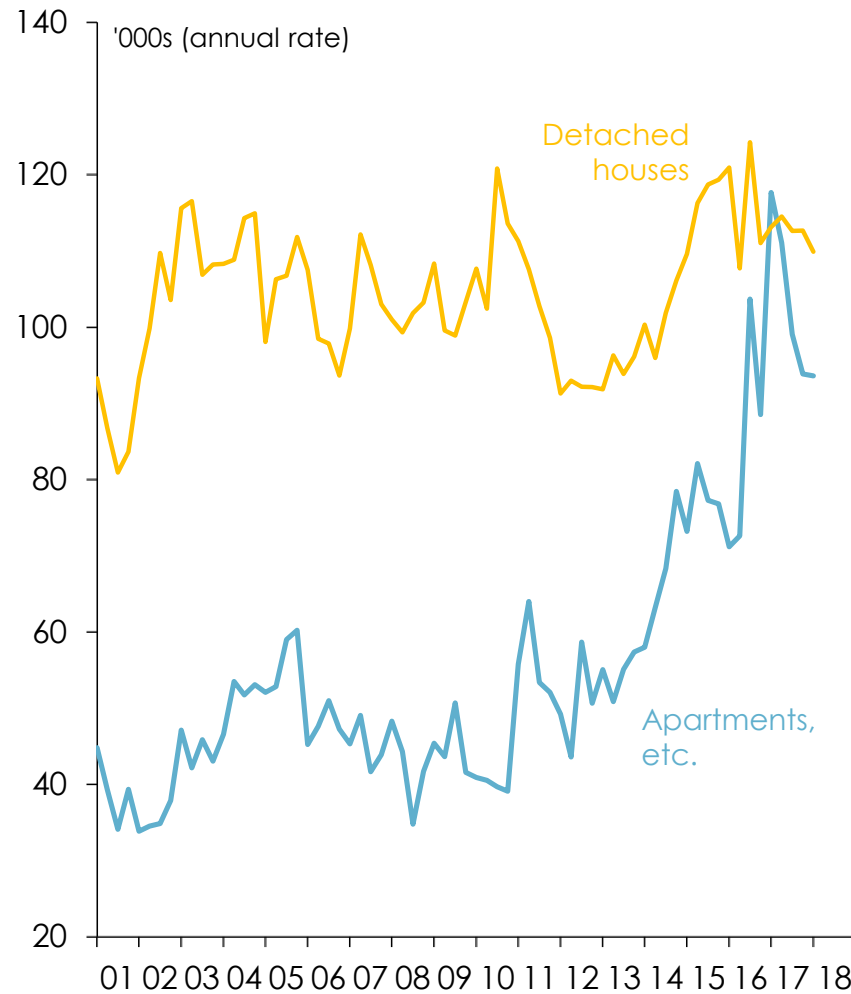
Interest-only residential property lending



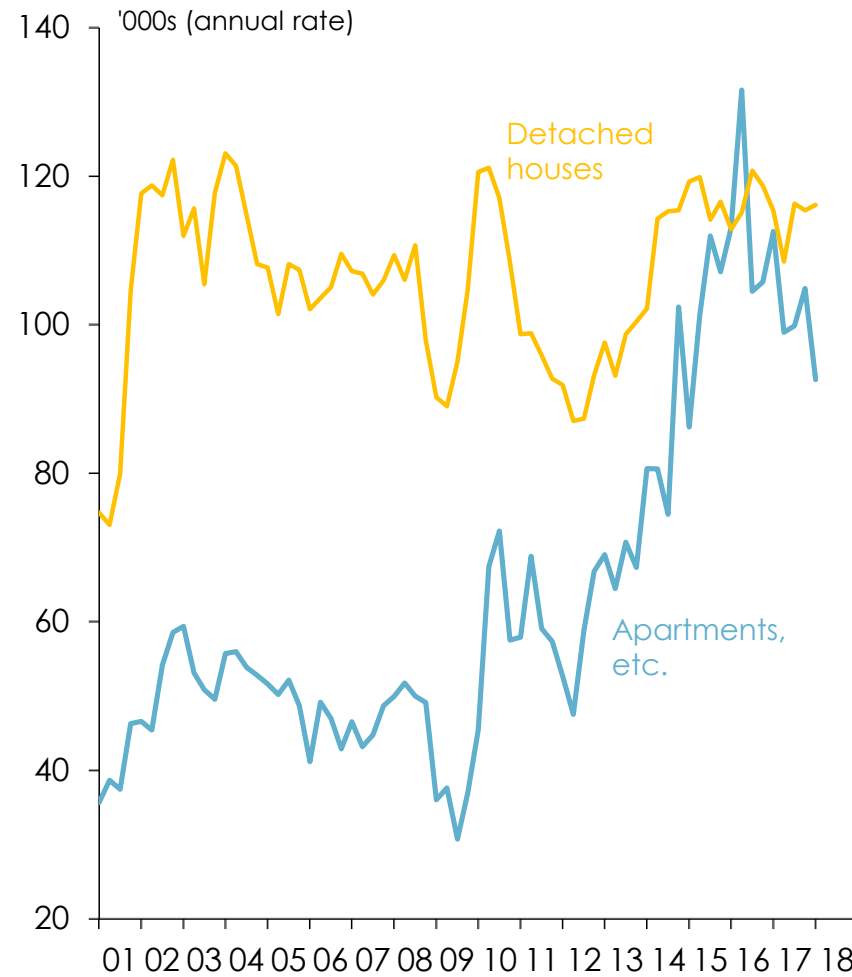
Sources: ABS; Australian Prudential Regulatory Authority (APRA).

Increased housing supply is confined to apartments – there has been no upsurge in supply of detached dwellings

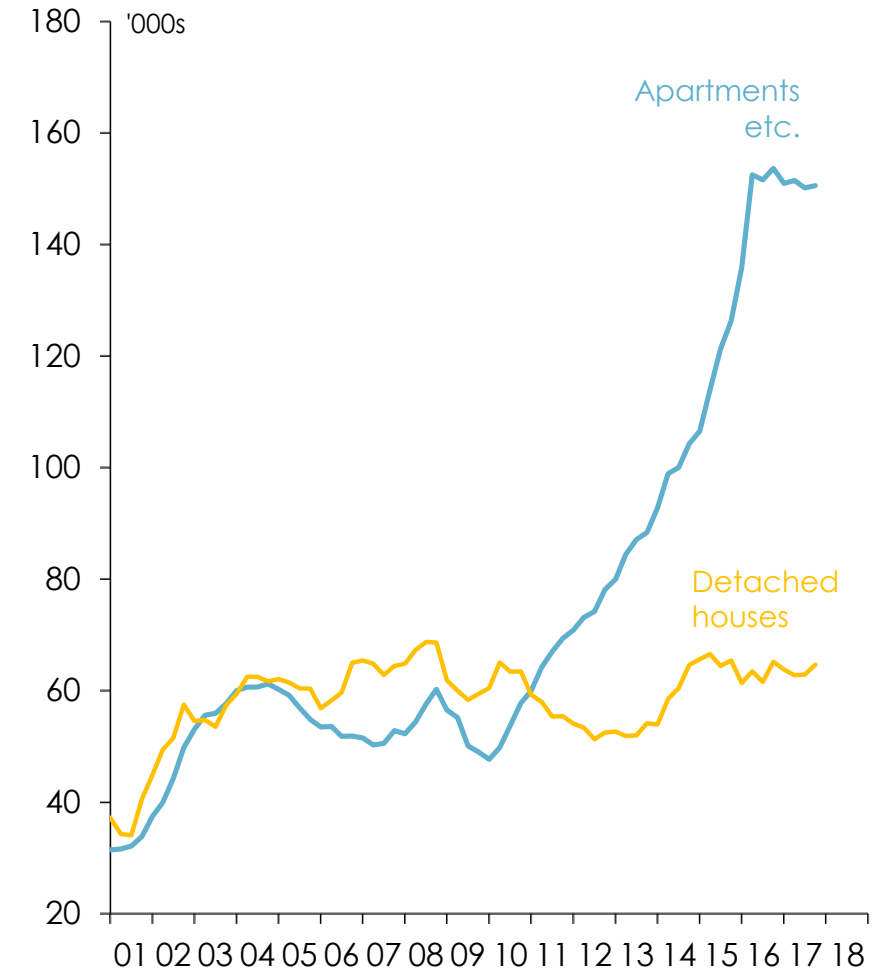
Housing completions



Housing commencements



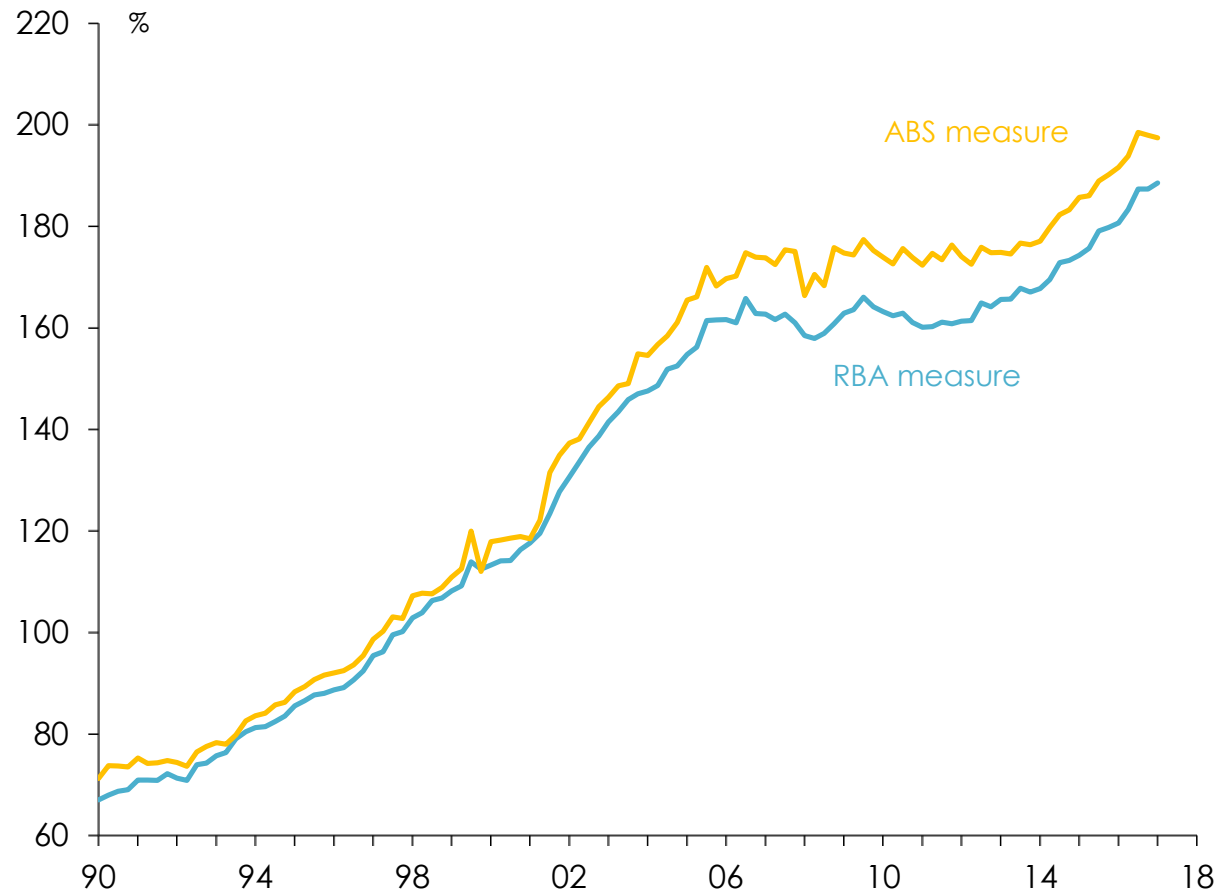
Housing under construction



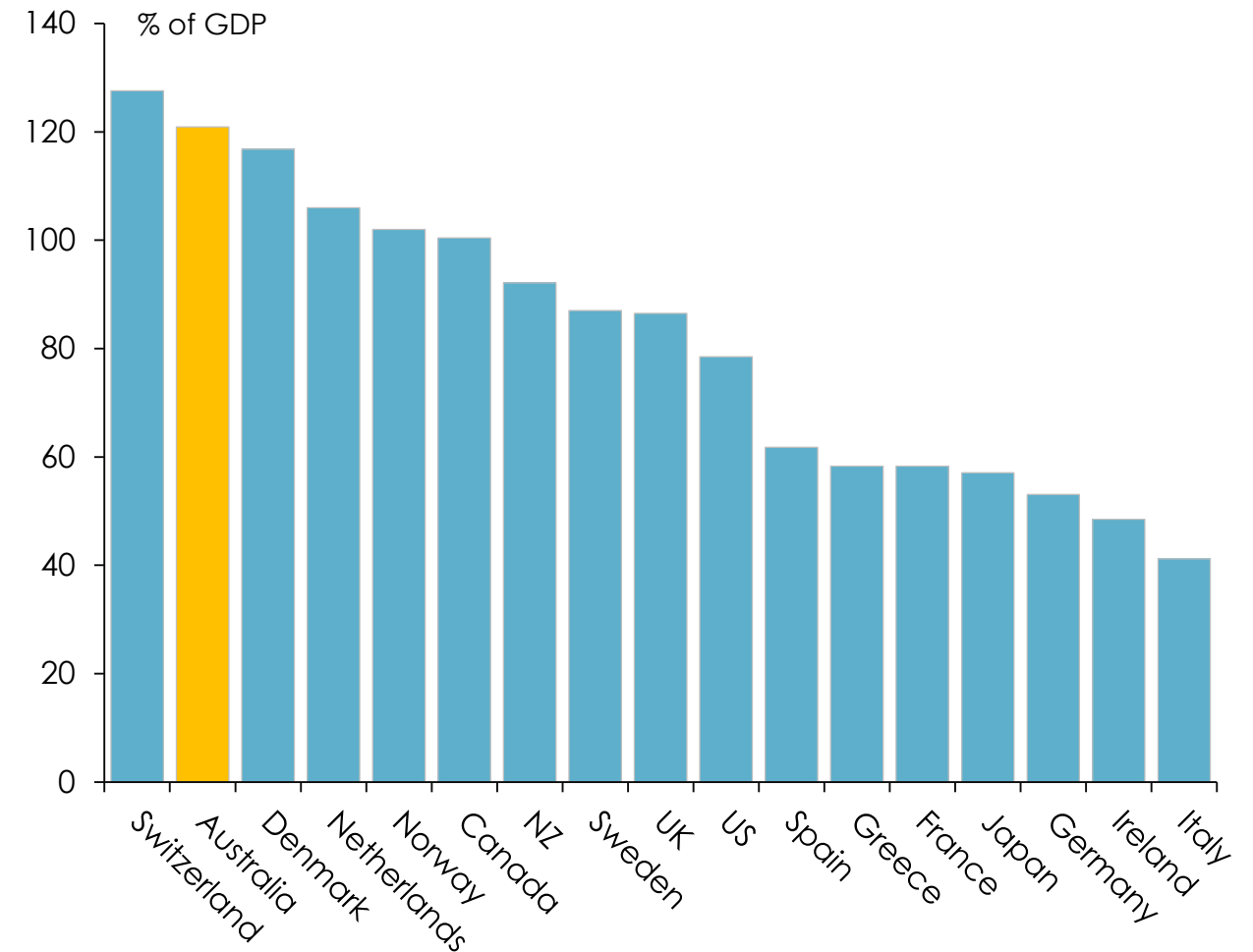
Source: ABS.

Australian households have a lot of debt, by both historical and international standards

Australian household debt-to-income ratio



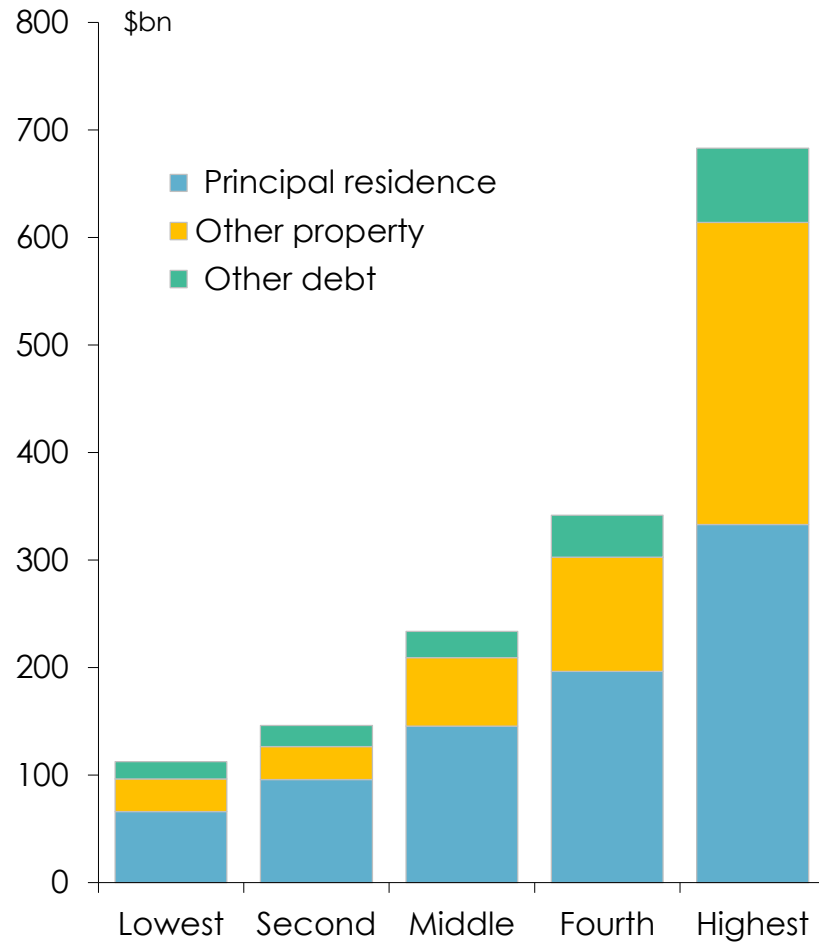
Household debt-to-GDP ratios, September 2017



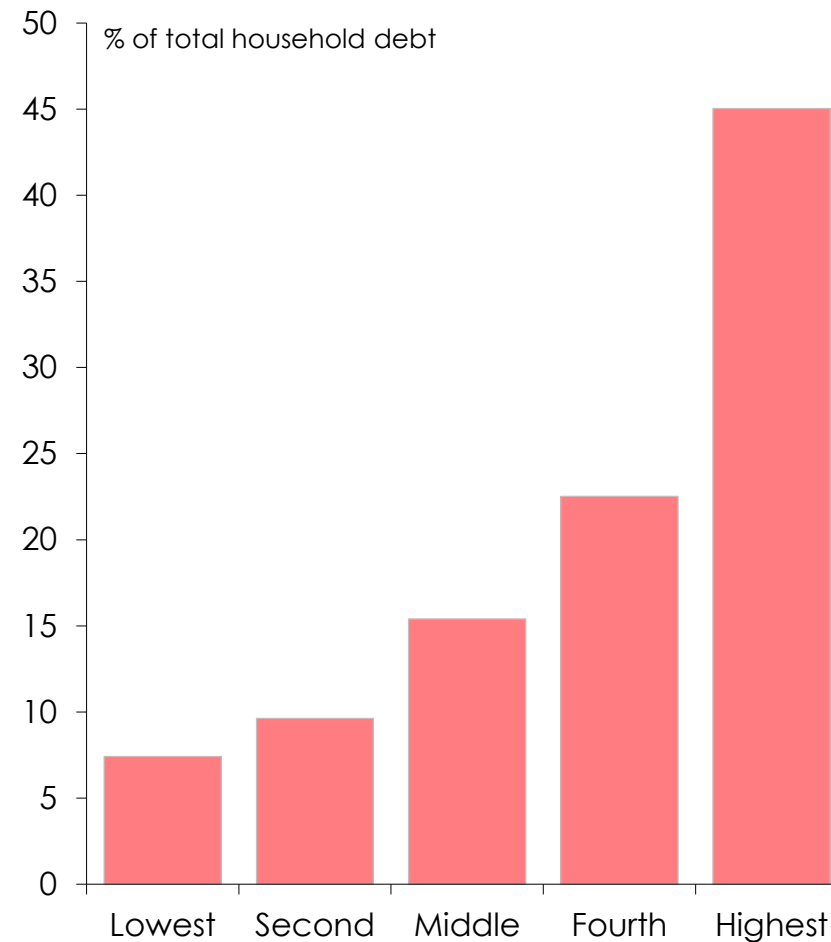
Note: RBA measure of debt-to-income ratio uses income before interest payments as the denominator. Sources: ABS; RBA; Bank for International Settlements.

Two-thirds of Australian household debt is owed by the richest 40% of households – and that hasn't changed much over the past 12 years

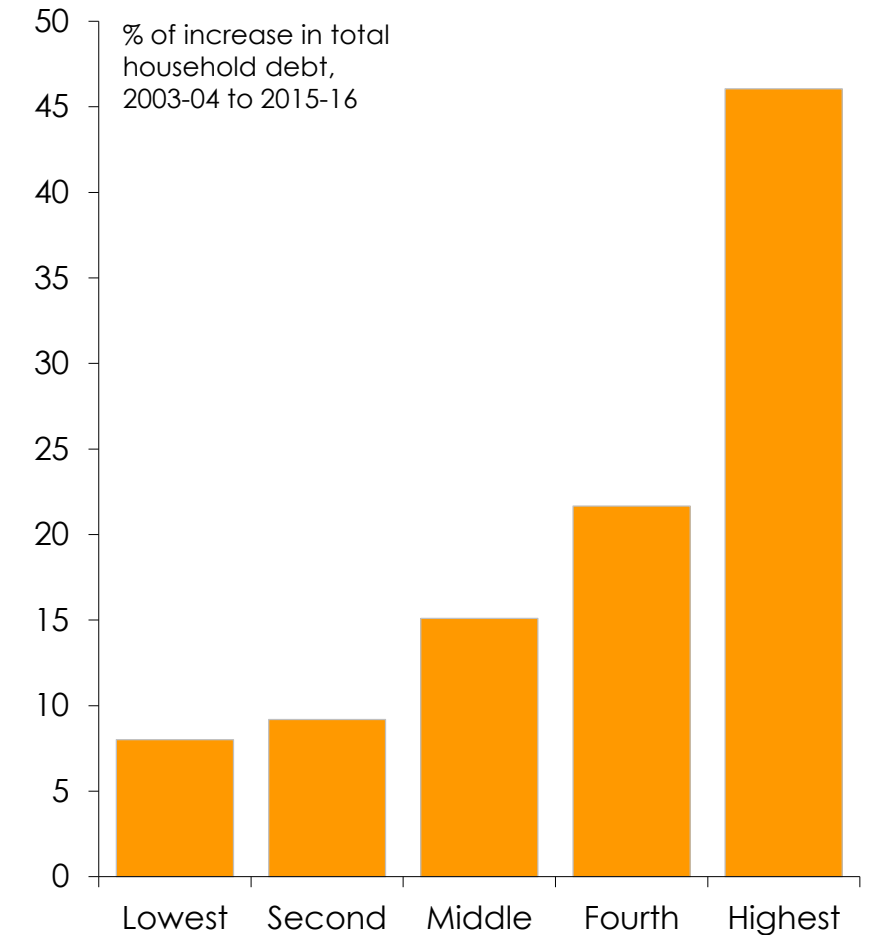
Household debt by income quintile, 2015-16



Share of total debt by income quintile, 2015-16



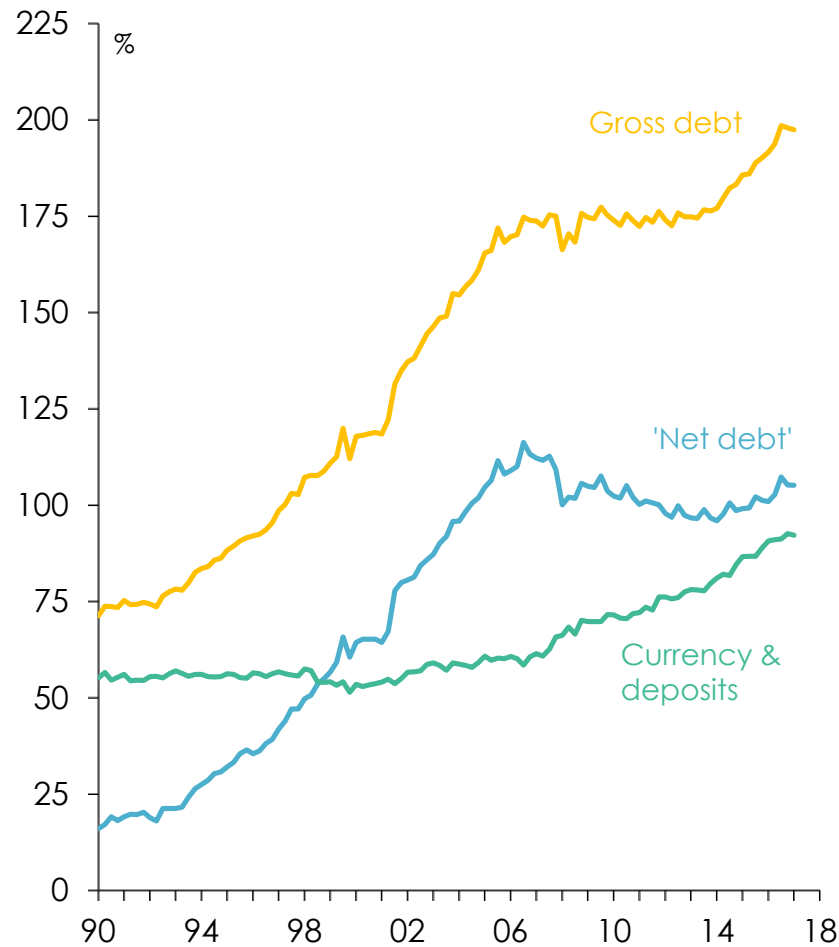
Share of increase in debt by quintile, 2003-04 to 2015-16



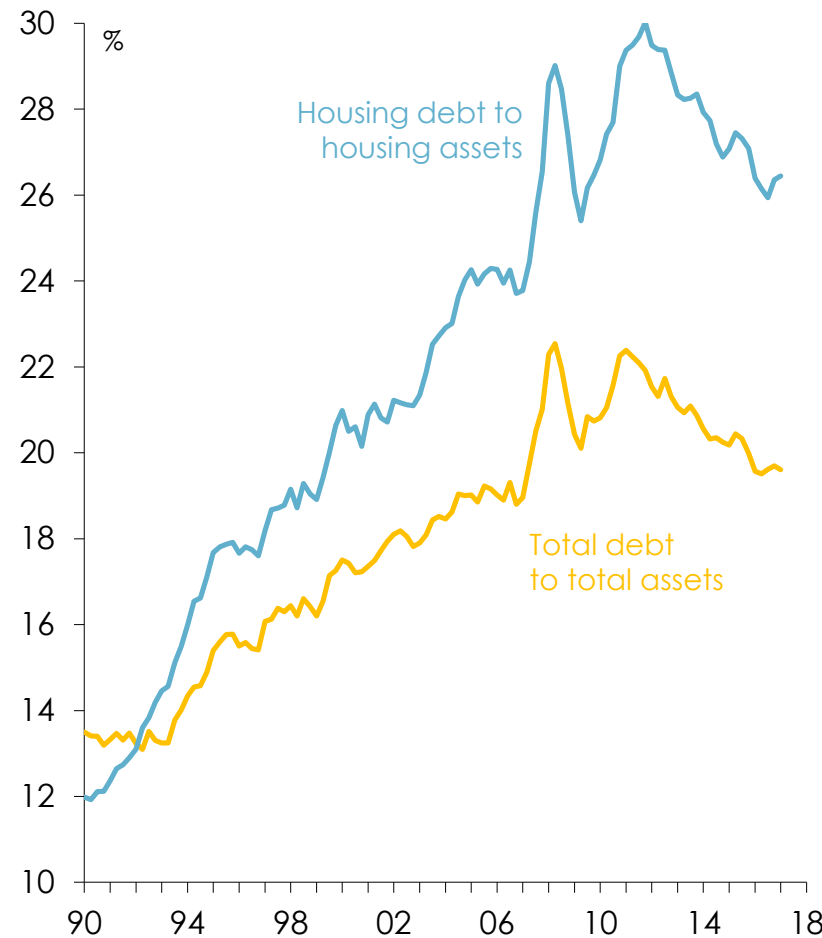
Source: ABS.

High level of household debt shouldn't be considered independently of the level of liquid assets, other assets or debt servicing capacity

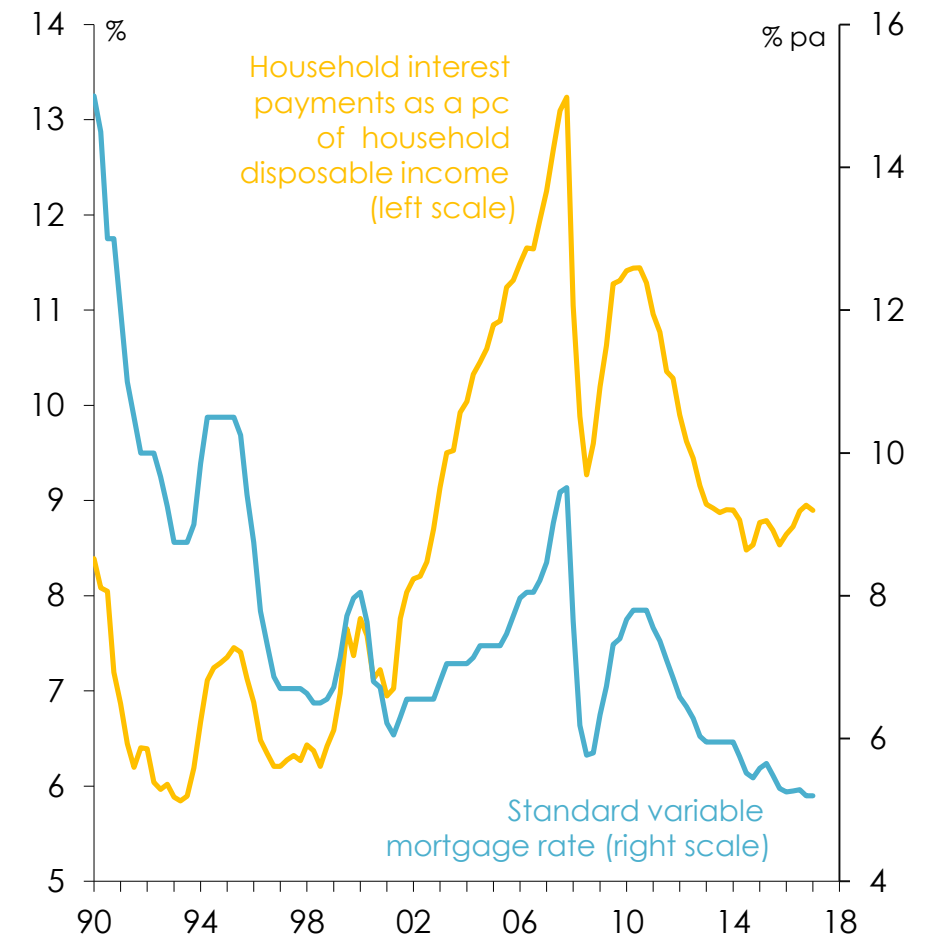
Household gross debt, liquid assets and net debt



Household debt-to-assets ratio



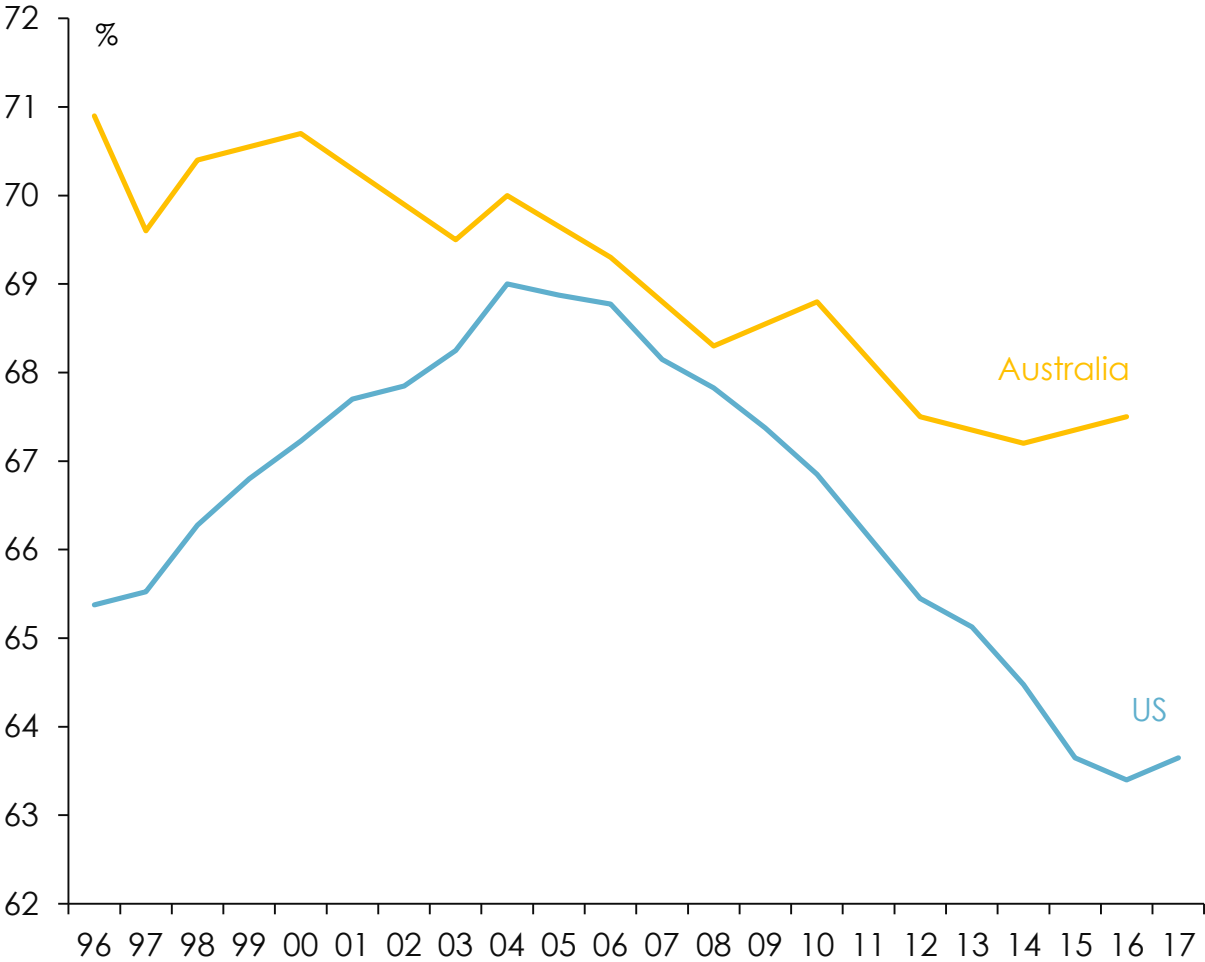
Household interest-to-income ratio



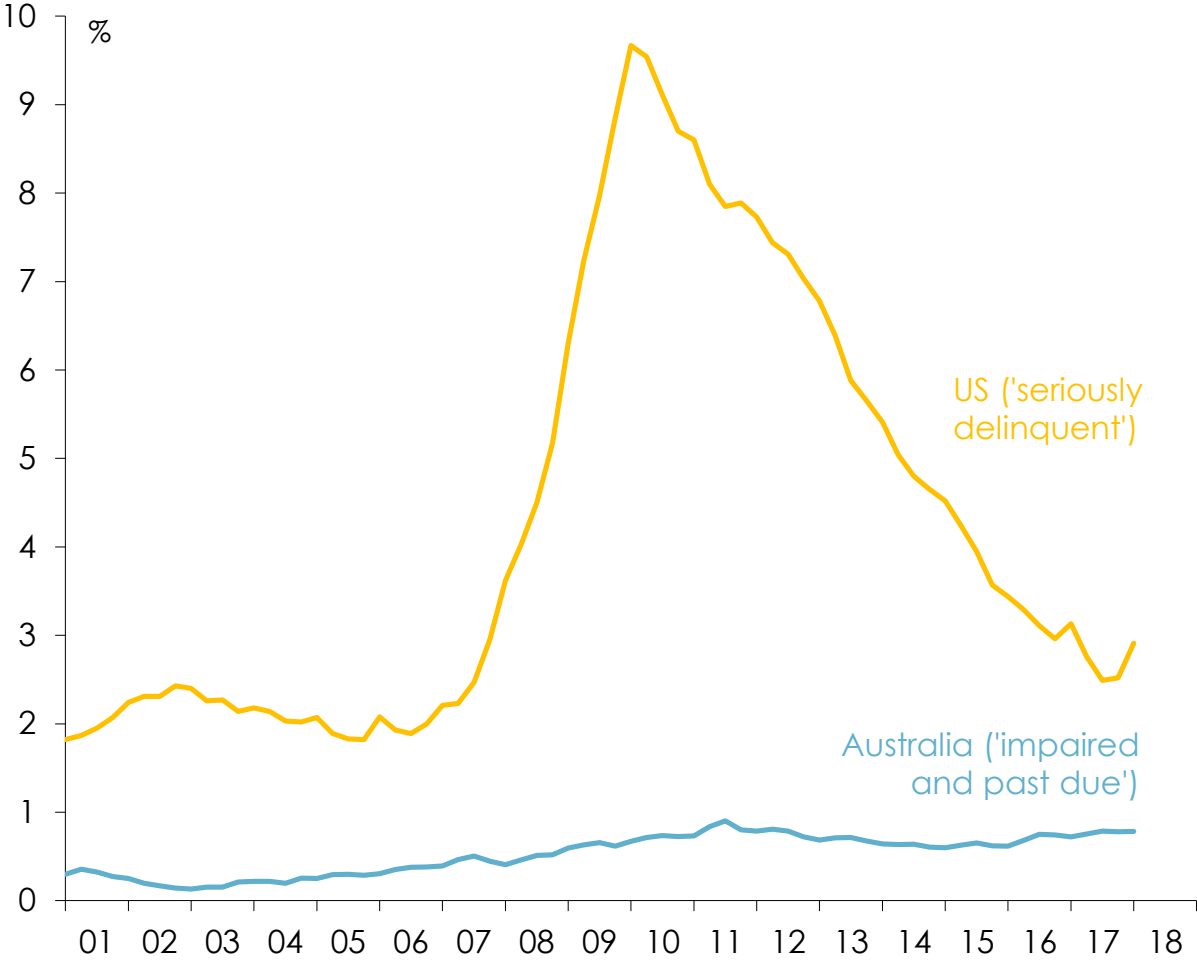
Sources: ABS; RBA.

There's unlikely to be a lot of 'forced sellers' in Australia, as there were in the US a decade ago ...

Home ownership rates, US and Australia



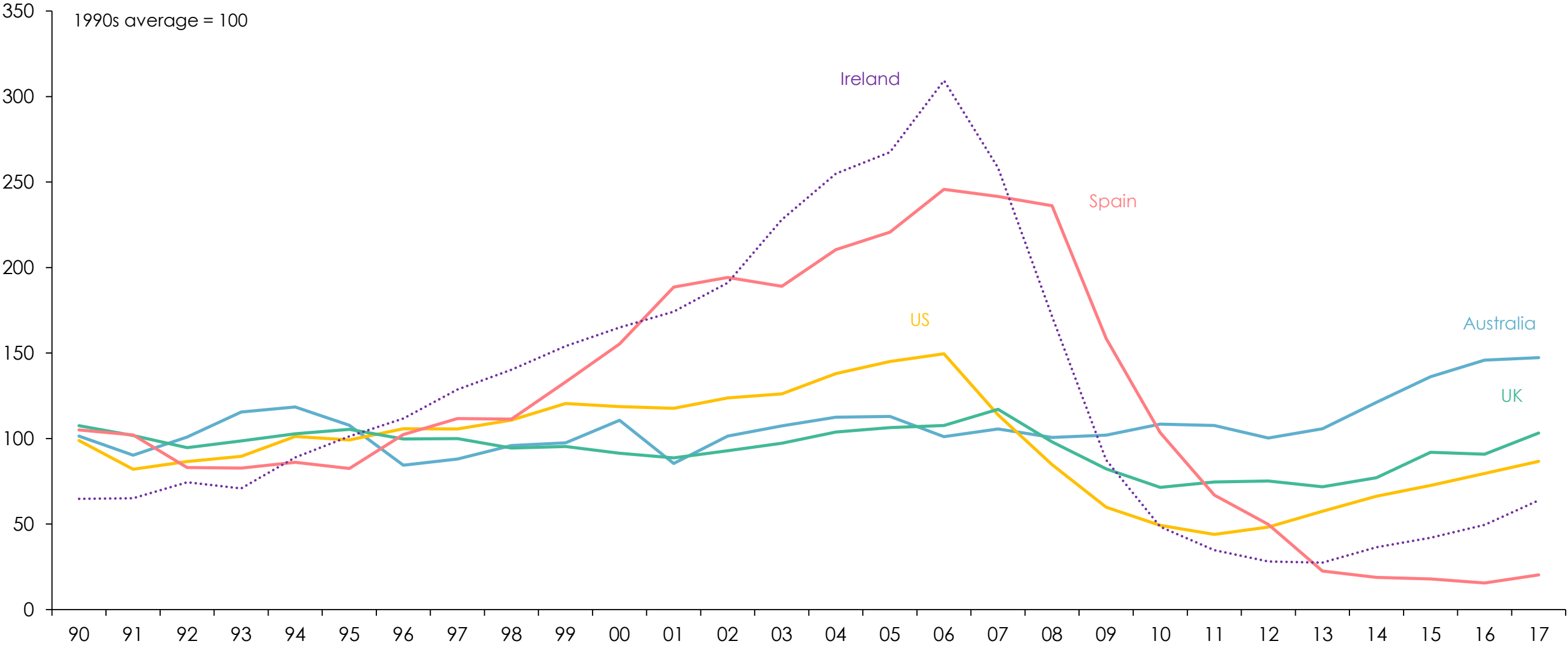
Mortgage delinquency rates, US and Australia



Sources: ABS, US Department of Commerce; ; Reserve Bank of Australia; Mortgage Bankers' Association of America.

... and they're unlikely to be selling into an over-supplied market than in the US, Spain or Ireland a decade ago

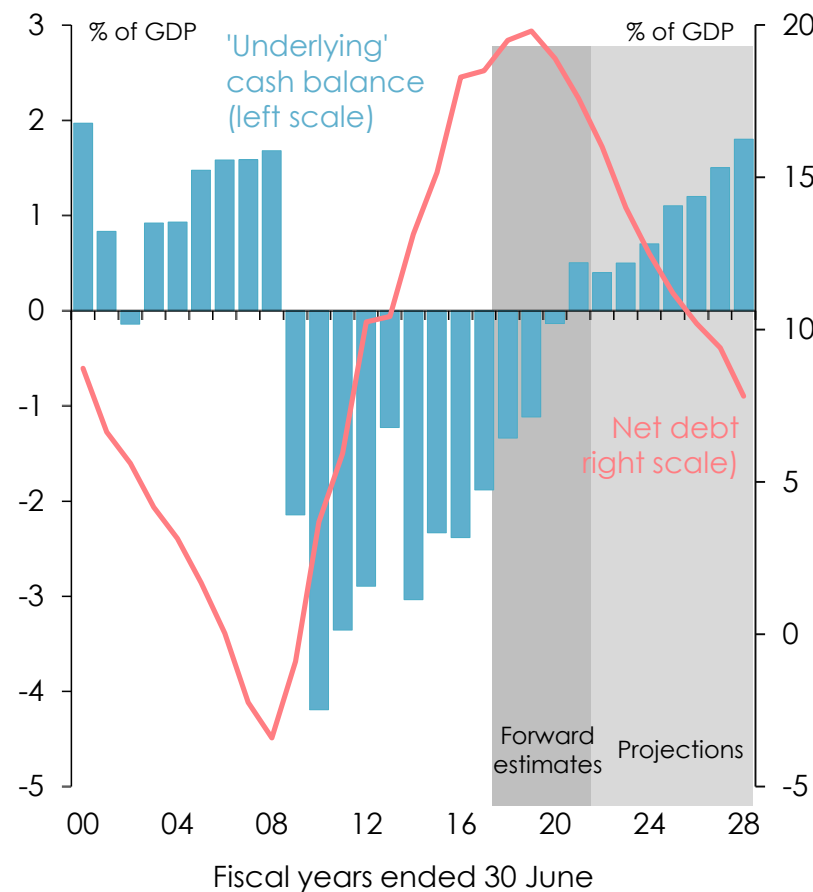
Dwelling completions – Australia and other 'advanced' economies



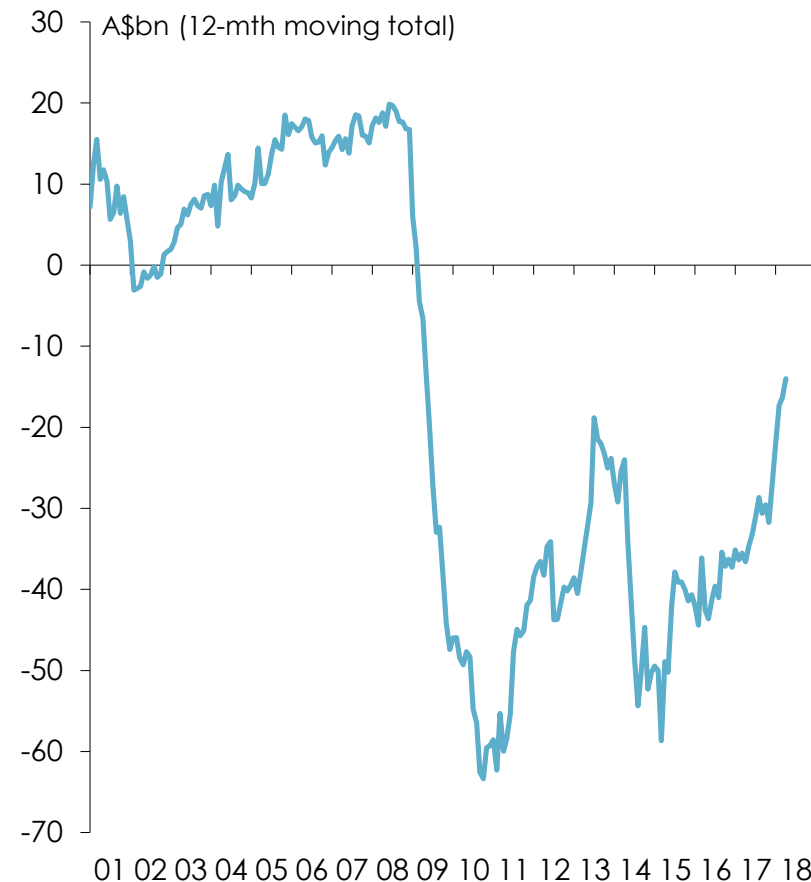
Sources: Australian Bureau of Statistics; US Commerce Department; UK Office of National Statistics; Instituto Nacional de Estadística d'España; Ireland Central Statistics Office.

The Turnbull Government wants to return the budget to surplus in three years and provide for both corporate and personal income tax cuts

Australian Government budget forecasts



Australian Government 'underlying' cash balance



□ The Government's budget position appears to be improving more rapidly than foreshadowed in December's MYEFO

- reflecting stronger-than-expected growth in employment and (possibly) exhaustion of the stock of corporate tax losses from the financial crisis
- although the forecast return to surplus by 2020-21 also relies heavily on an assumed pick-up in wages growth in 2019-20

□ The Government remains committed to cutting the company tax rate for large companies (turnover >\$50mn) by FY 2025

- thus far blocked in the Senate

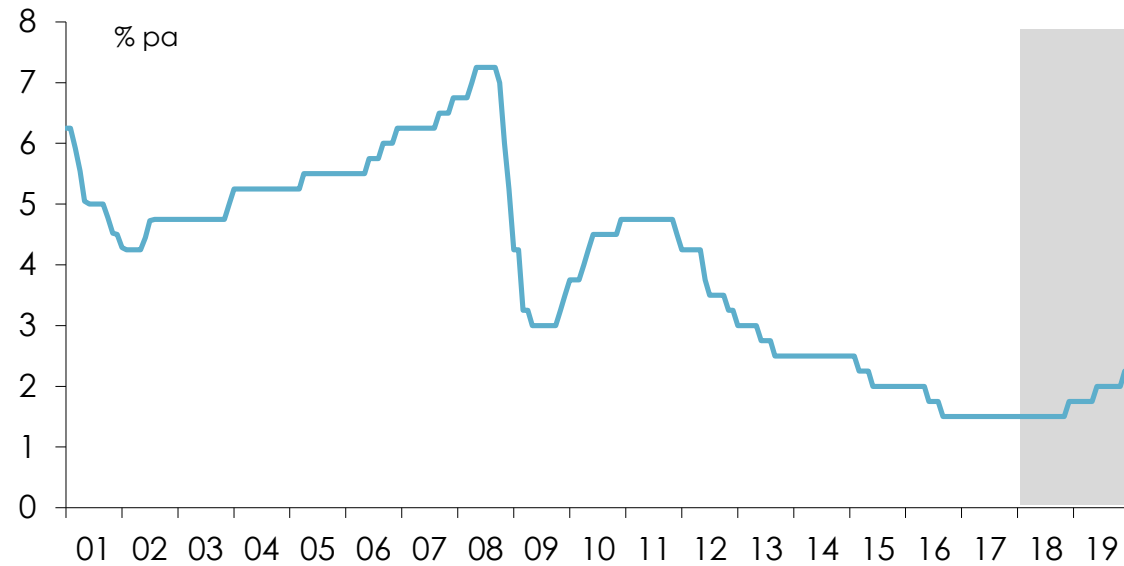
□ But it may now have more room to foreshadow personal income tax cuts in next week's Budget

- if the longer-term economic projections are valid then there is more 'fat' in the budget projections than generally realized

Source: Australian Government *Mid-Year Economic & Fiscal Outlook* December 2017. Note 'projections' assume that tax revenue is 'capped' at 23.9% of GDP from 2021-22 onwards.

The next movement in RBA rates will be upwards – but not in any hurry

RBA cash rate



RBA forecasts

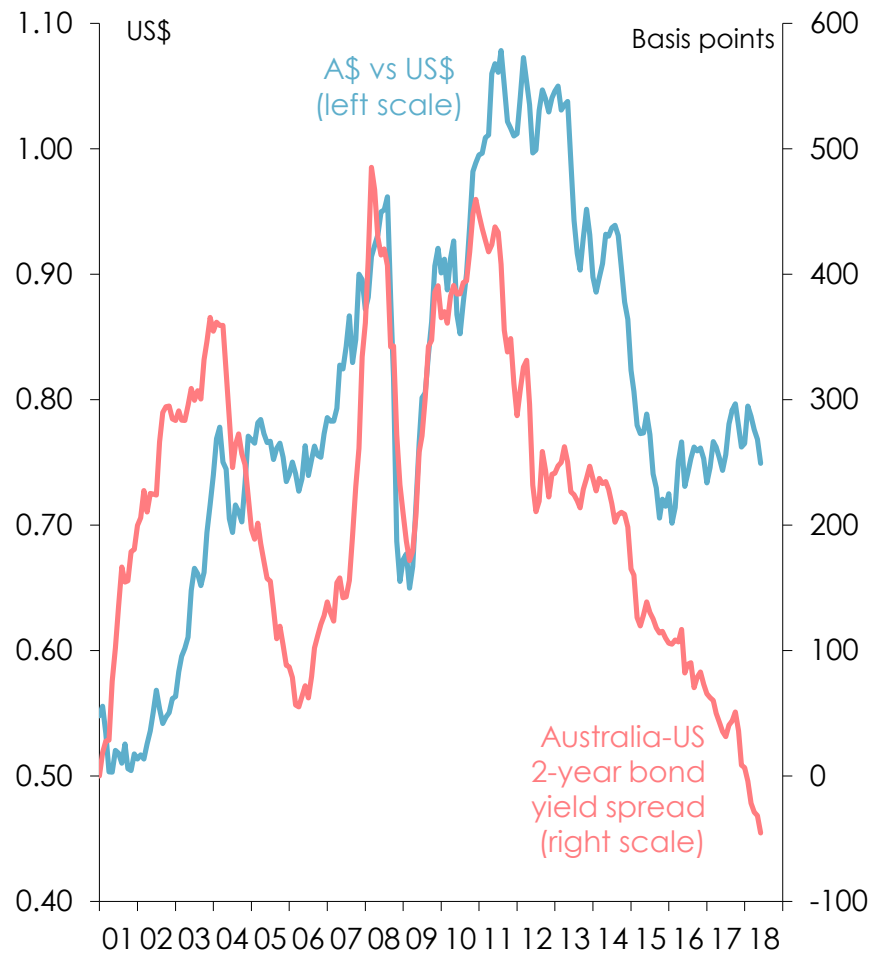
| | Year-ended | | | | | |
|----------------------------------|------------|----------|----------|----------|----------|----------|
| | Dec 2017 | Jun 2018 | Dec 2018 | Jun 2019 | Dec 2019 | Jun 2020 |
| GDP growth | 2½ | 2¾ | 3¼ | 3½ | 3¾ | 3 |
| Unemployment rate ^(b) | 5.5 | 5¼ | 5¼ | 5¼ | 5¼ | 5¼ |
| CPI inflation | 1.9 | 2 | 2¼ | 2¼ | 2¼ | 2¼ |
| Underlying inflation | 1¾ | 1¾ | 1¾ | 2 | 2 | 2¼ |

- ❑ The RBA expects economic growth to remain ‘below trend’ until the second half of 2018, ‘spare capacity’ in the labour market to persist until after 2019, and ‘underlying’ inflation to remain below its target band until mid-2019
- ❑ These are not the forecasts of a central bank that is on the cusp of tightening monetary policy
- ❑ Of course, the RBA need not keep interest rates at current record lows until all of the key economic variables are where they want them to be
- ❑ But the RBA’s current set of forecasts does not impel any urgency about moving away from current monetary policy settings
- ❑ The RBA would be delighted to see [further] increases in foreign interest rates while it ‘stands pat’ reflected in a decline in the A\$
- ❑ First move now not expected before November this year

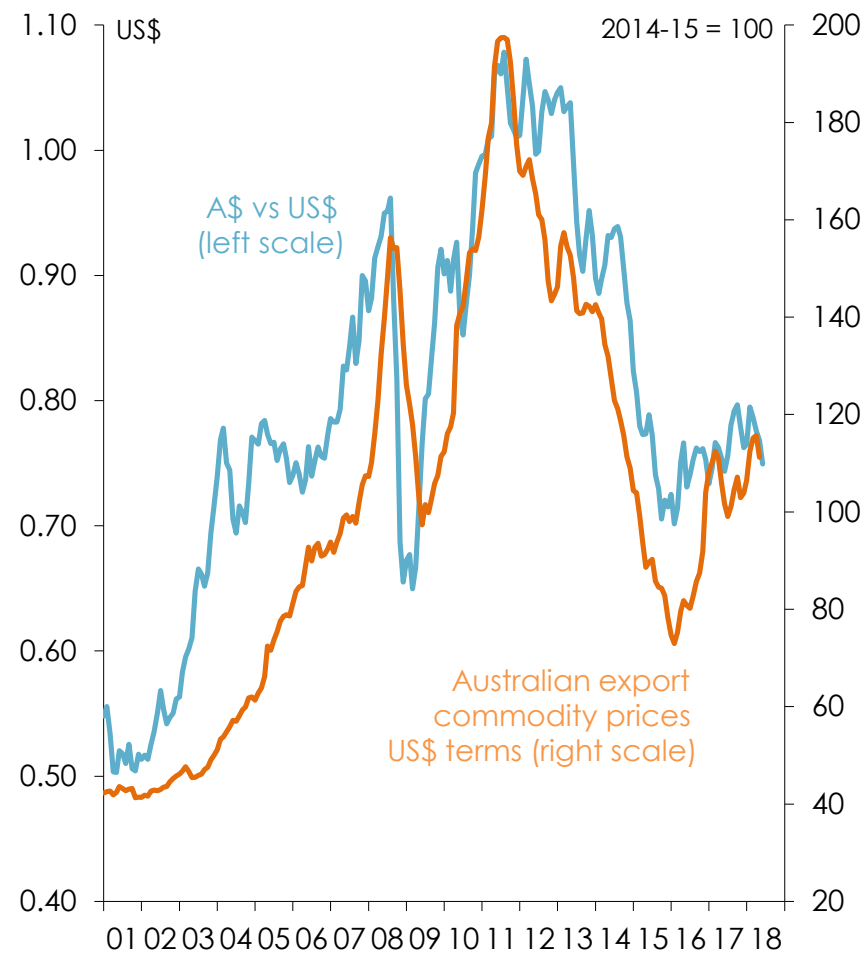
Source: RBA, *Statement on Monetary Policy*, February 2018.

Australian rates are now below US rates – but the effect of that on the A\$ has been offset by stronger commodity prices

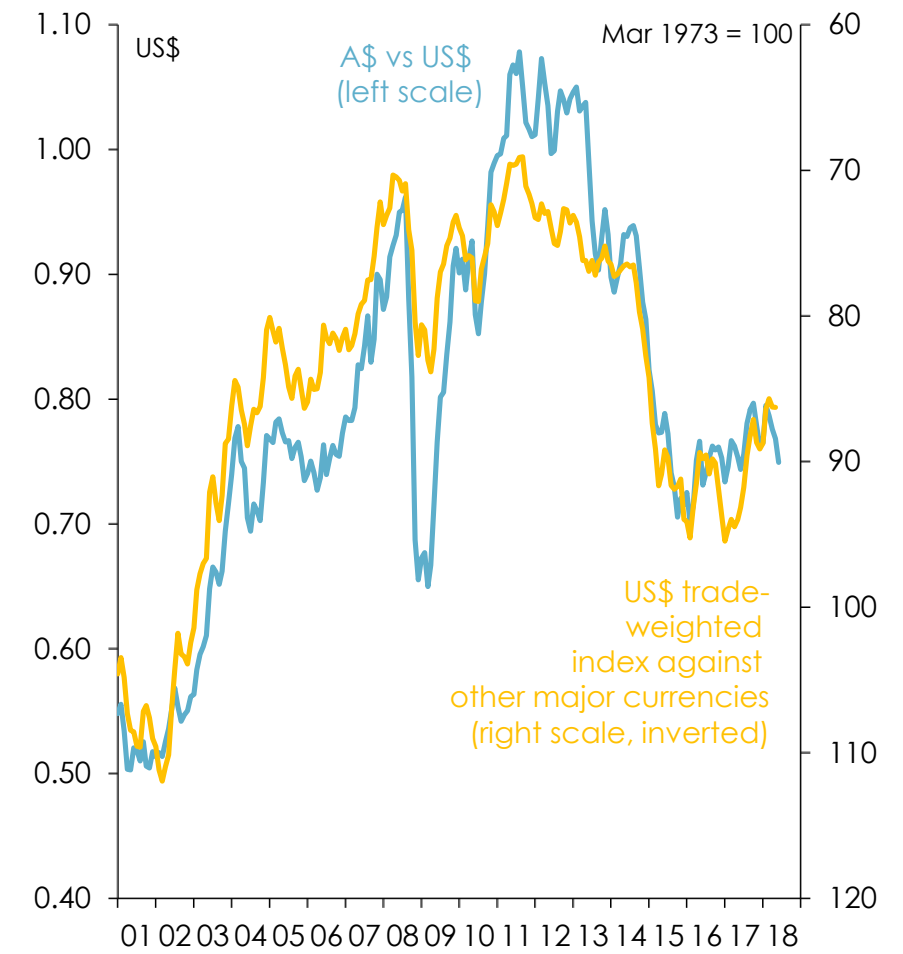
A\$-US\$ rate and Australia-US interest rate spreads



A\$-US\$ rate and commodity prices



A\$-US\$ rate and US\$ vs other major currencies



Sources: Thomson Reuters Datastream; Federal Reserve Board; RBA.

Principal risks to the Australian economic outlook

❑ A 'hard landing' in China

- China takes a larger proportion of Australia's exports than any single country has done since the UK in the 1950s, and moreover also strongly influences the prices of many of our exports to other countries – so an abrupt slowdown in the Chinese economy would inevitably have a major impact on Australia
- Australia's tourism, education and agricultural exports are also vulnerable to expressions of Chinese 'displeasure' at Australian government policies or attitudes on 'geo-political' issues

❑ A global 'trade war' and other threats to the 'rules based' international economic system

- Imposition of tariffs and other trade barriers by the US, and 'tit-for-tat' retaliation by other countries, threatens to undermine business confidence, disrupt international trade, force prices up, and detract from economic growth – there are no 'winners' in trade wars – and Australia would not be exempt

❑ A slump in the US\$

- A sharp fall in the US\$ triggered by economic or political stability concerns about the US would (all else being equal) likely see upward pressure on the A\$ (and other currencies), adversely affecting Australian economic growth, putting unwelcome downward pressure on Australian inflation and potentially forcing the RBA to cut rates.

❑ A 'housing bust'

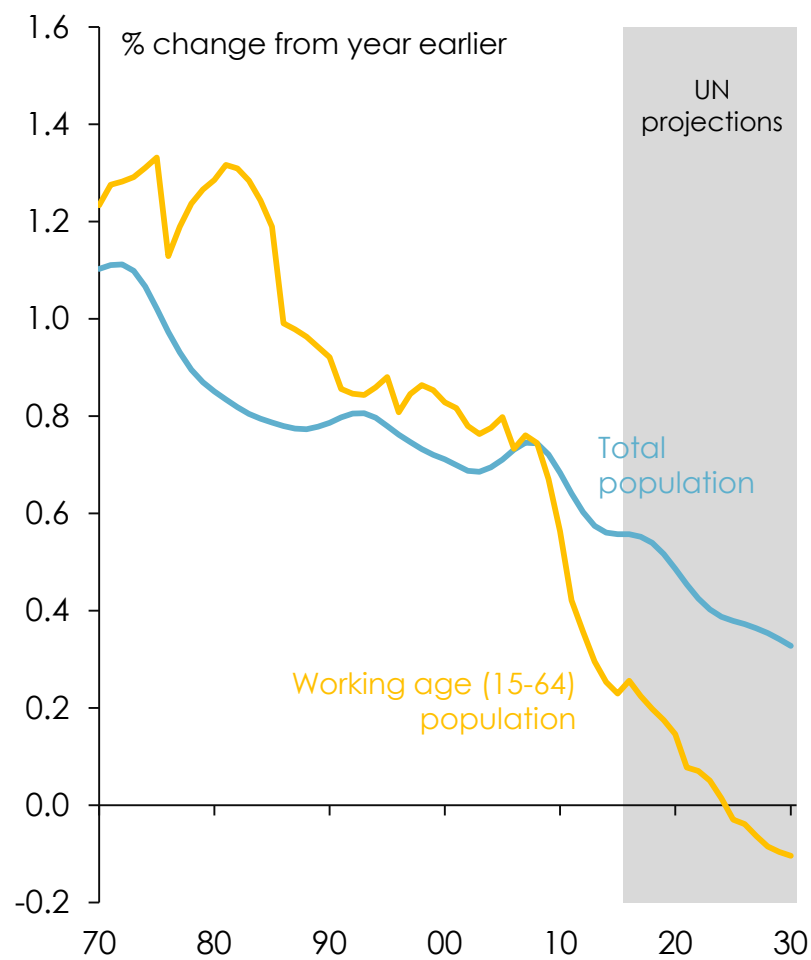
- This is the risk most commonly cited by foreign observers. A sharp fall in housing prices represents a greater threat to economic activity than it does to the financial system, because of the response it would trigger among mortgaged households to avoid defaulting on their loans (sharp reductions in discretionary spending in order to maintain repayments). However for reasons outlined in this presentation a 'housing bust' is not a high-probability scenario.

❑ An abrupt slowing in immigration

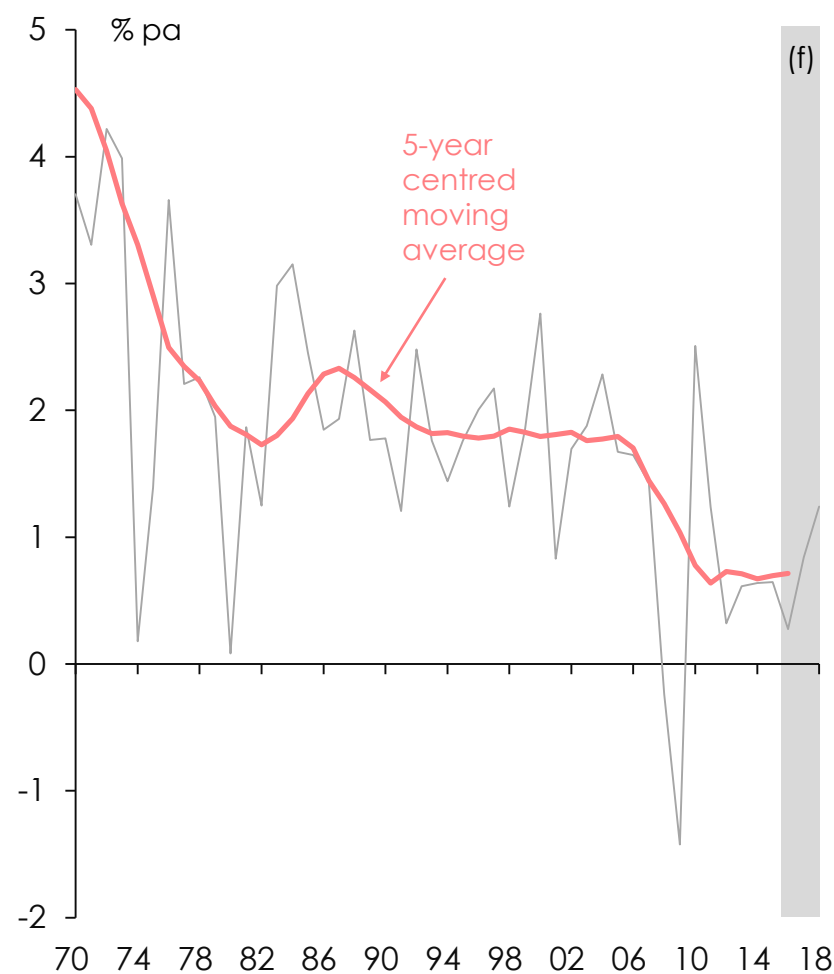
- would undermine one of the most important but least recognized drivers of Australian economic growth.

The medium-to-longer term outlook for 'advanced' economies is limited by demographic change and slower productivity growth

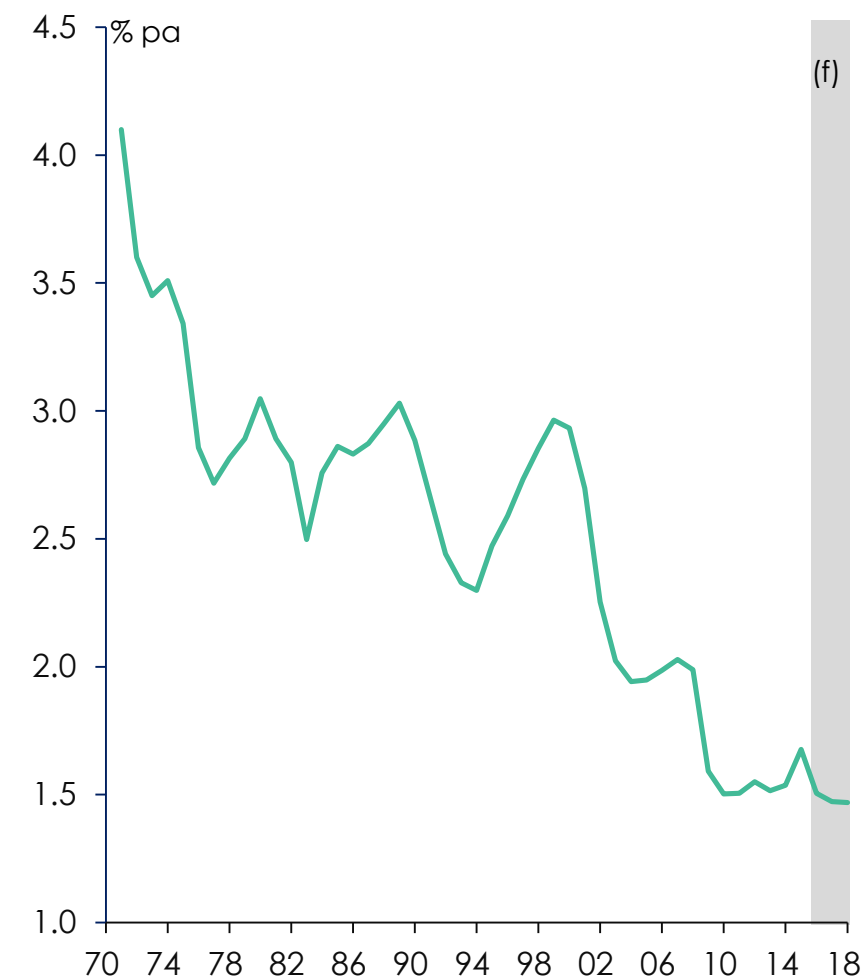
OECD area population growth



OECD area labour productivity growth



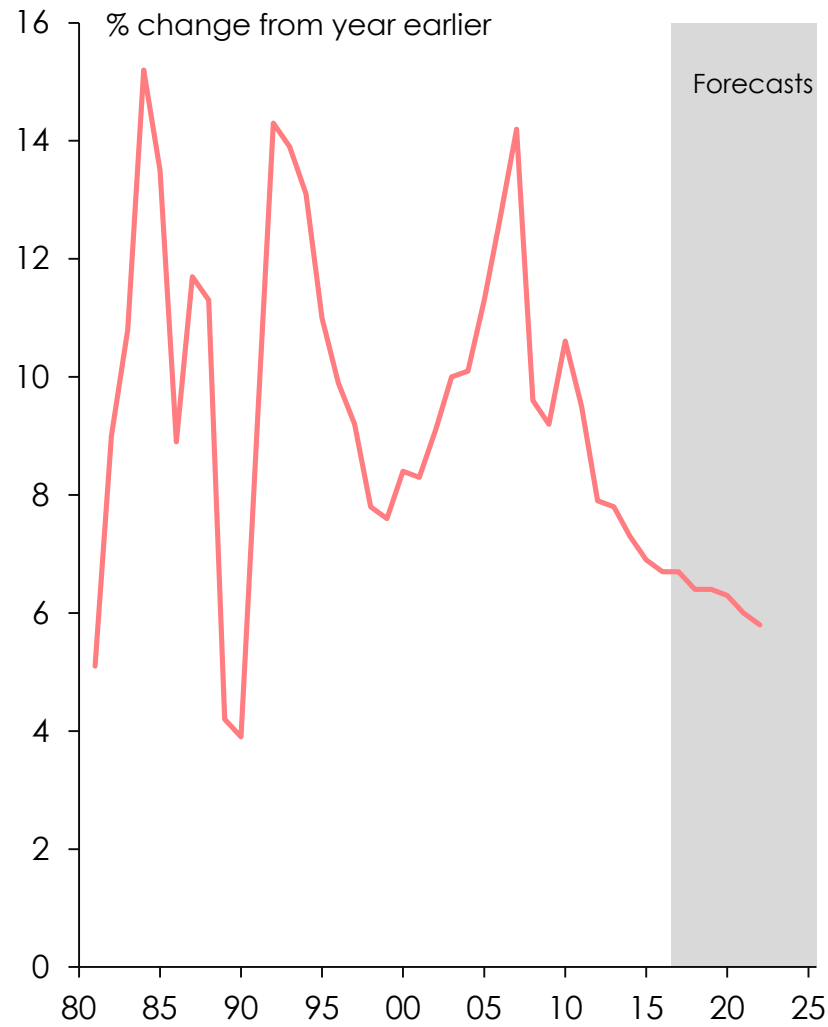
OECD area potential GDP growth



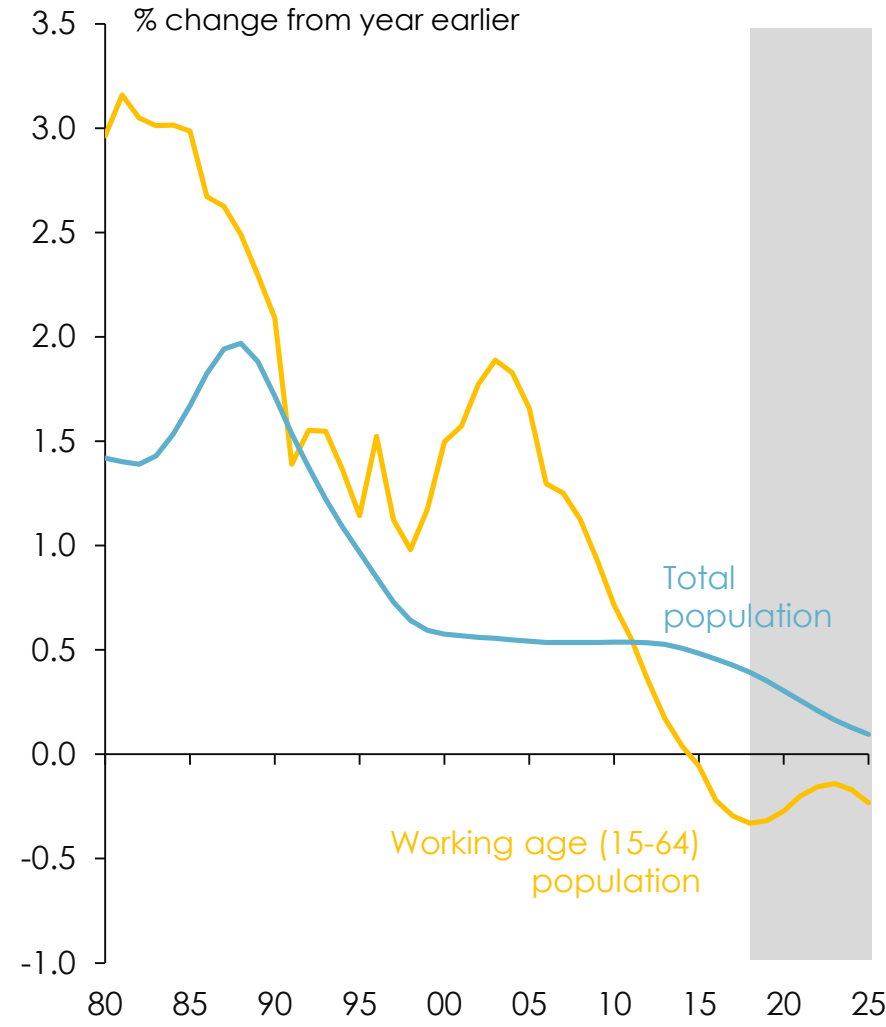
Sources: United Nations Economic & Social Affairs Division, Population Branch, *World Population Prospects – The 2017 Revision*; Organization for Economic Co-operation & Development (OECD), *Economic Outlook* database June 2017. 'Potential growth' means growth in the level of real GDP assuming full employment of the available labour force. Note that the OECD area includes some 'emerging' economies (Mexico, Turkey, Chile) and excludes some 'advanced' ones (Taiwan, Hong Kong and Singapore)

China's long-term outlook will also be severely constrained by the ageing of its population – although it has more potential for productivity growth

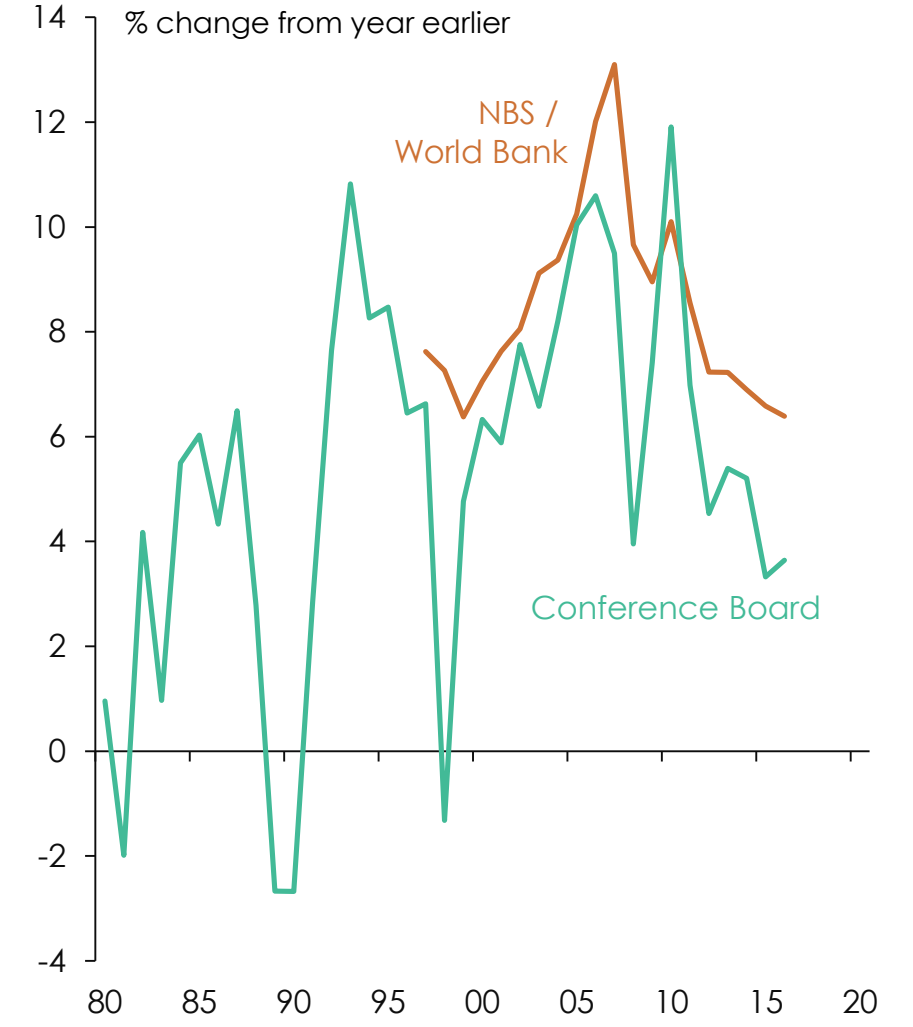
China real GDP growth



Chinese population



Chinese labour productivity



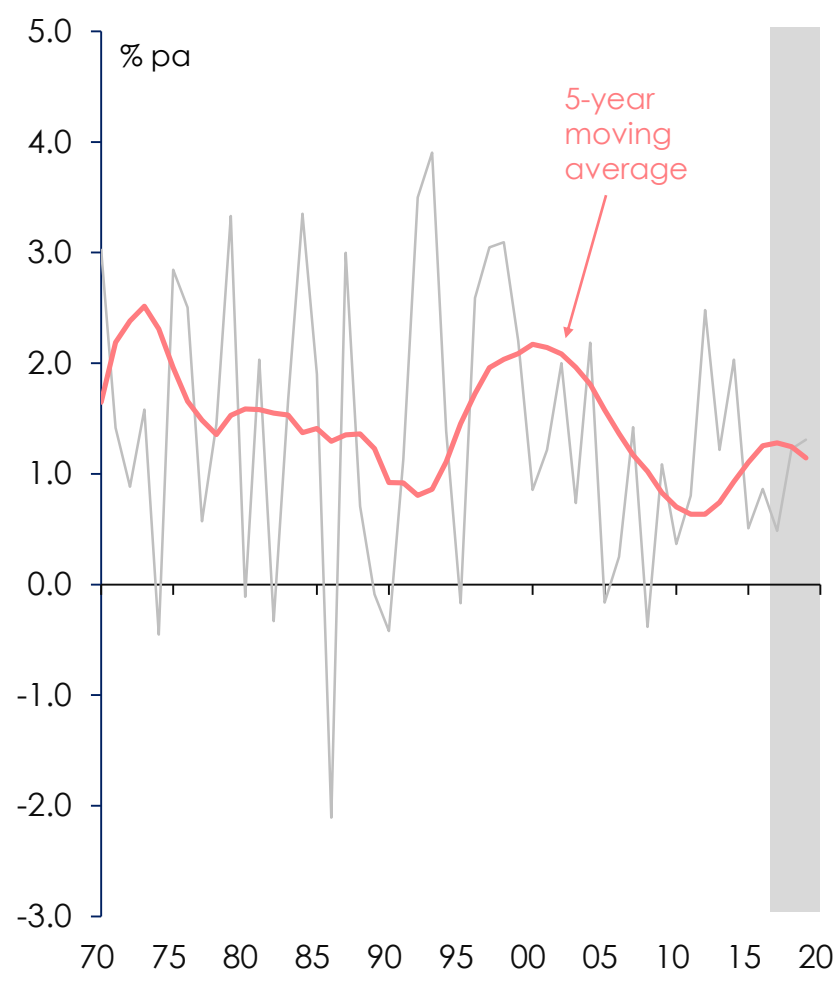
Sources: China National Bureau of Statistics; IMF; UN Economic & Social Affairs Division, Population Branch; The Conference Board; World Bank Group.

Australia's demographic profile isn't as challenging as that of most other 'advanced' economies but potential growth will still be slower

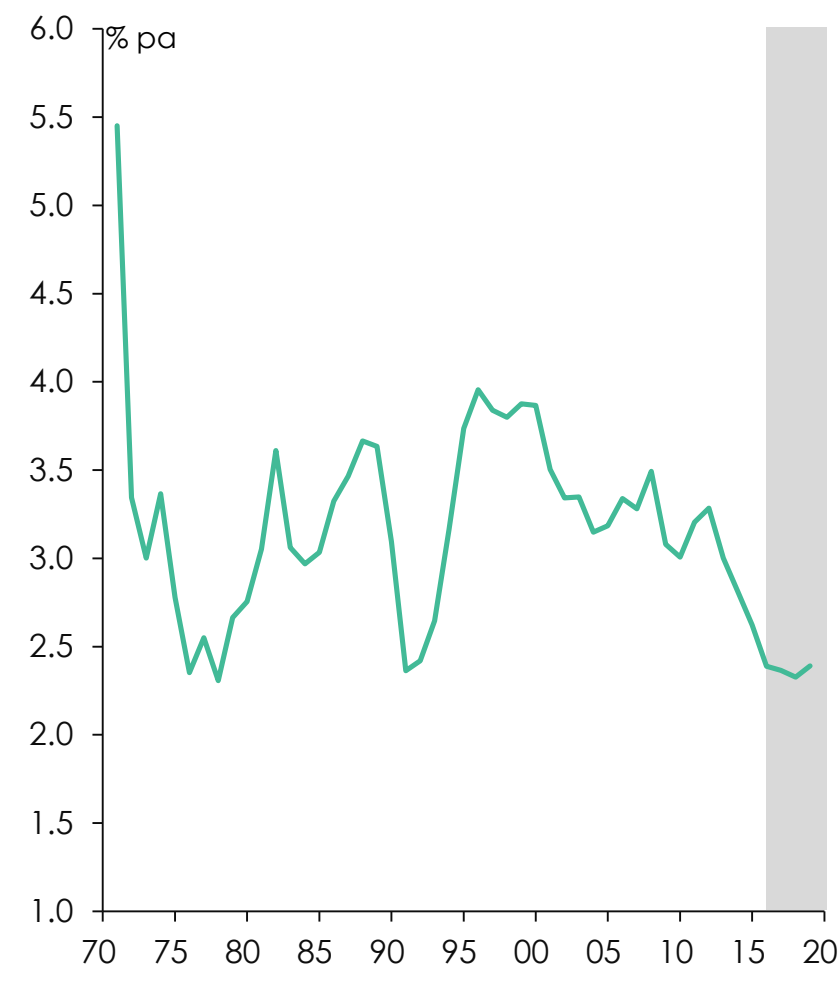
Australian population growth



Australian labour productivity growth



Australian potential GDP growth



Sources: United Nations Economic & Social Affairs Division, Population Branch, *World Population Prospects – The 2017 Revision*; Organization for Economic Co-operation & Development (OECD), *Economic Outlook* database December 2017. 'Potential growth' means growth in the level of real GDP assuming full employment of the available labour force.