

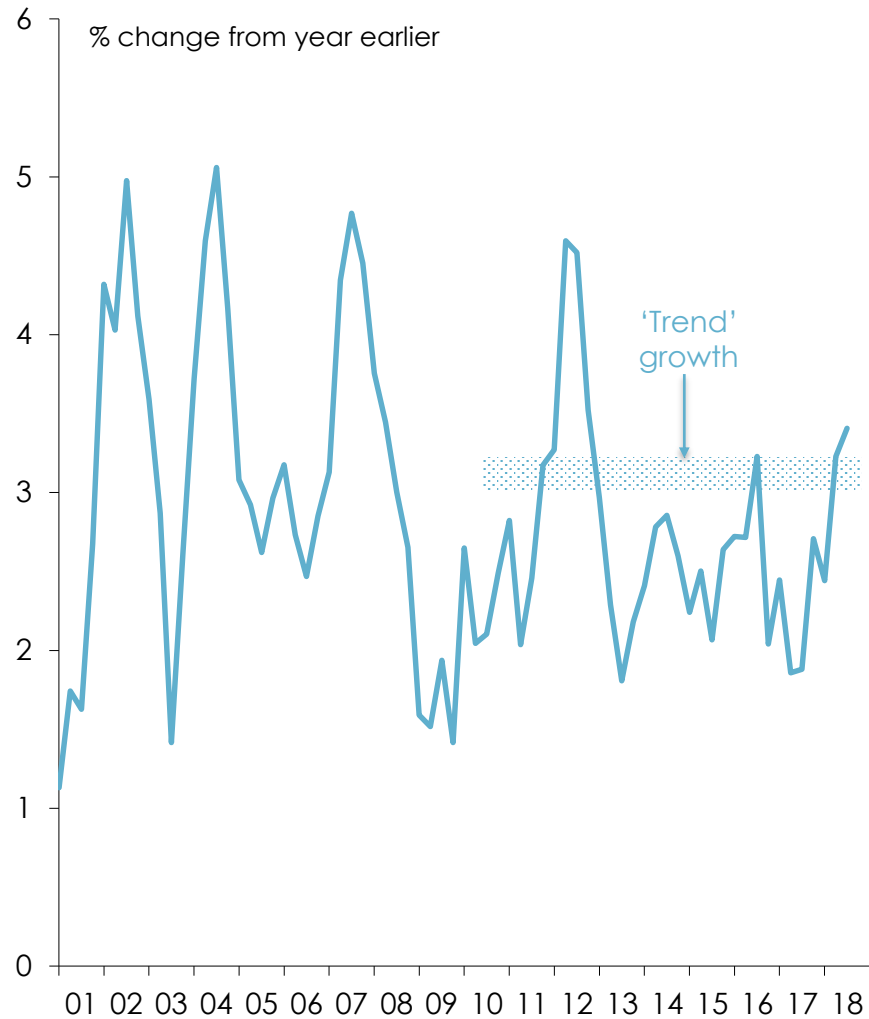
OUTLOOK FOR THE AUSTRALIAN ECONOMY

PRESENTATION TO A LUNCH HOSTED BY
SHARP & CARTER

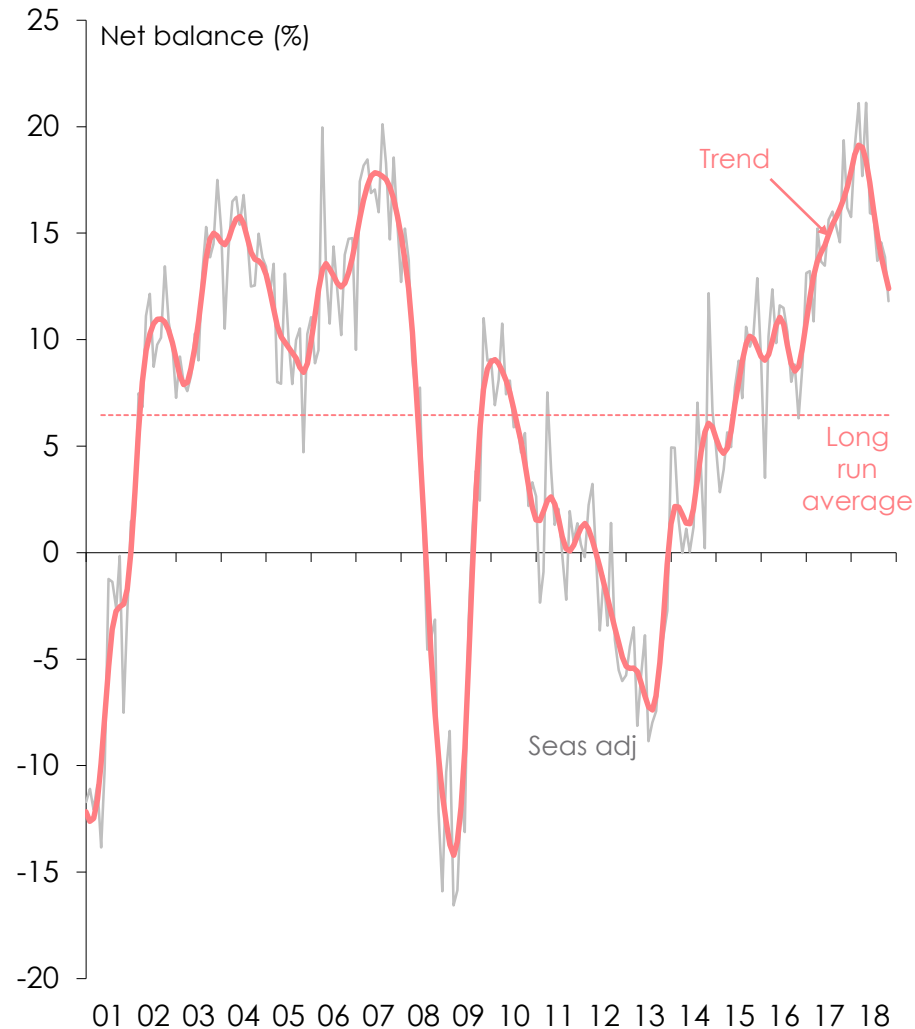
MELBOURNE, 16TH NOVEMBER 2018

Australian economic growth is now above 'trend', business conditions are 'good', but both business and consumer confidence are soft

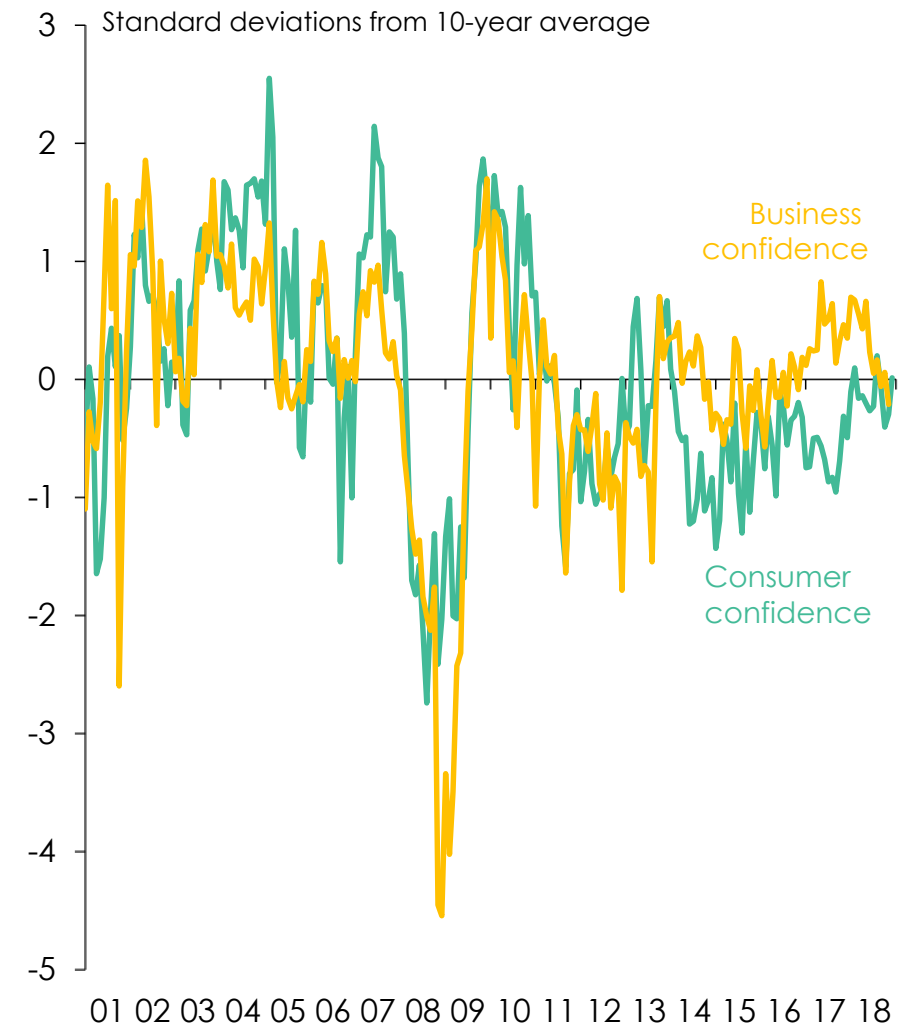
Economic growth (real GDP)



'Business conditions' (NAB survey)



Business and consumer confidence

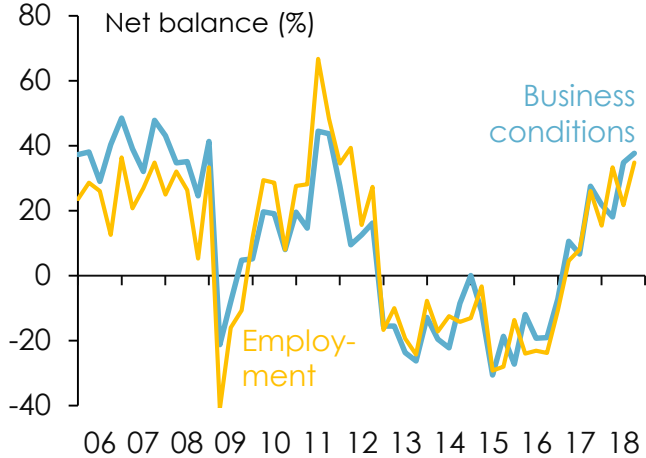


Sources: ABS; National Australia Bank; Westpac-Melbourne Institute.

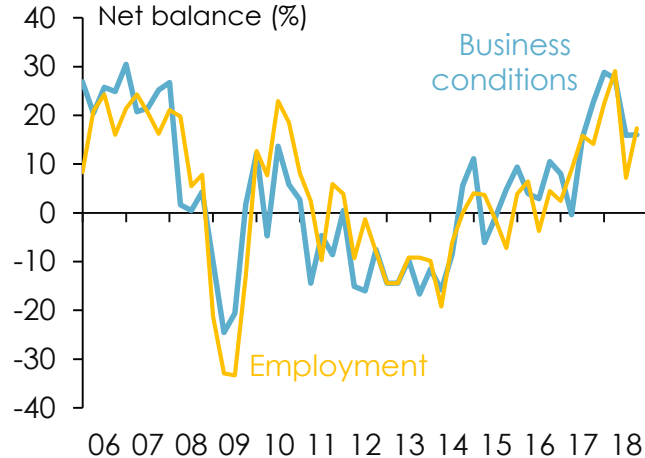
Economic growth is more even across major sectors, with mining and even manufacturing picking up, though retail is still struggling

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

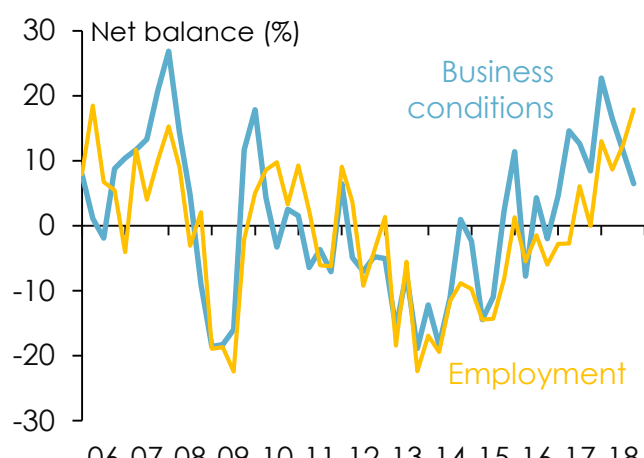
Mining



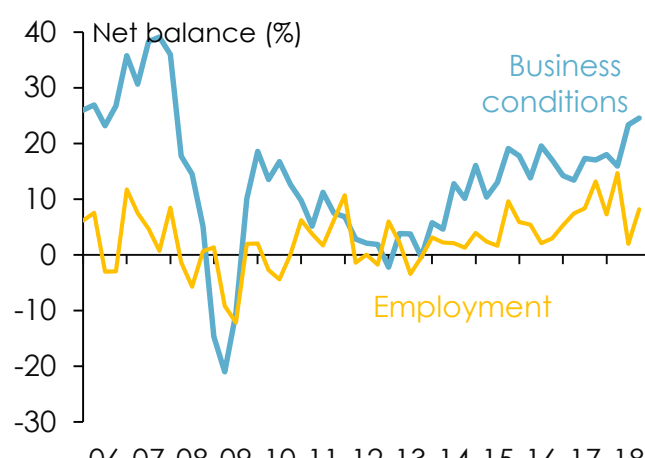
Construction



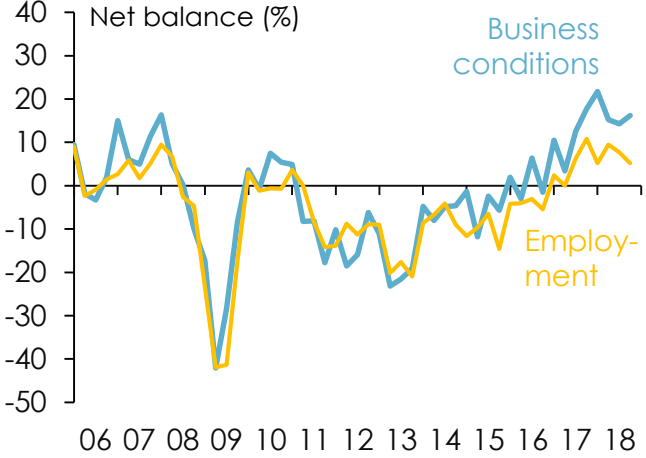
Wholesale trade



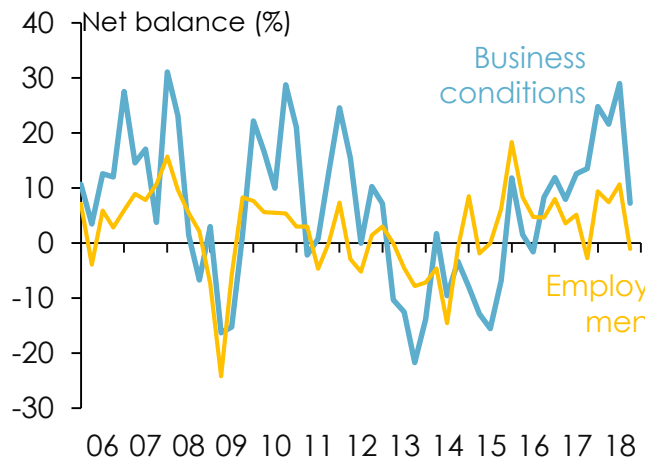
Finance



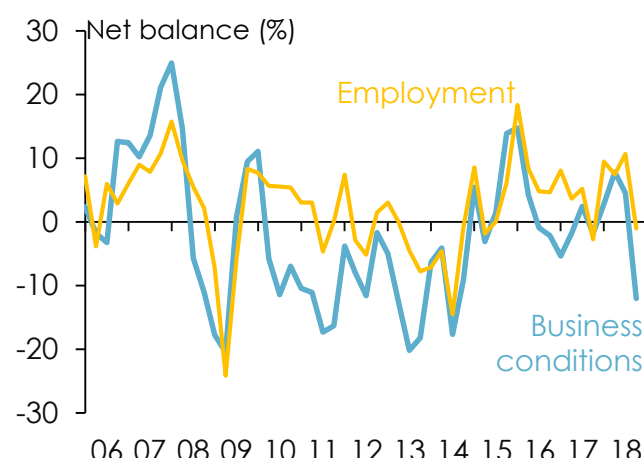
Manufacturing



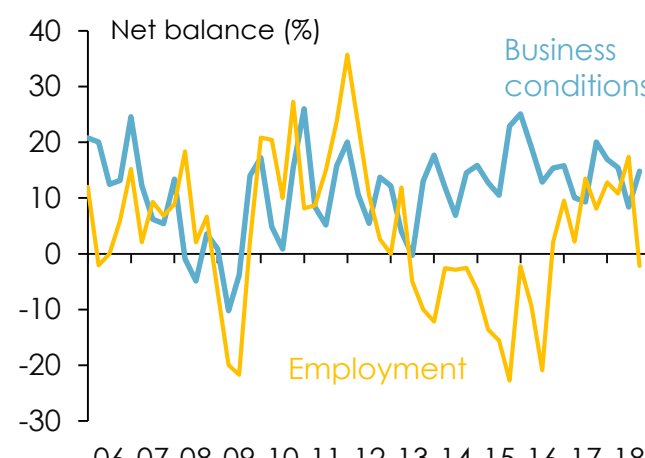
Transport



Retail trade



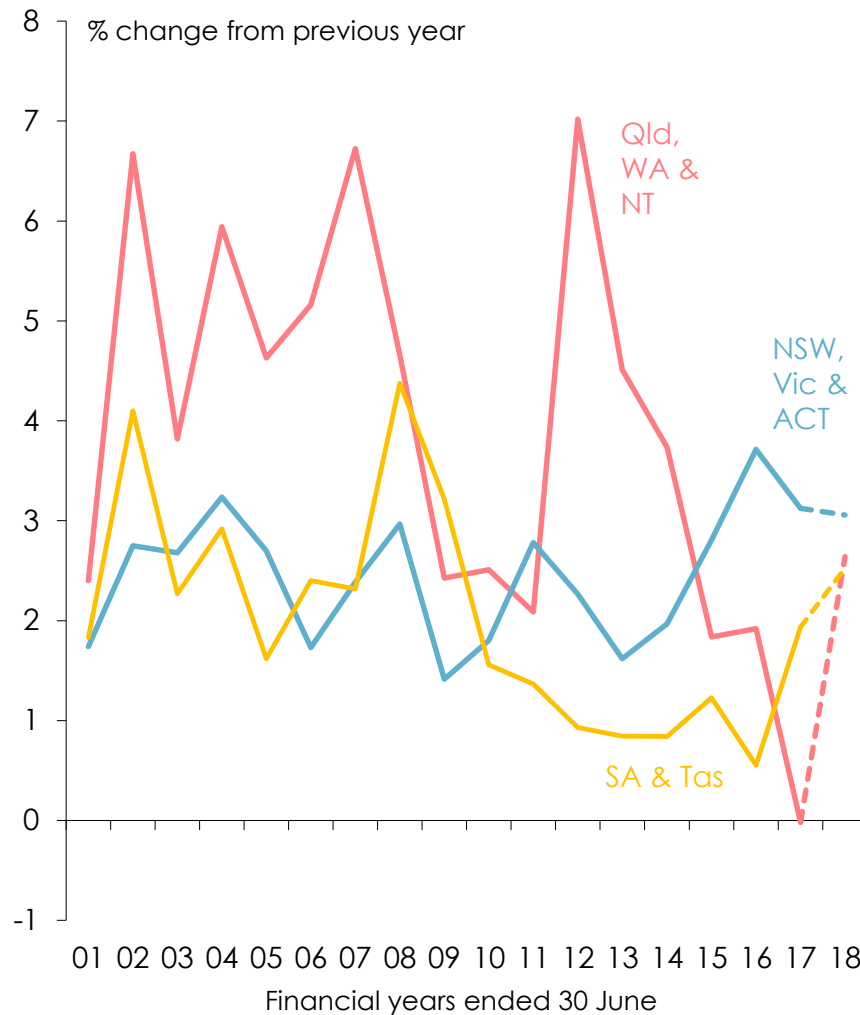
Recreation



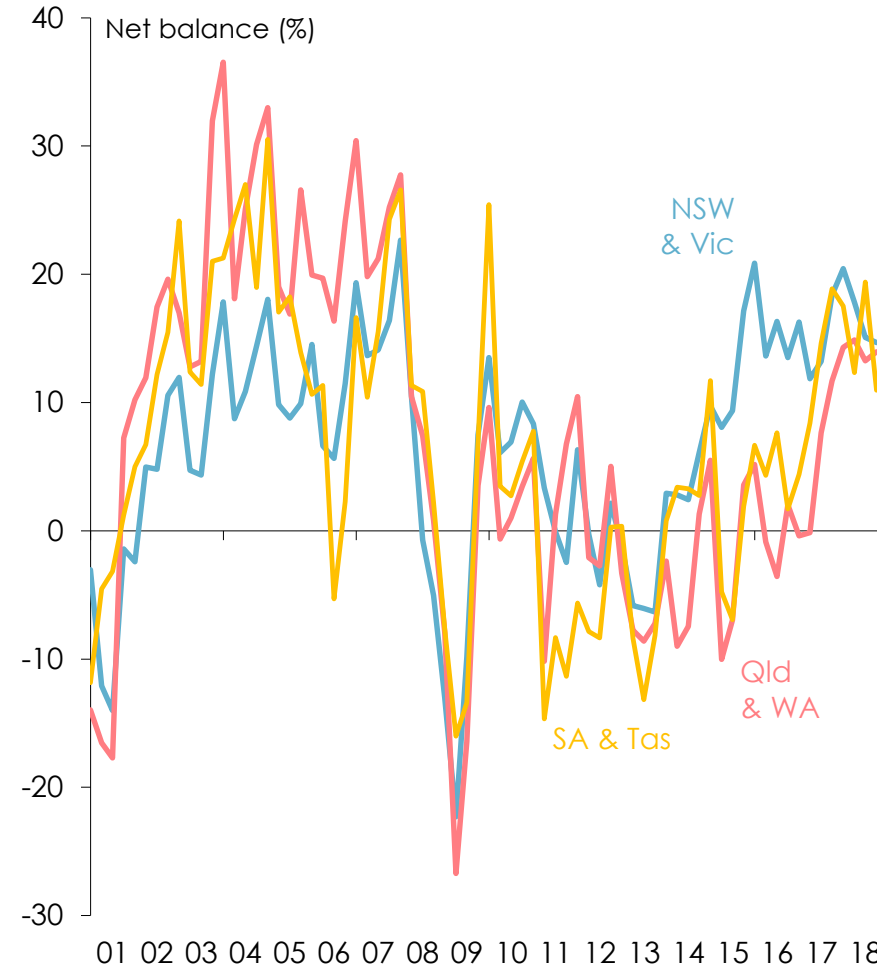
Source: National Australia Bank.

The strongest-performing state economies are in NSW and Victoria, but growth is more evenly distributed across Australia than previously

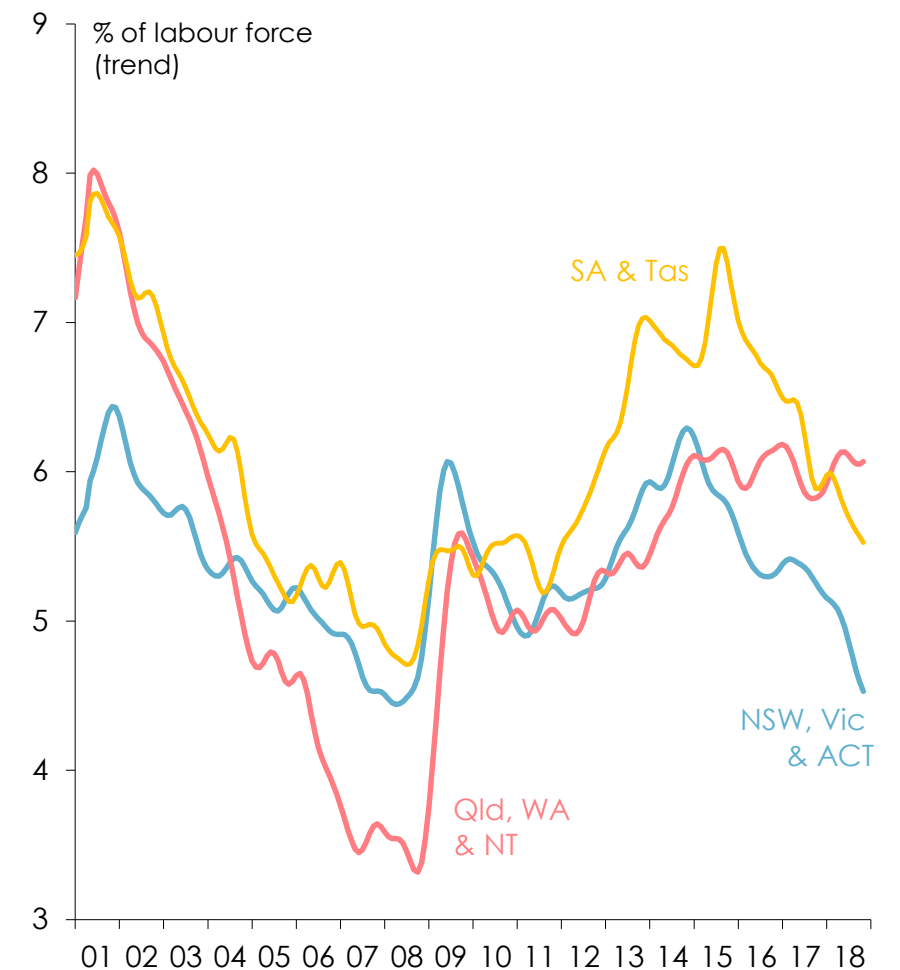
Economic growth (real GSP)



'Business conditions' (NAB survey)



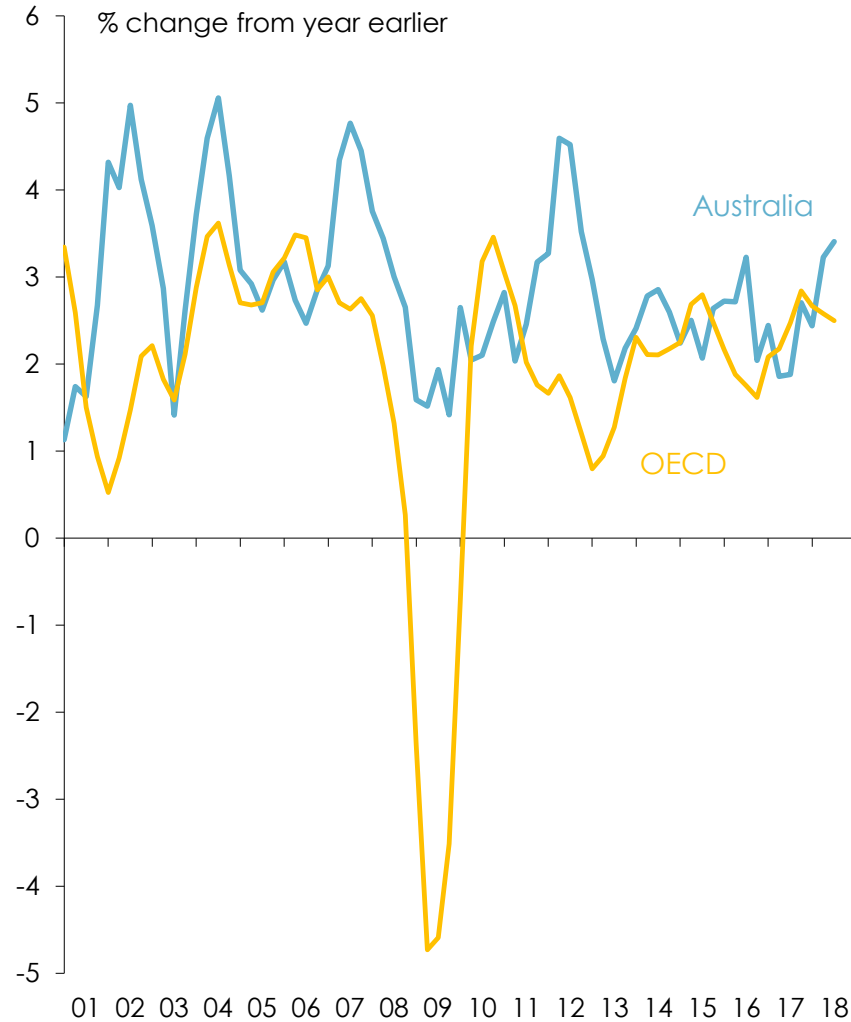
Unemployment rates



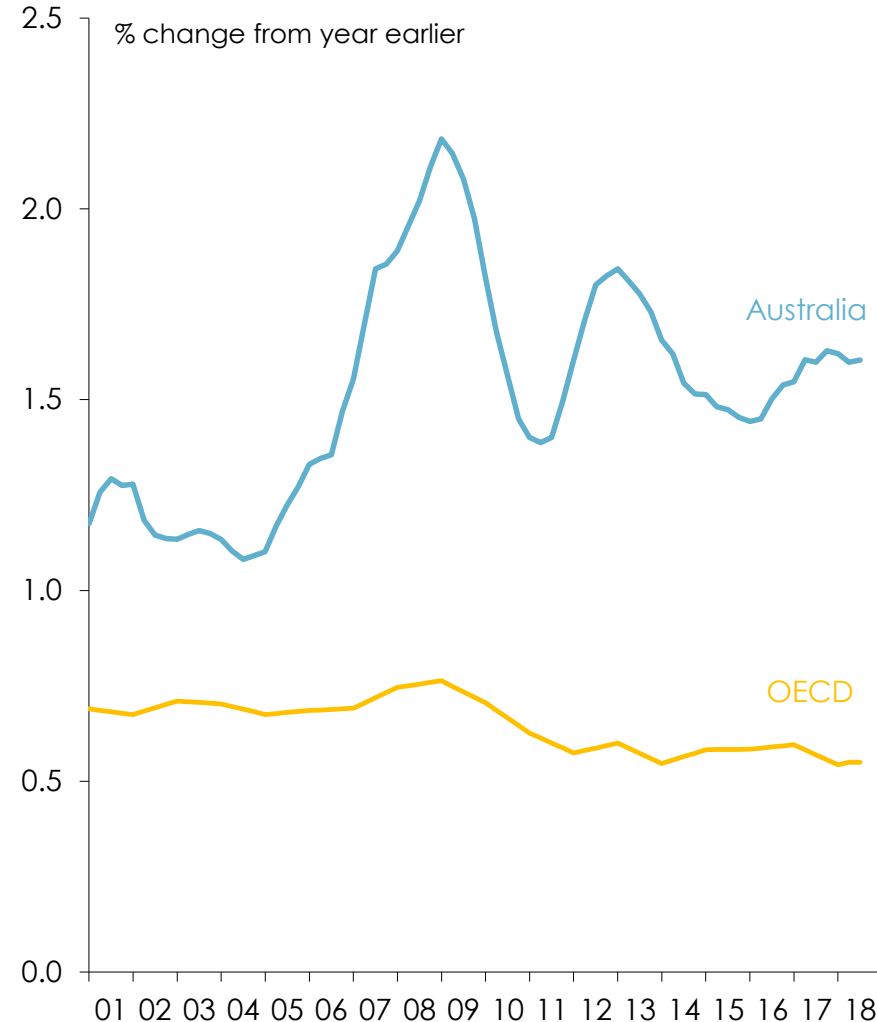
Note: 2017-18 estimates for growth in gross state product (GSP) are from 2018-19 State and Territory Budget Papers. Business conditions for pairs of states are population-weighted averages. Sources: ABS; State & Territory Budget Papers; National Australia Bank; Corinna Economic Advisory.

Australia's above-average economic growth owes a lot to population growth – without which, per capita GDP growth has been below average

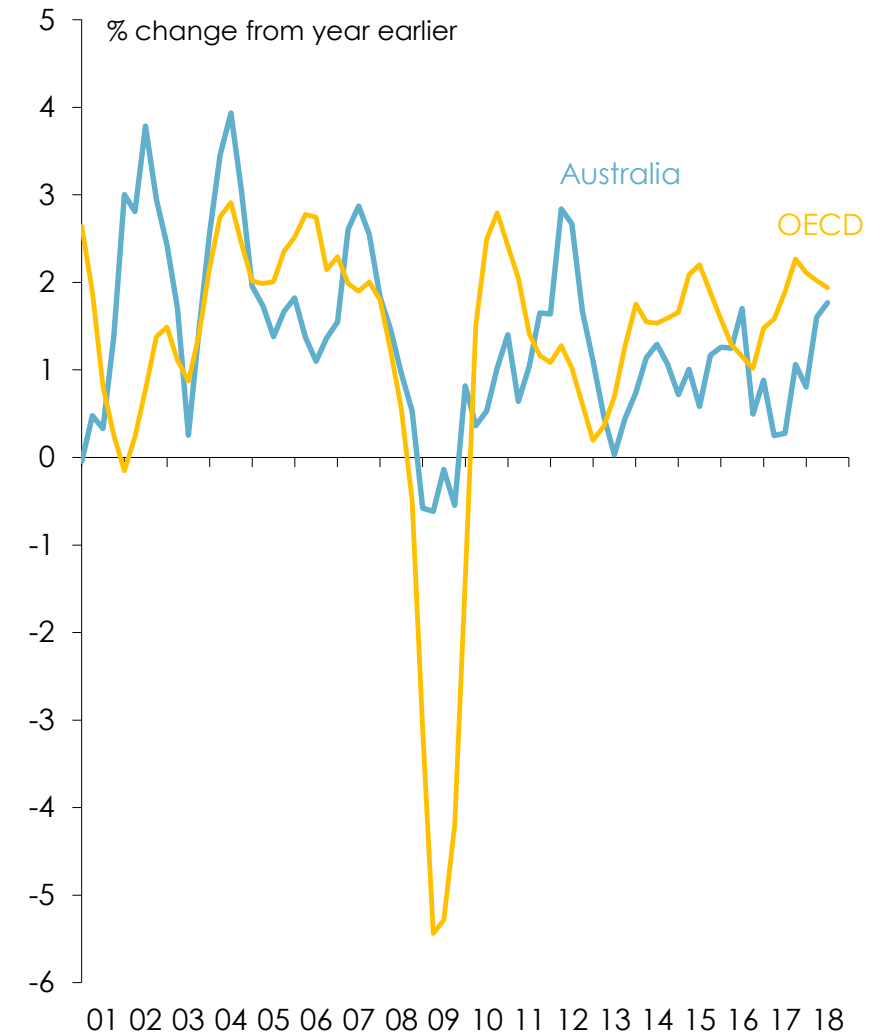
Real GDP growth



Population growth



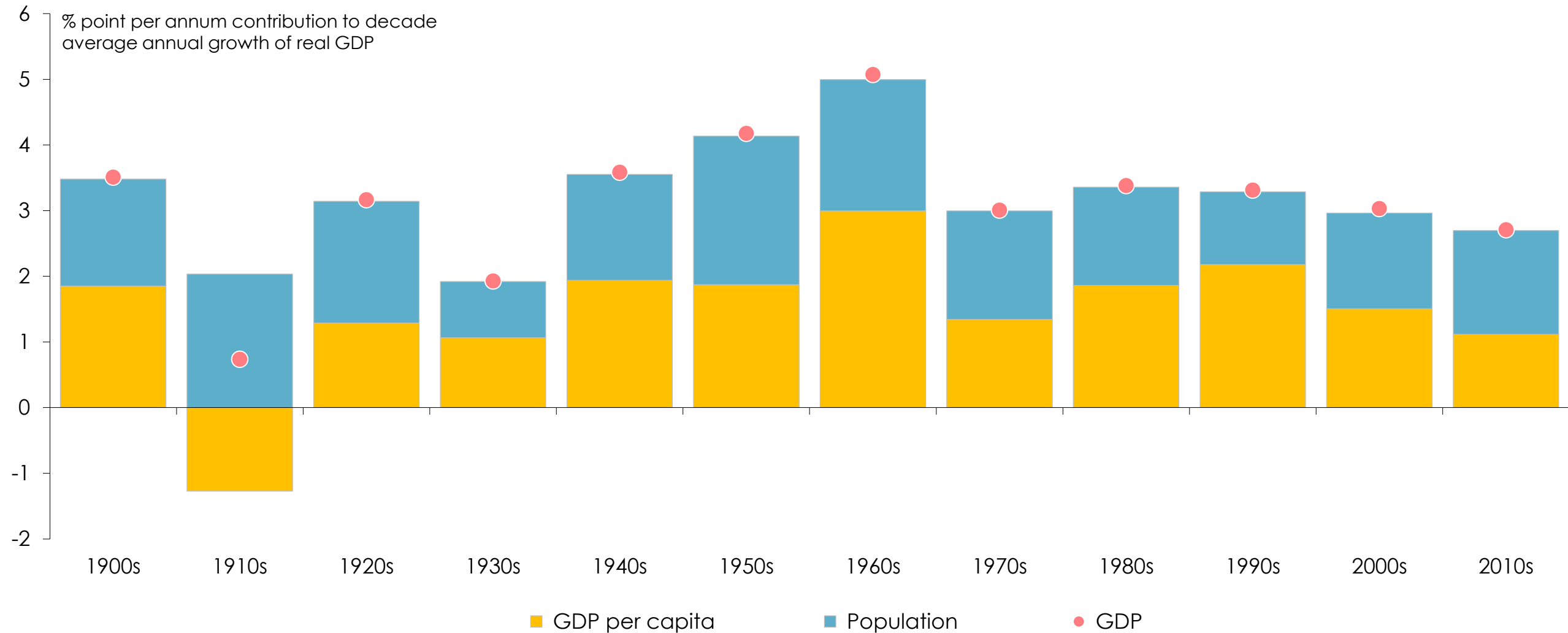
Real per capita GDP growth



Note: OECD (Organization for Economic Co-operation and Development) comprises 34 (mostly) 'advanced' economies in Europe and North America plus Japan, Korea, Australia, New Zealand, Mexico, Chile, Turkey and Israel.
Sources: Australian Bureau of Statistics; OECD.

Australia's overall economic growth in the current decade owes more to population growth than any decade since the 1920s

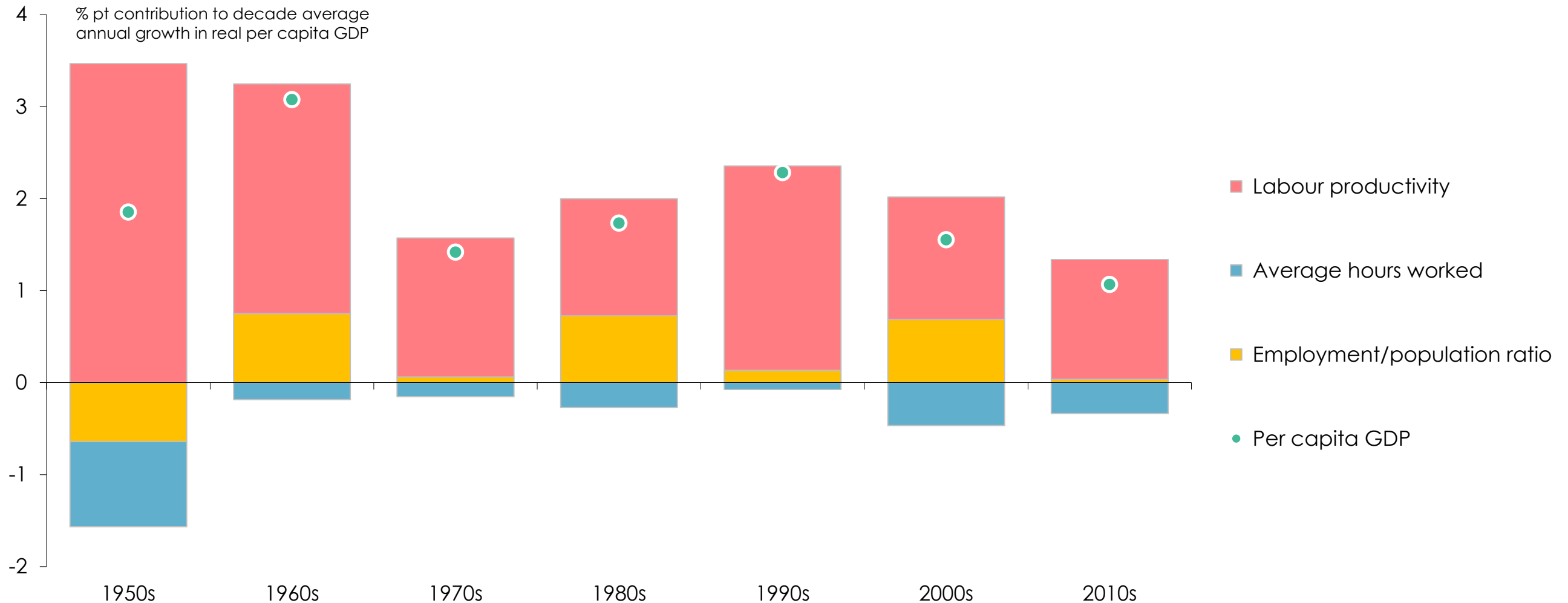
Sources of Australian real GDP growth by decade, 1900-2018



Note: "2010s" is 2010-11 through 2017-18. Sources: ABS; Department of Foreign Affairs & Trade.

Weak per capita growth in the current decade reflects the impact of population ageing on employment participation, and poor productivity

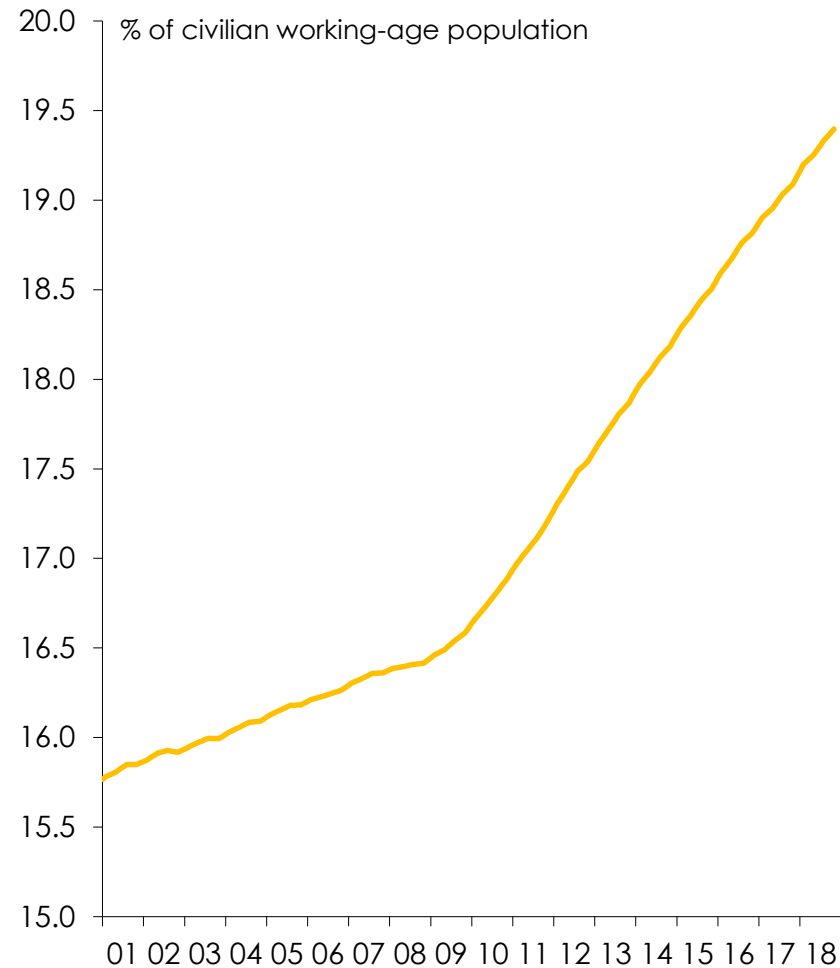
Sources of Australian real per capita GDP growth by decade, 1950-2018



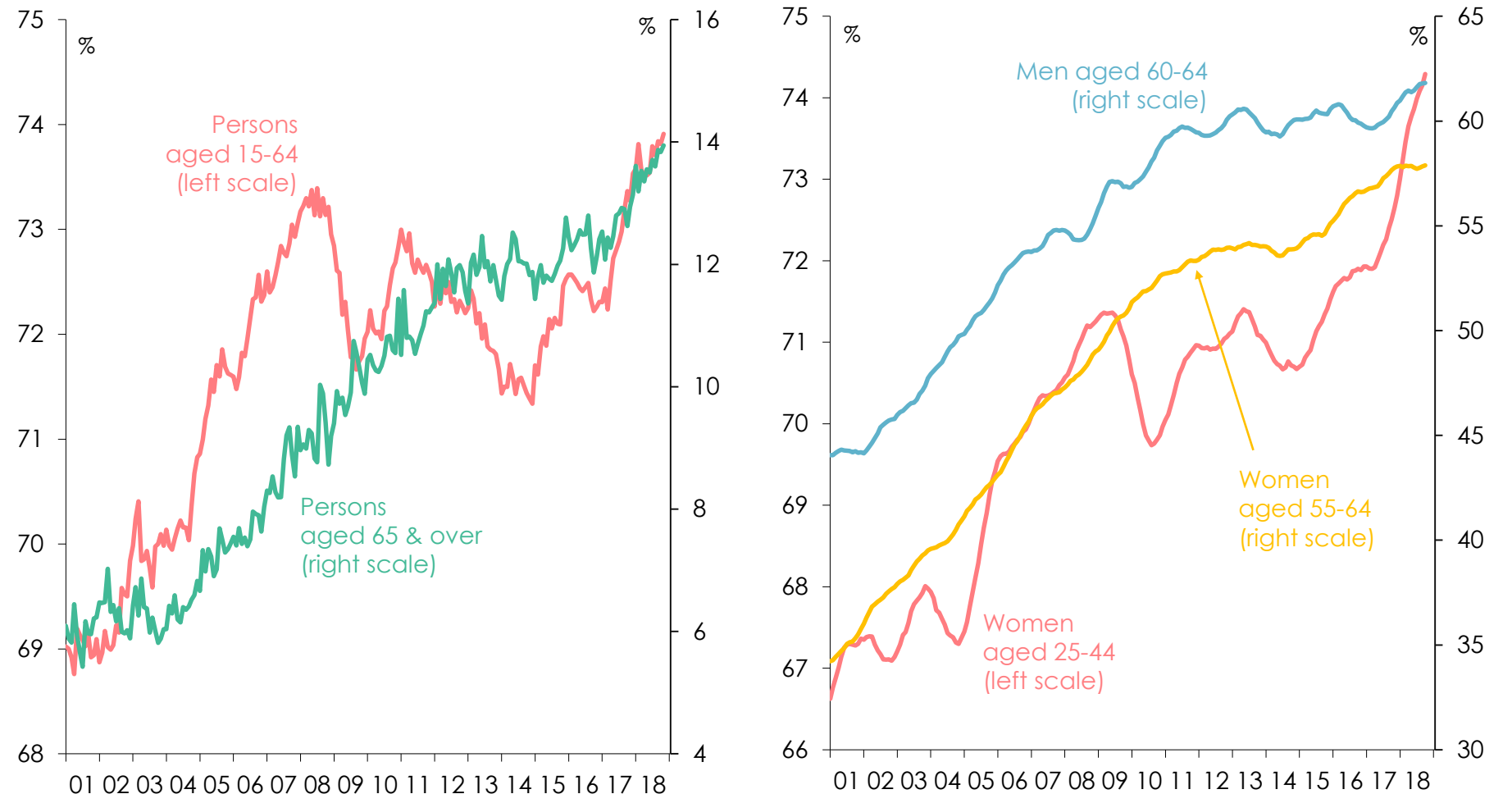
Note: "2010s" is 2011 through 2018. Sources: The Conference Board, *Total Economy Database 2018*; Corinna Economic Advisory.

Impact of demographic change on labour force participation is being offset by higher participation by women aged 25-44 and 55-64, and men 60-64

People aged 65+ as a pc of 'working age' (15+) population



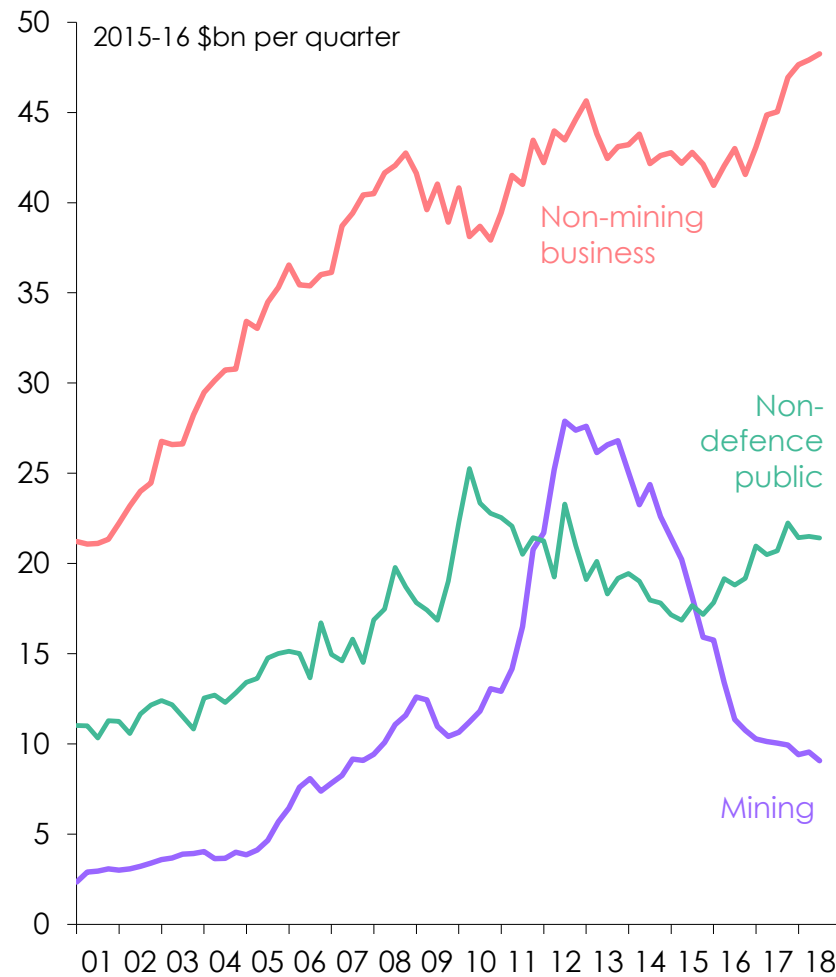
Employment-to-population ratios, selected age and gender groups



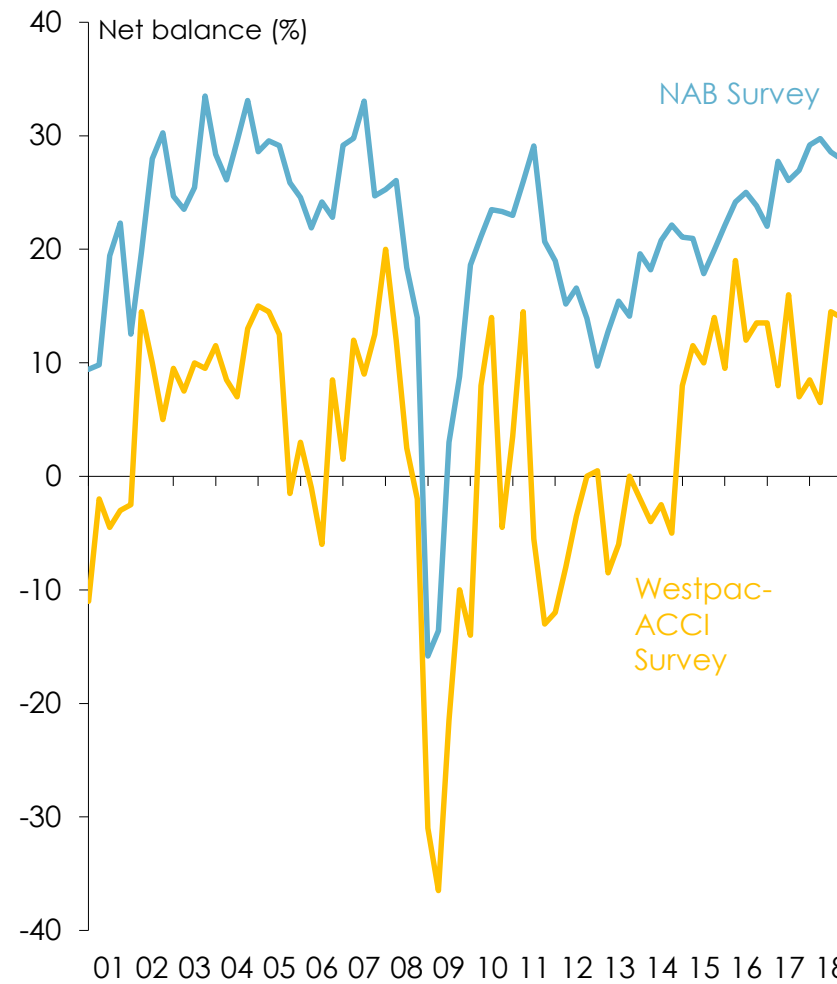
Note: charts show 12-month moving averages of original (ie, not seasonally adjusted) data.
Sources: ABS ; Corinna Economic Advisory.

Non-mining business investment has picked up, and should remain solid – while there's also a lot of public infrastructure investment under way

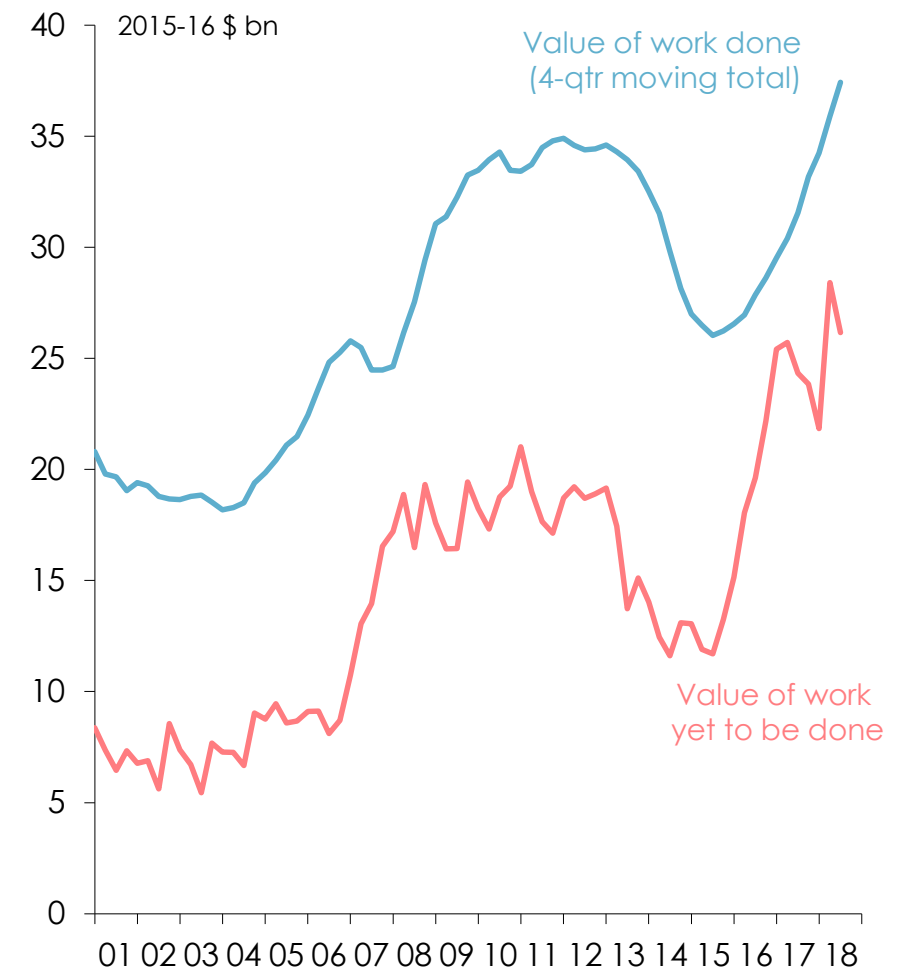
Non-residential investment, by type



Business capital investment intentions



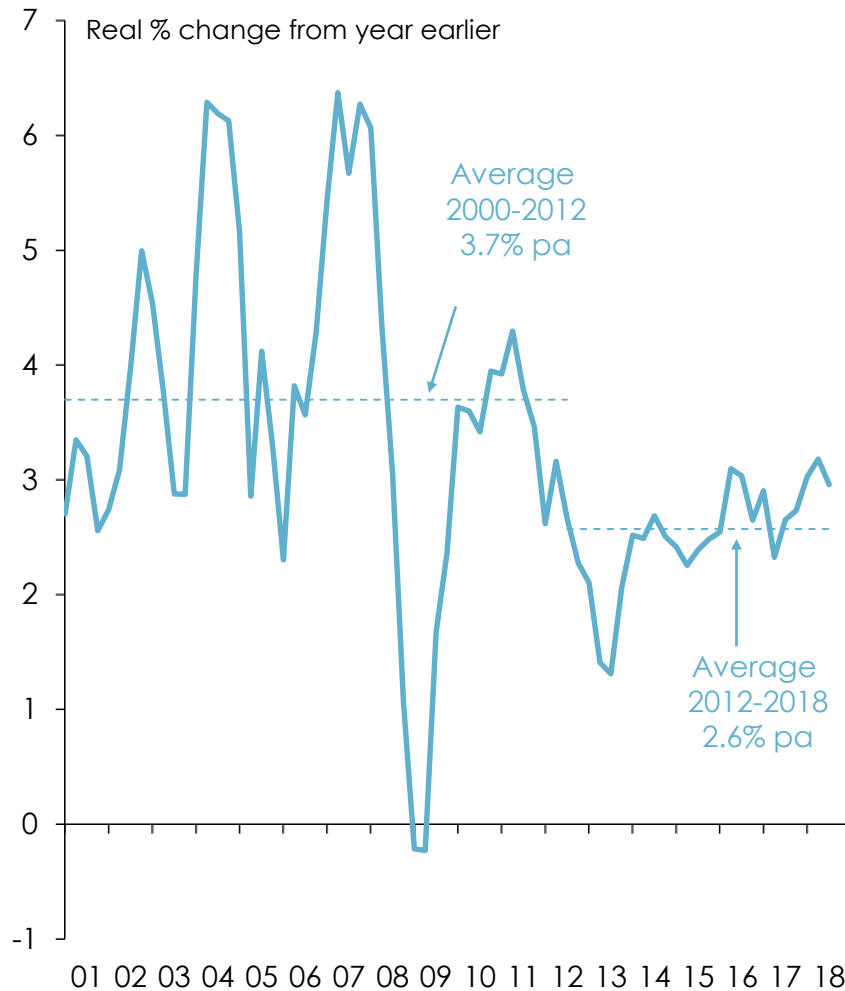
Public sector engineering construction work



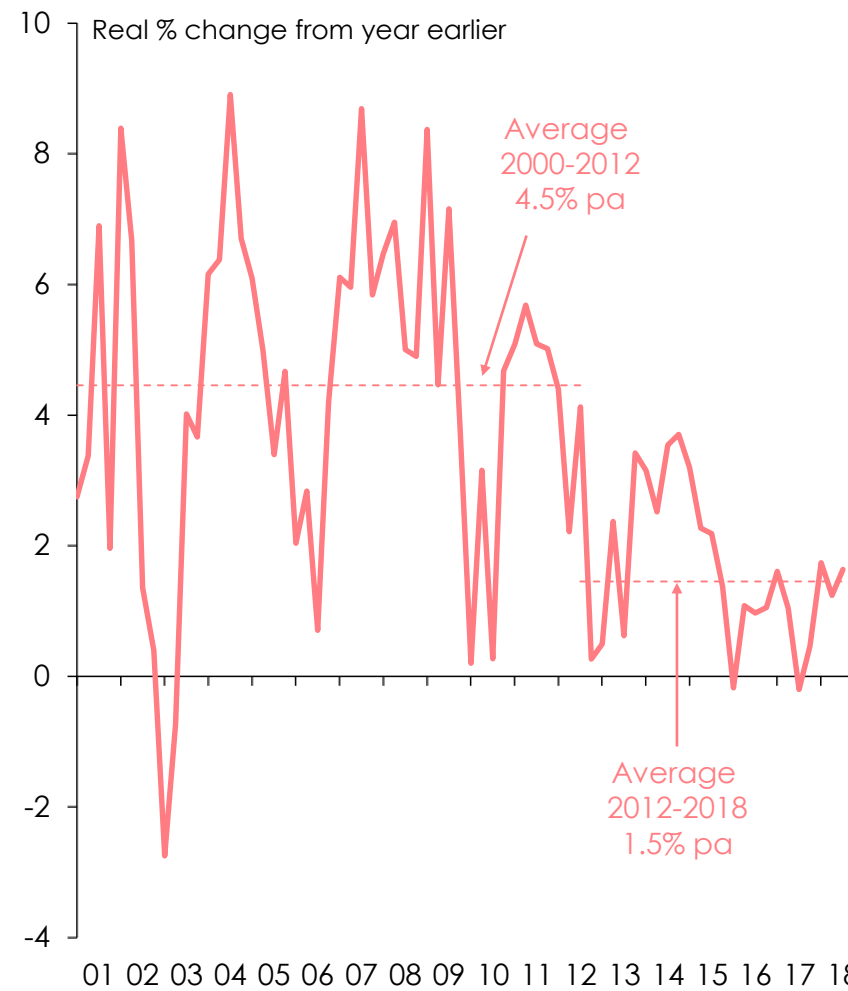
Note: Public sector engineering construction includes work done, or to be done, by the private sector for the public sector, as well as by the public sector itself.
Sources: ABS; National Australia Bank; Westpac/Australian Chamber of Commerce & Industry.

Household spending has grown faster over the past year than the post-mining boom average, but that can't be sustained unless income picks up

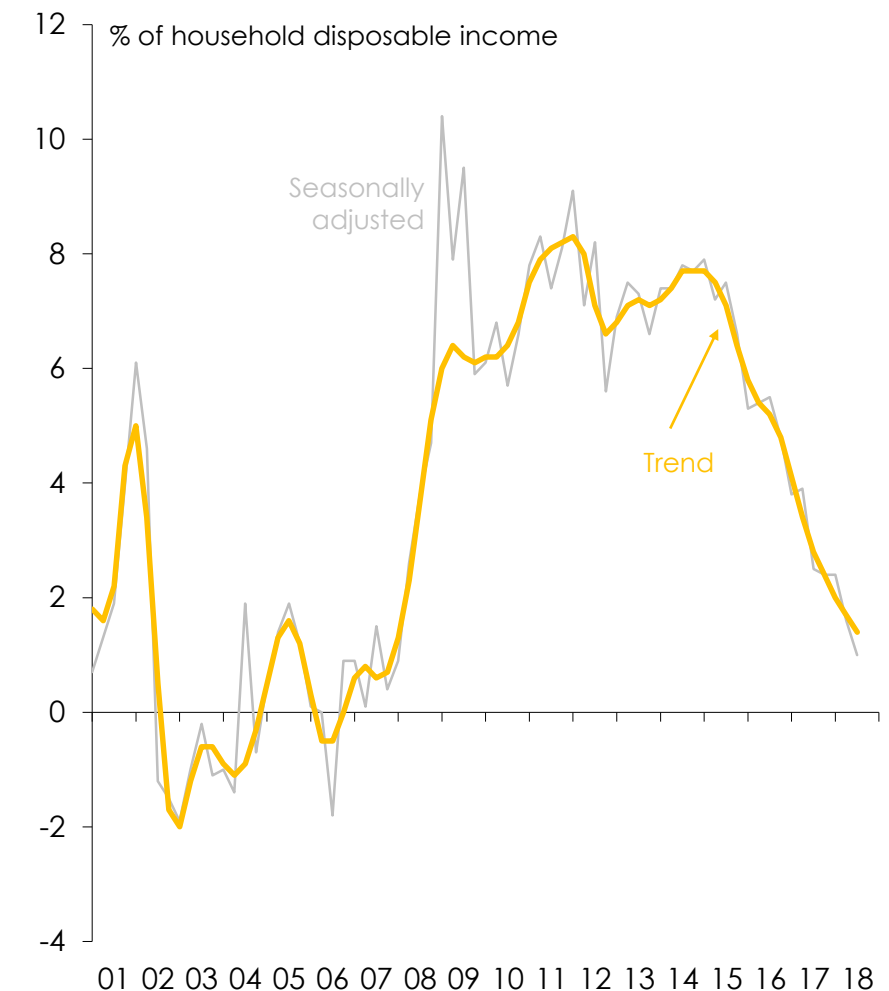
Household consumption expenditure



Household disposable income



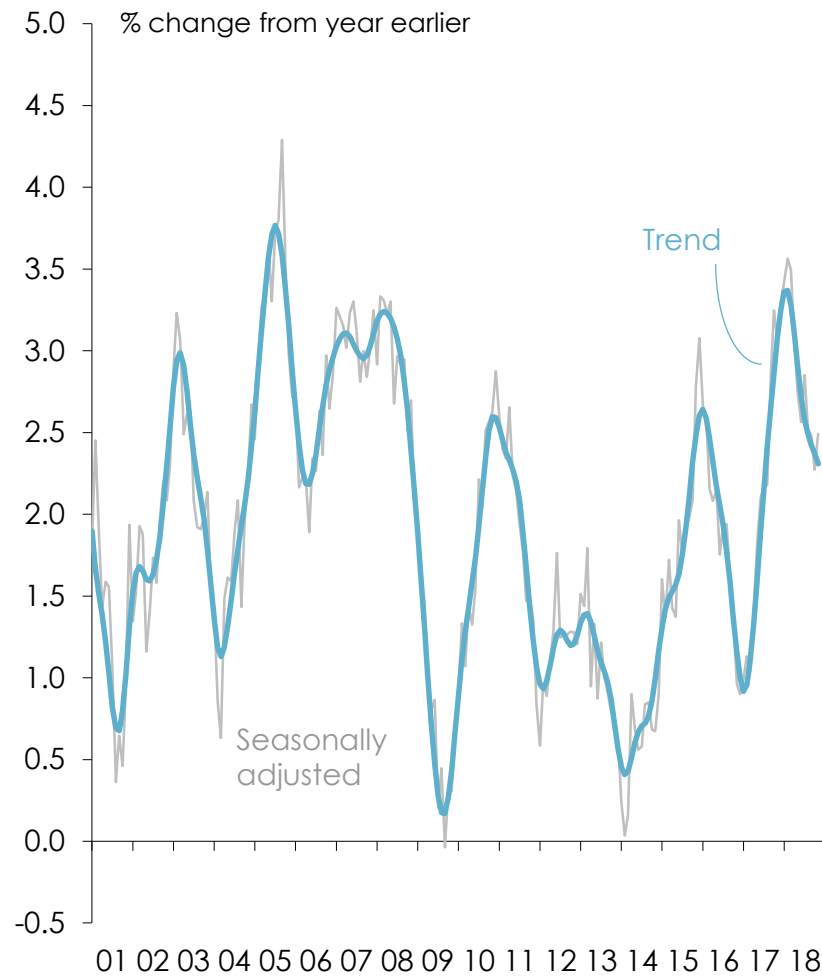
Household saving



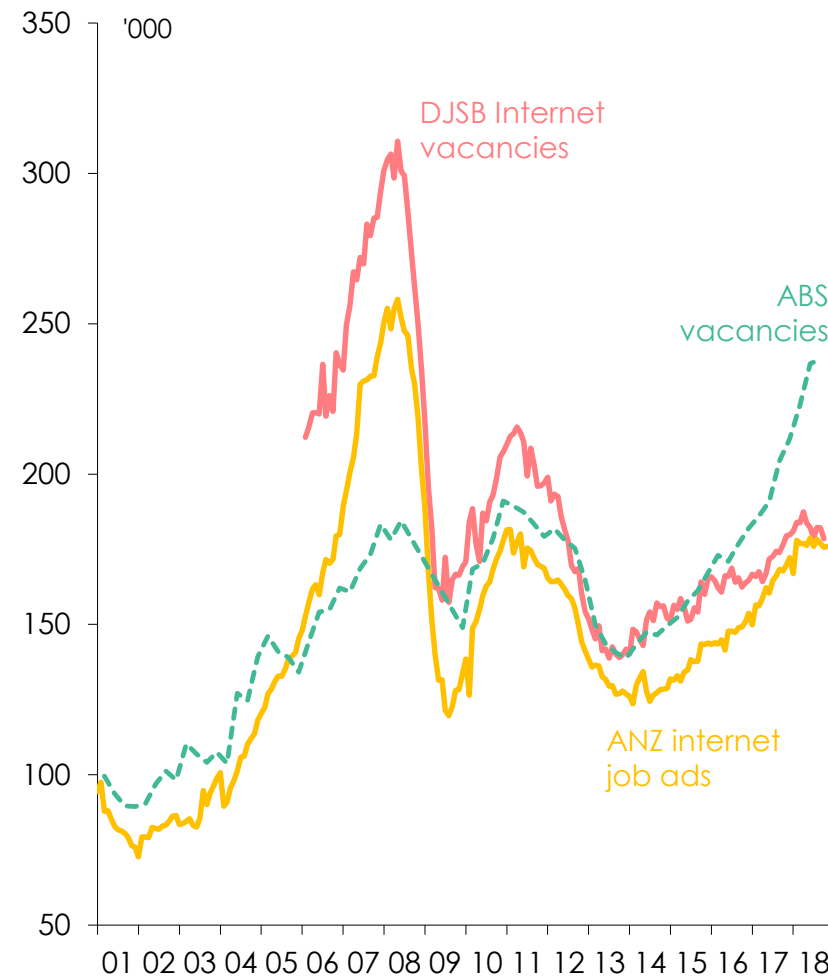
Source: ABS.

Employment growth has been strong since 2017, and should continue at a reasonable pace next year – though not in all the same sectors

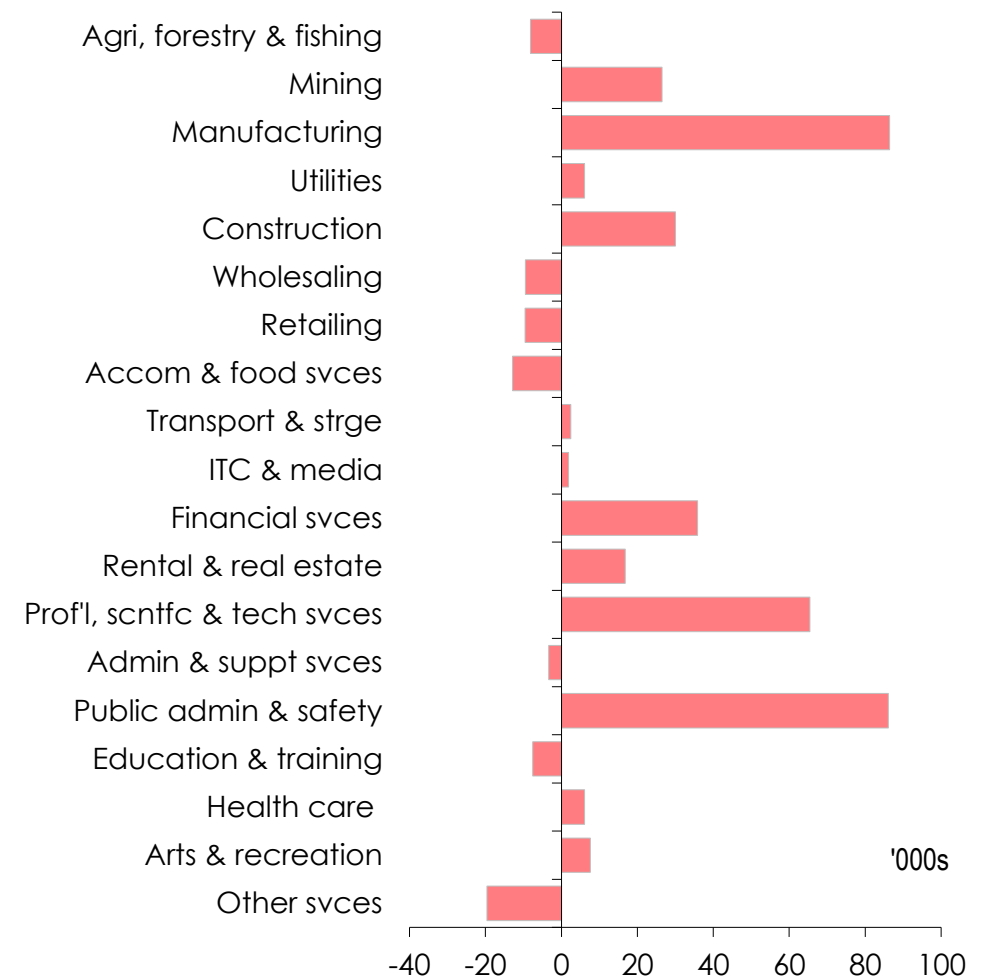
Employment growth



Job advertisements and vacancies



Employment growth by industry, year to August 2018



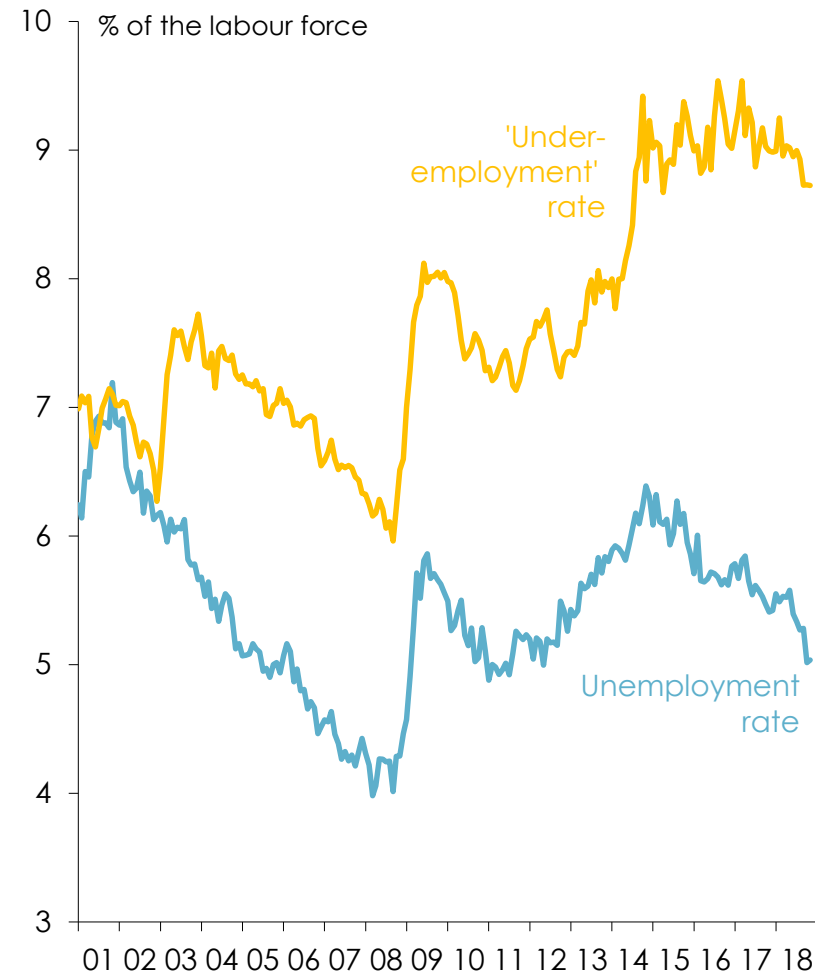
Sources: ABS; Australian Government Department of Jobs & Small Business; ANZ Bank.

Wage growth remains unusually low, partly because there is still 'spare capacity' in the labour market

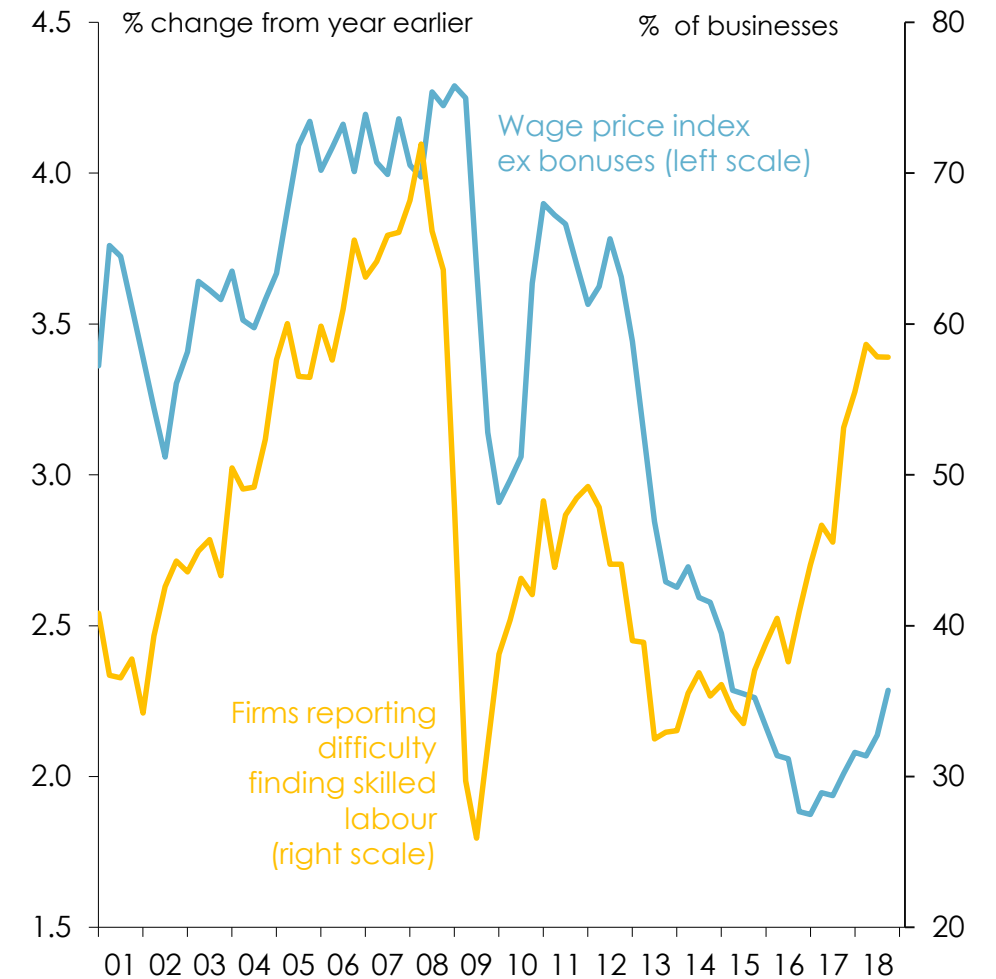
Wages growth



Unemployment and 'under-employment'



Labour shortages and wage increases



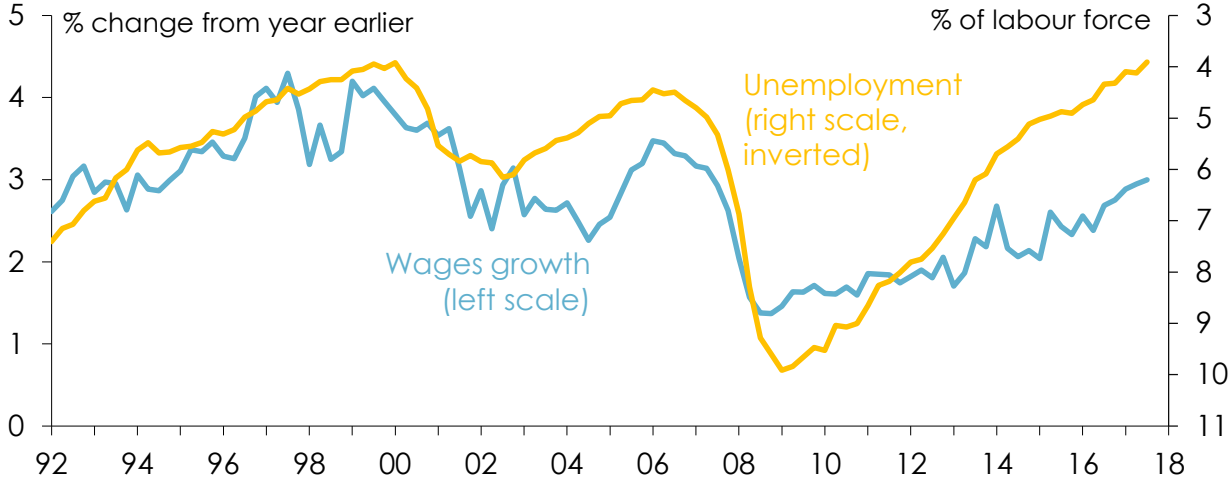
Note: 'Under-employment' is people working part-time (and hence not 'unemployed'), but who are willing and able to work more hours than currently.

Sources: ABS ; National Australia Bank

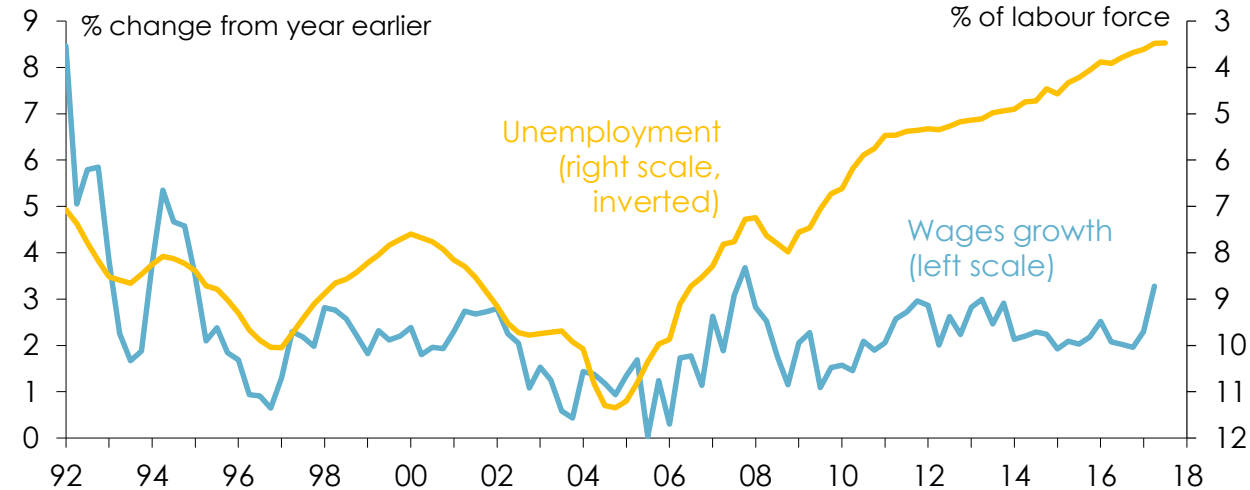
Overseas experience suggests unemployment needs to be lower for longer than previously before wages growth begins to accelerate

Wages growth and unemployment – major ‘advanced’ economies

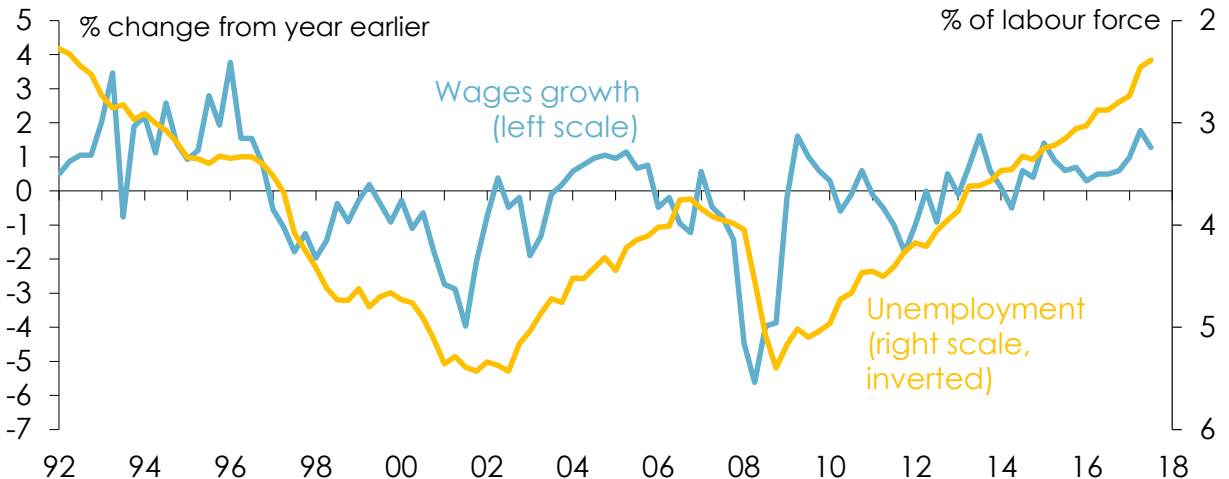
United States



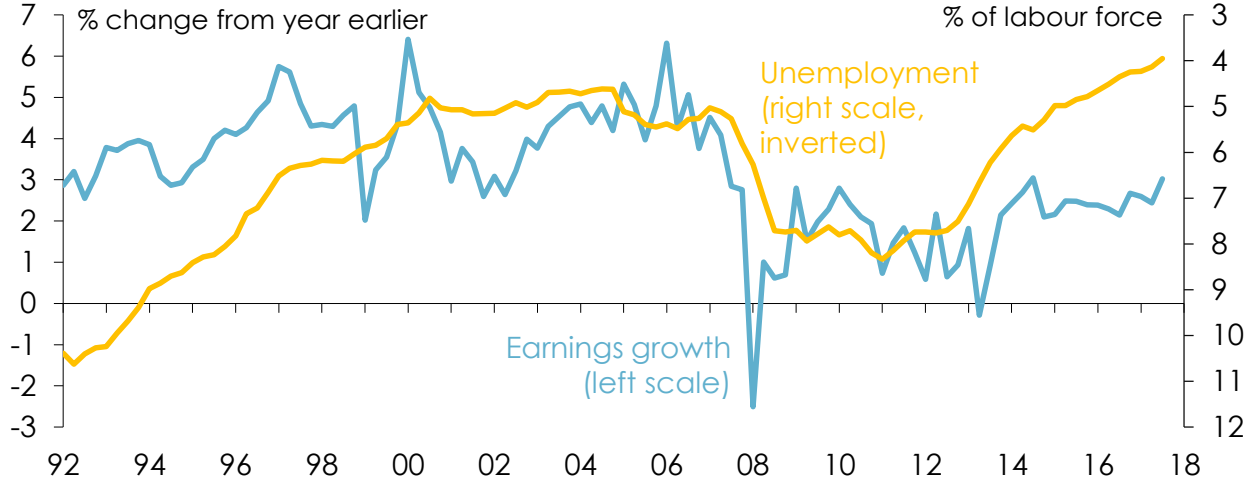
Germany



Japan



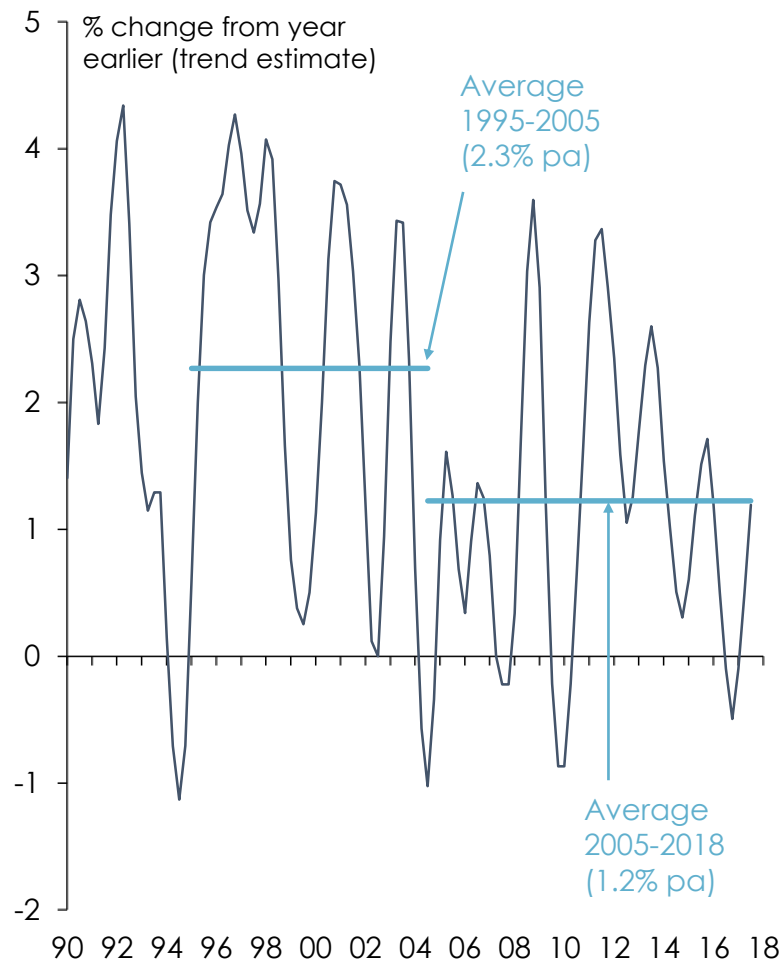
United Kingdom



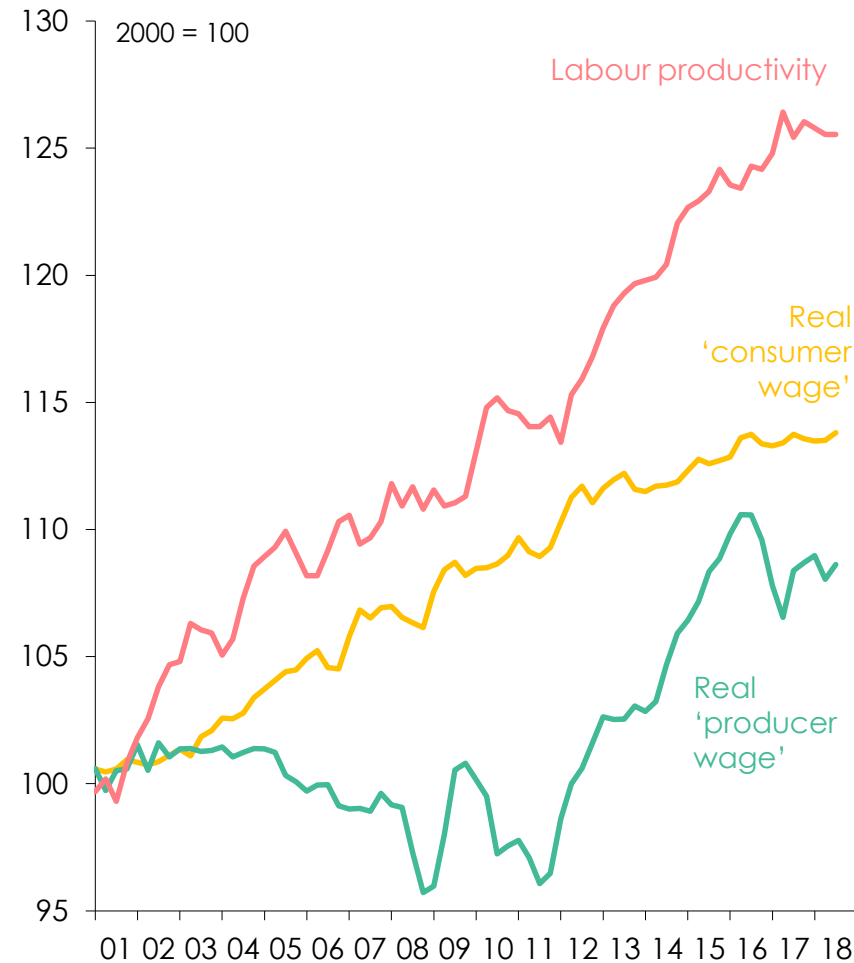
Note: US measure of wages growth is the wages component of the employment cost index; UK measure is 'underlying' average earnings.
Sources: US Bureau of Labor Statistics & Commerce Department; Statistics Japan; German Federal Statistics Office; UK Office of National Statistics.

Low wages growth partly reflects slower productivity growth – but that isn't the only reason because wages have grown even less than productivity

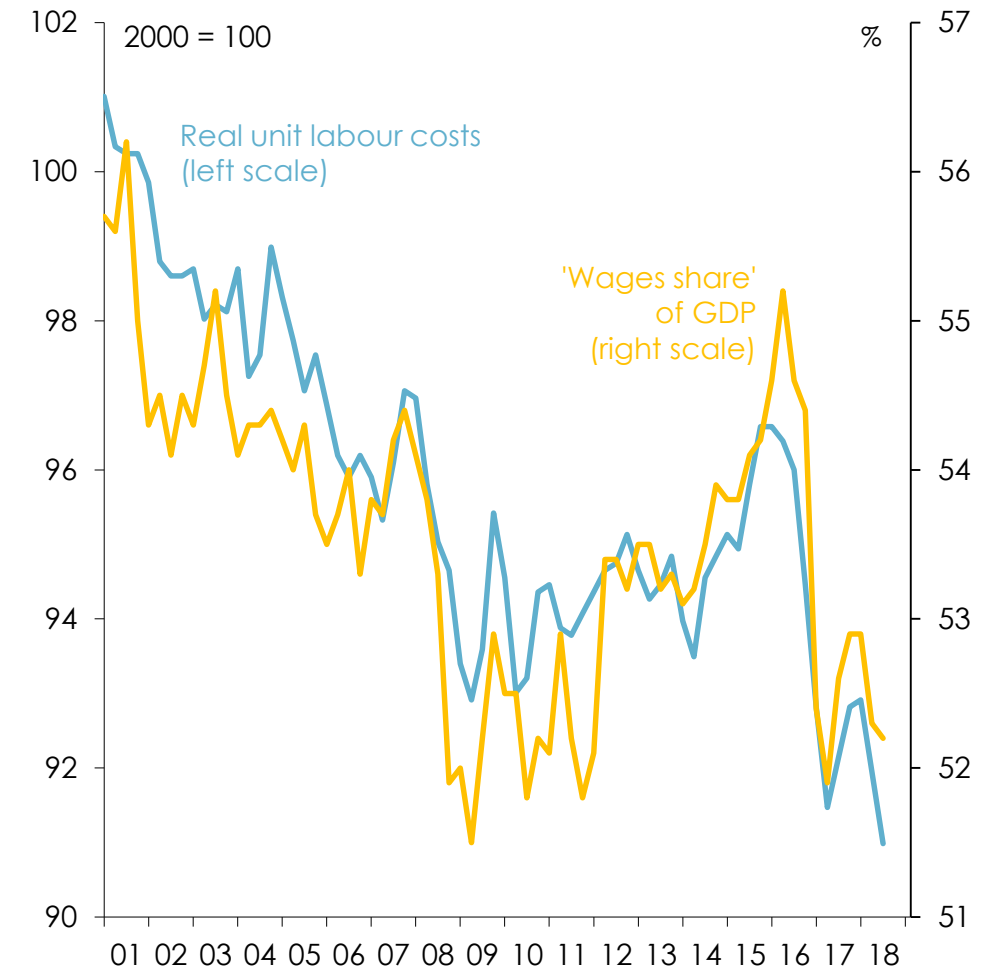
Australian labour productivity growth



Productivity and real wages growth



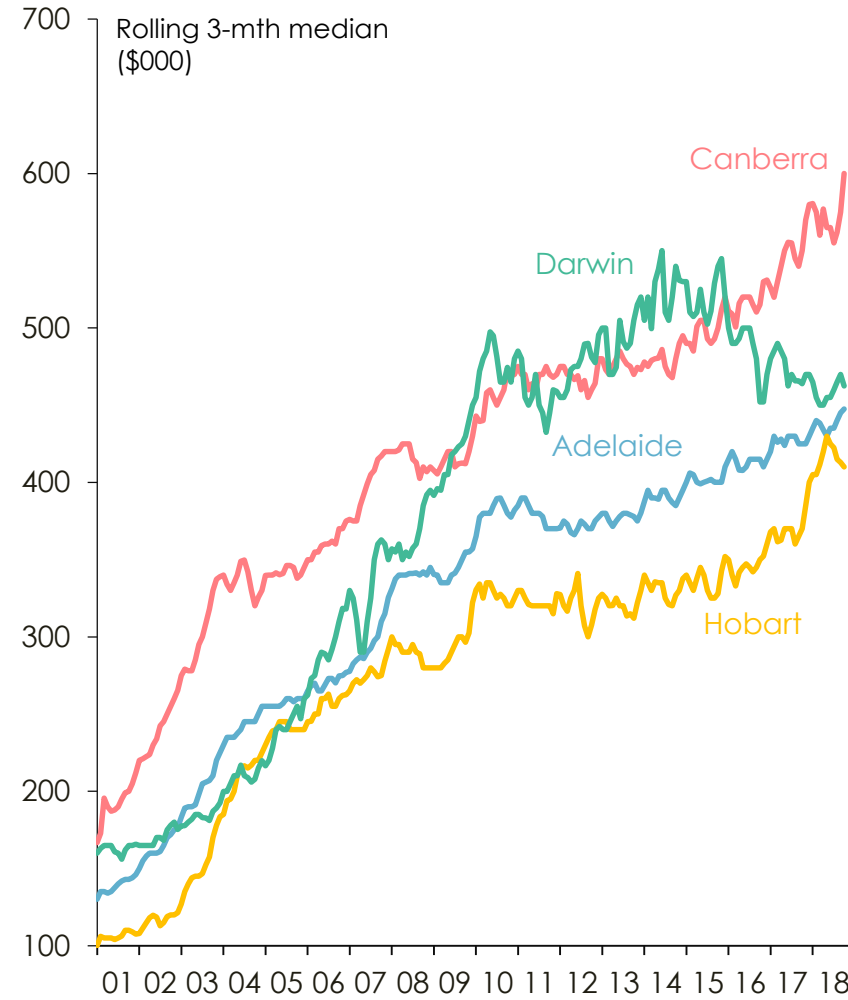
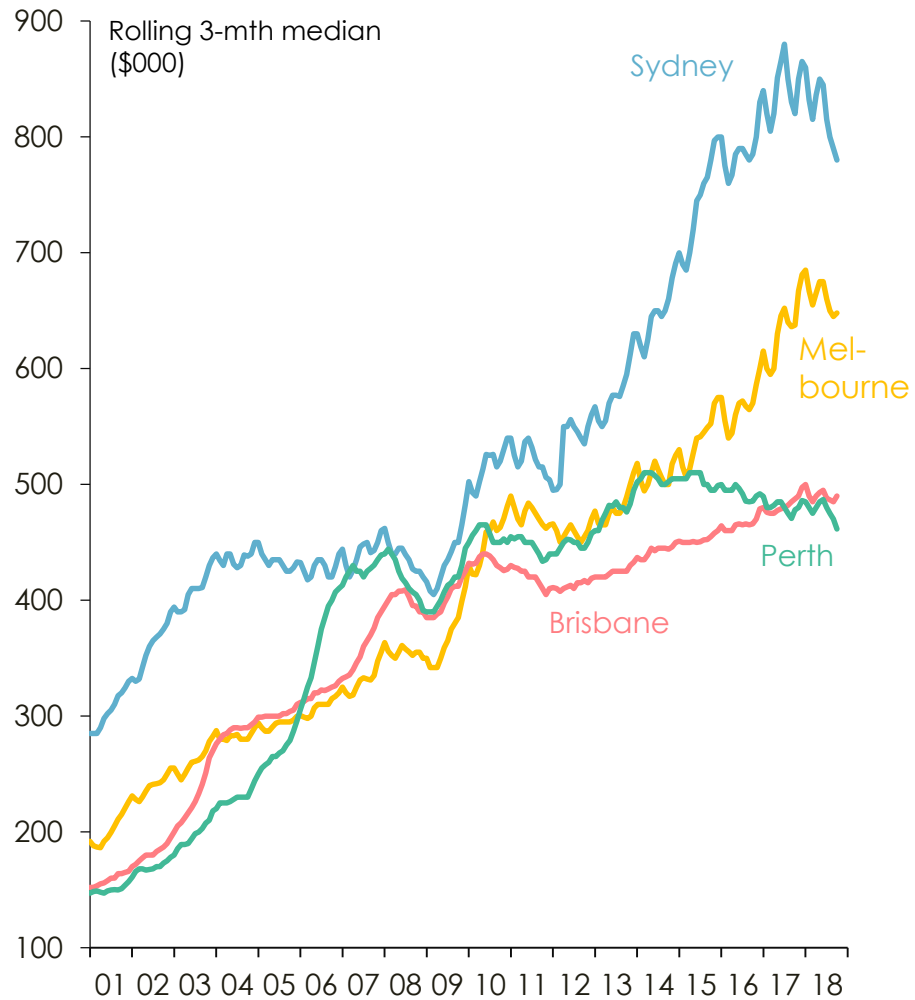
Real unit labour costs and the 'wages share' of GDP



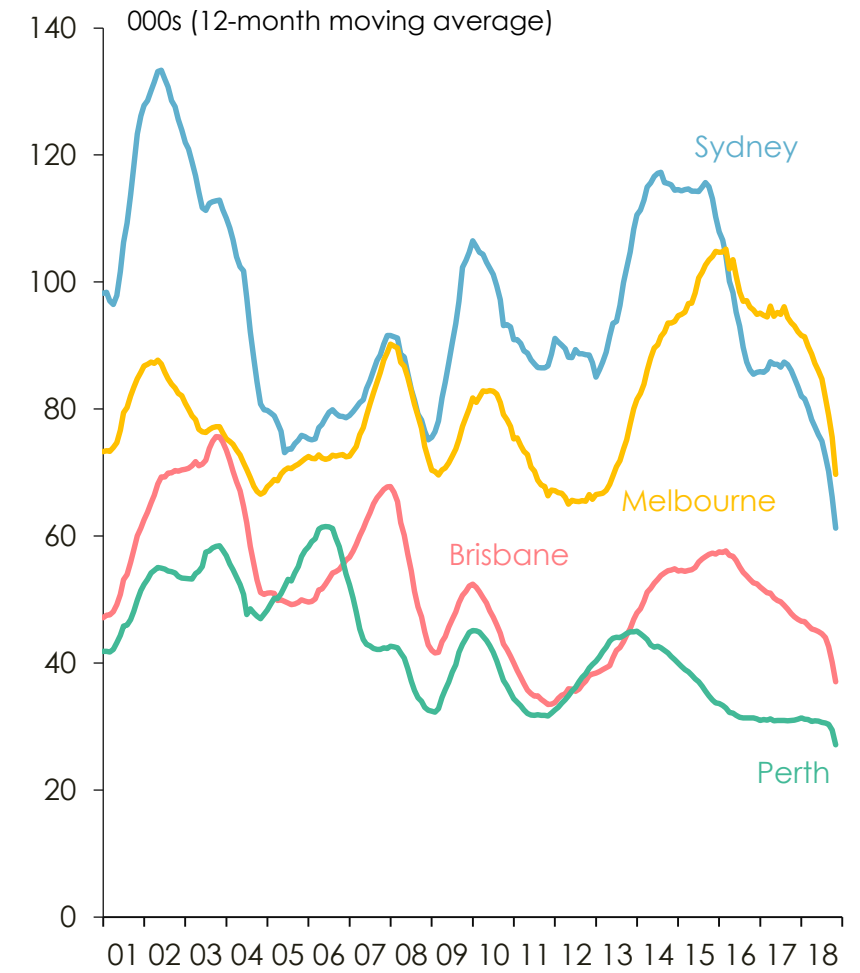
Note: The real 'consumer wage' is the wage price index deflated by the CPI (ie, real wages from employees' standpoint). The real 'producer wage' is the wage price index deflated by the implicit price deflator of non-farm GDP (ie, real wages from employers' standpoint). 'Real unit labour costs' is real wages (plus on-costs) per unit of output, or (equivalently) wages (and on-costs) per hour divided by output per hour (labour productivity). Source: ABS.

Households may be much more cautious about reducing saving now that property prices have turned

Capital city median dwelling sale prices



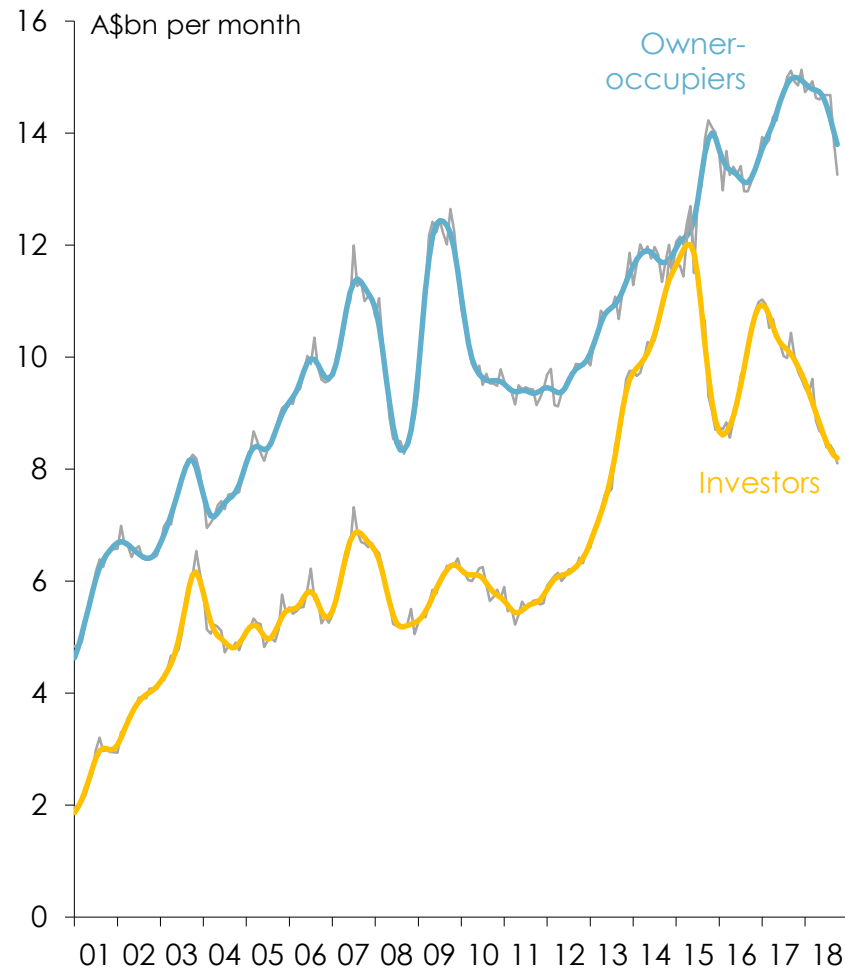
Sales volumes



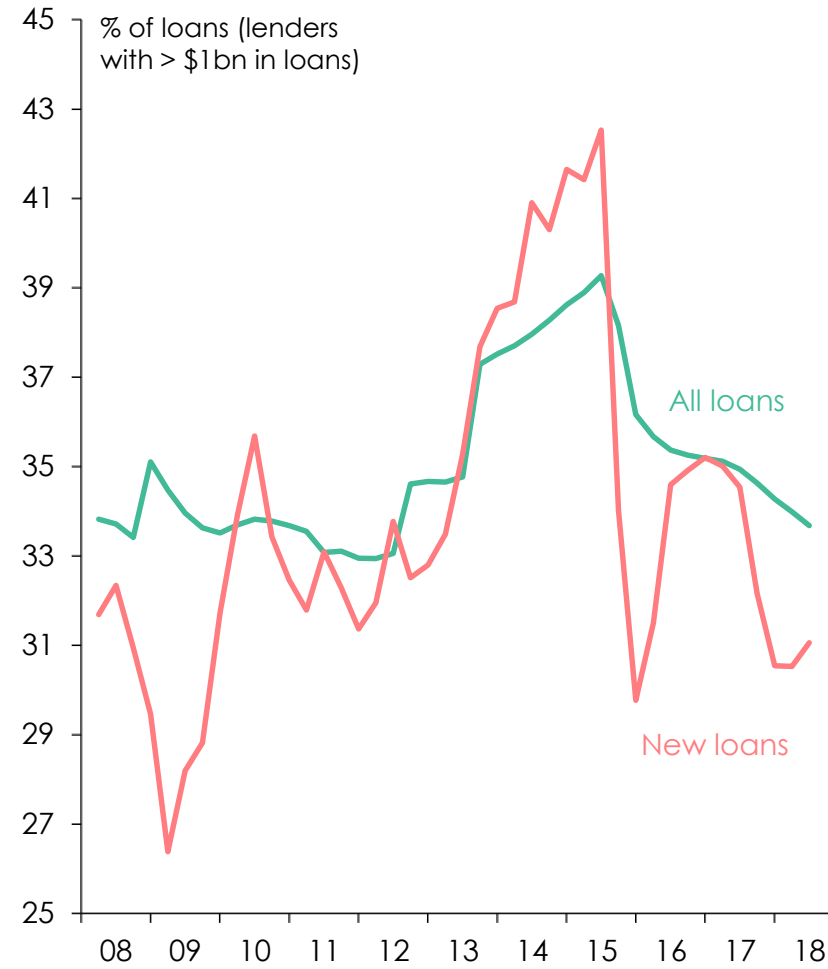
Source: CoreLogic.

The decline in east coast property prices over the past year partly reflects weaker demand from investors – including foreign investors

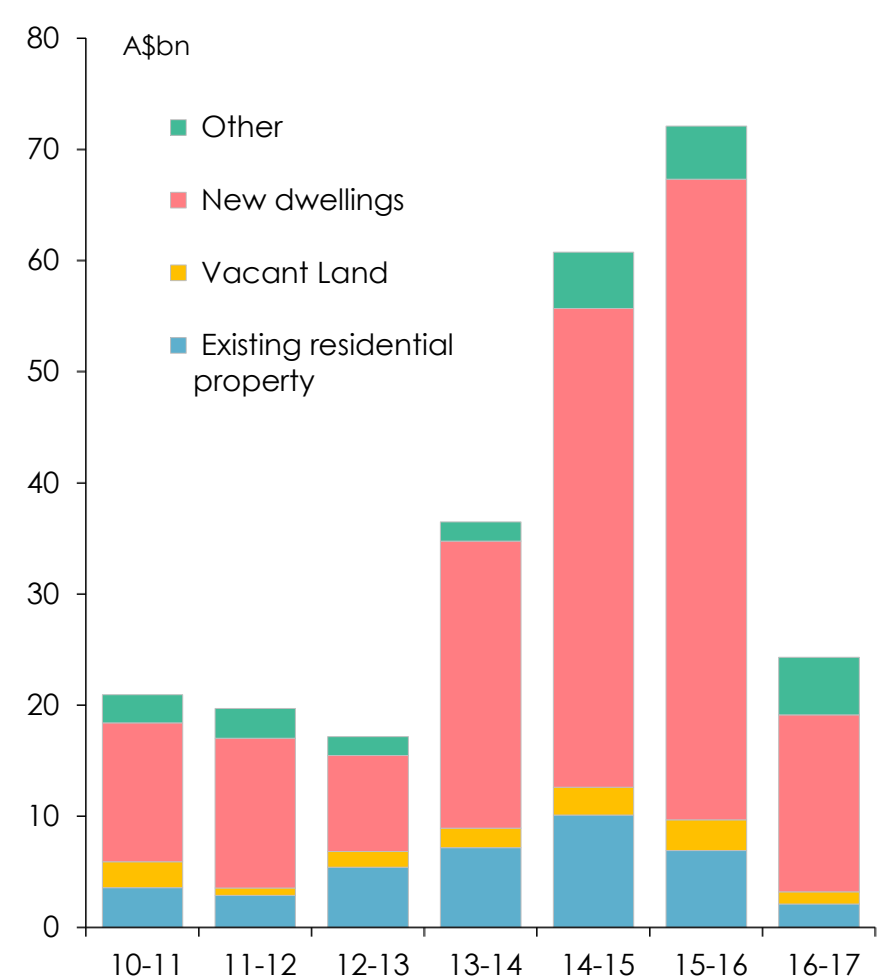
Housing finance commitments by type of borrower



Lending to property investors as a pc of total



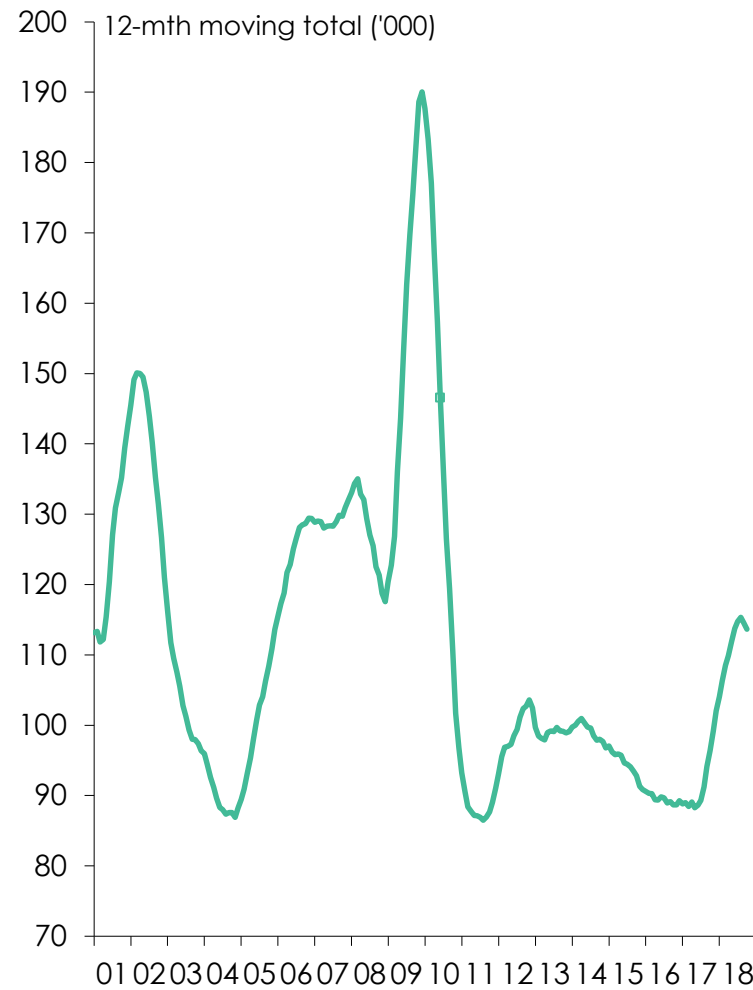
FIRB approvals for investment in residential real estate



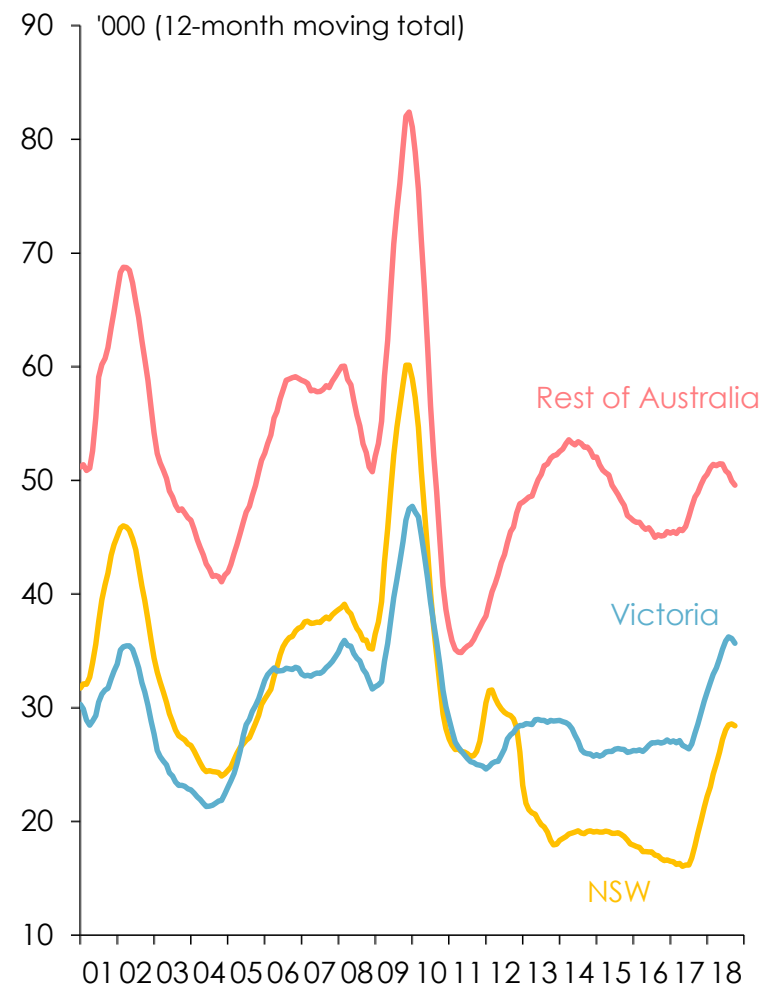
Sources: ABS; APRA; Foreign Investment Review Board.

The easing in demand from investors is 'making room' for first time buyers – who have been 'squeezed' out of the market since the late 1990s

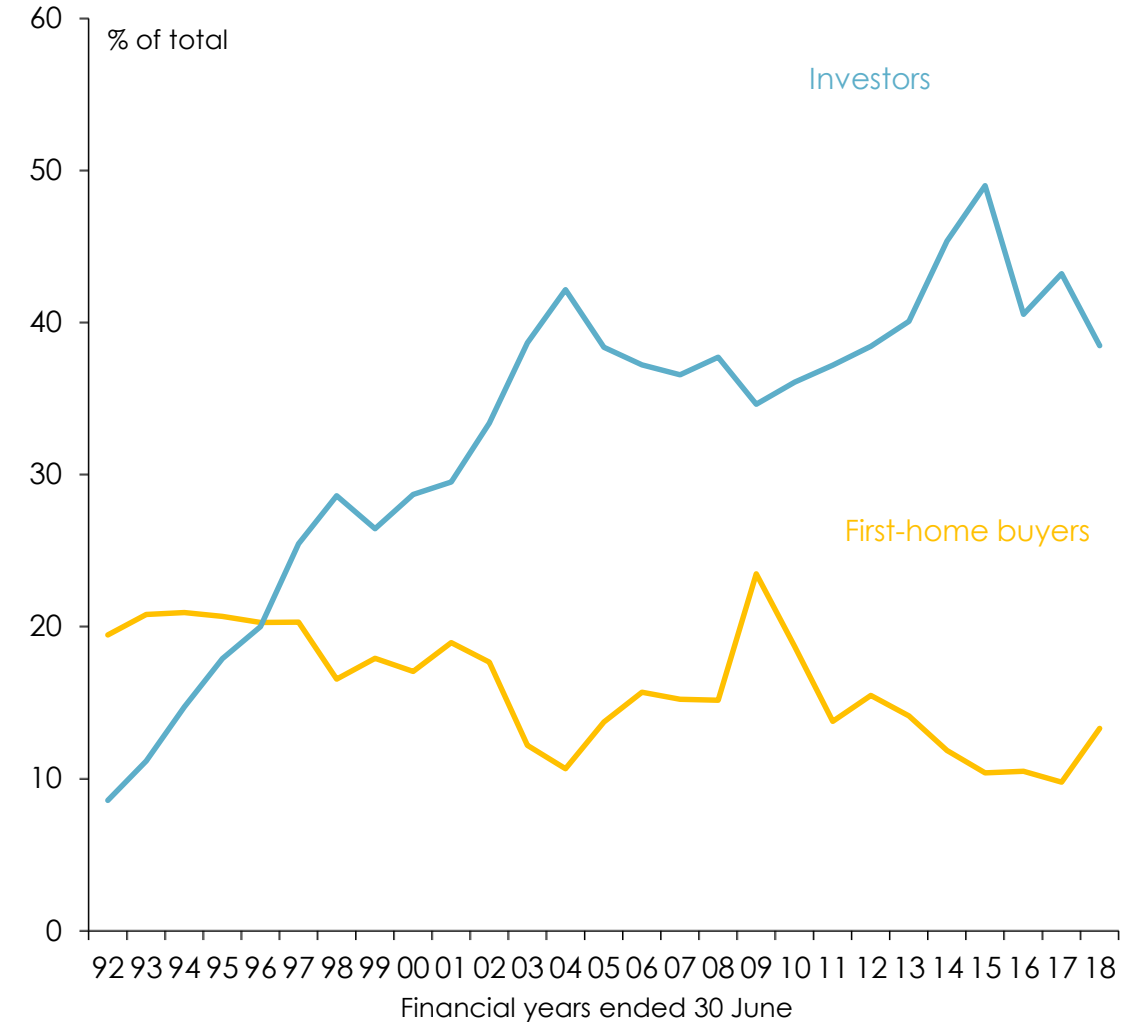
Finance commitments to first-time buyers



FTB finance commitments, by State



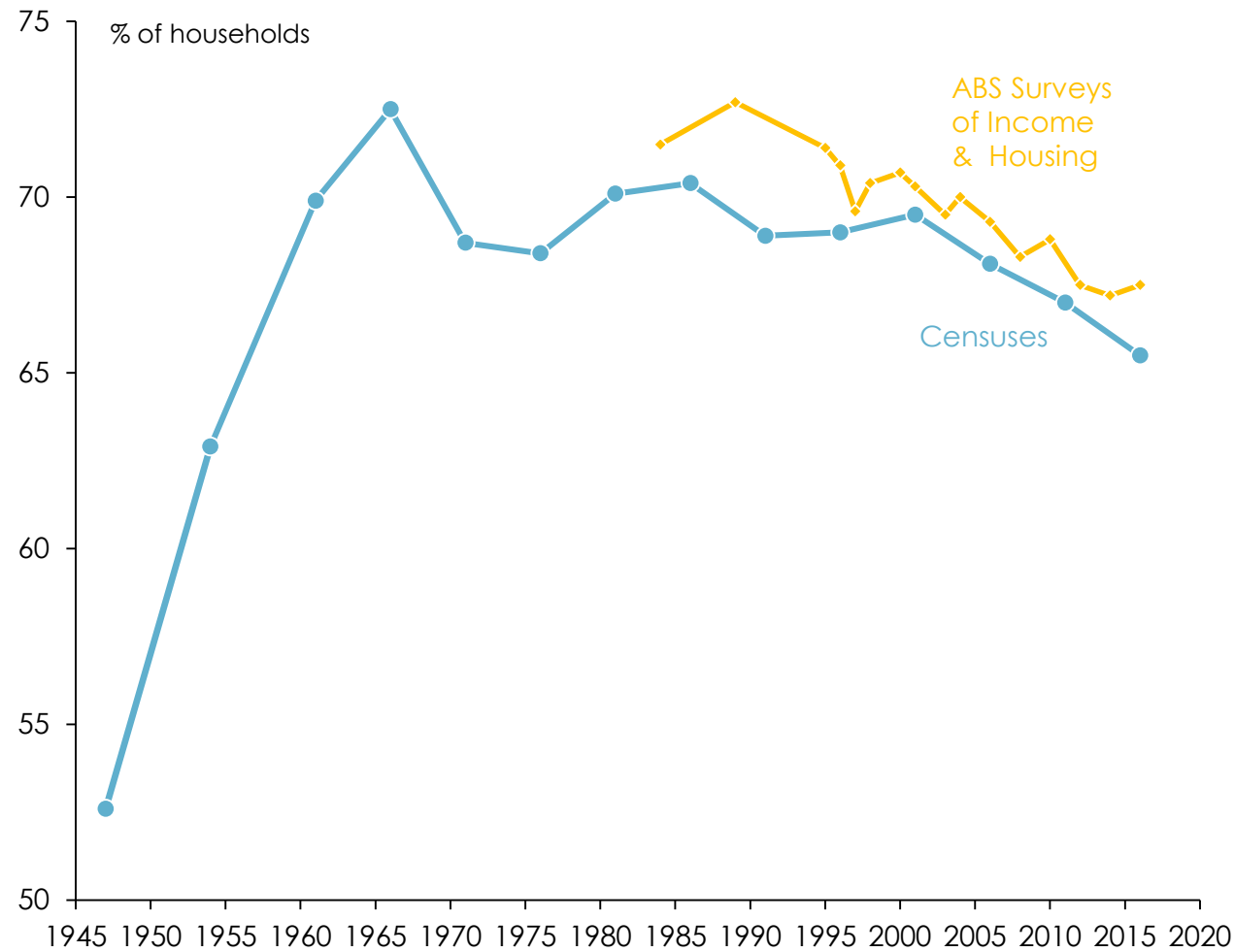
Lending to first home buyers vs investors



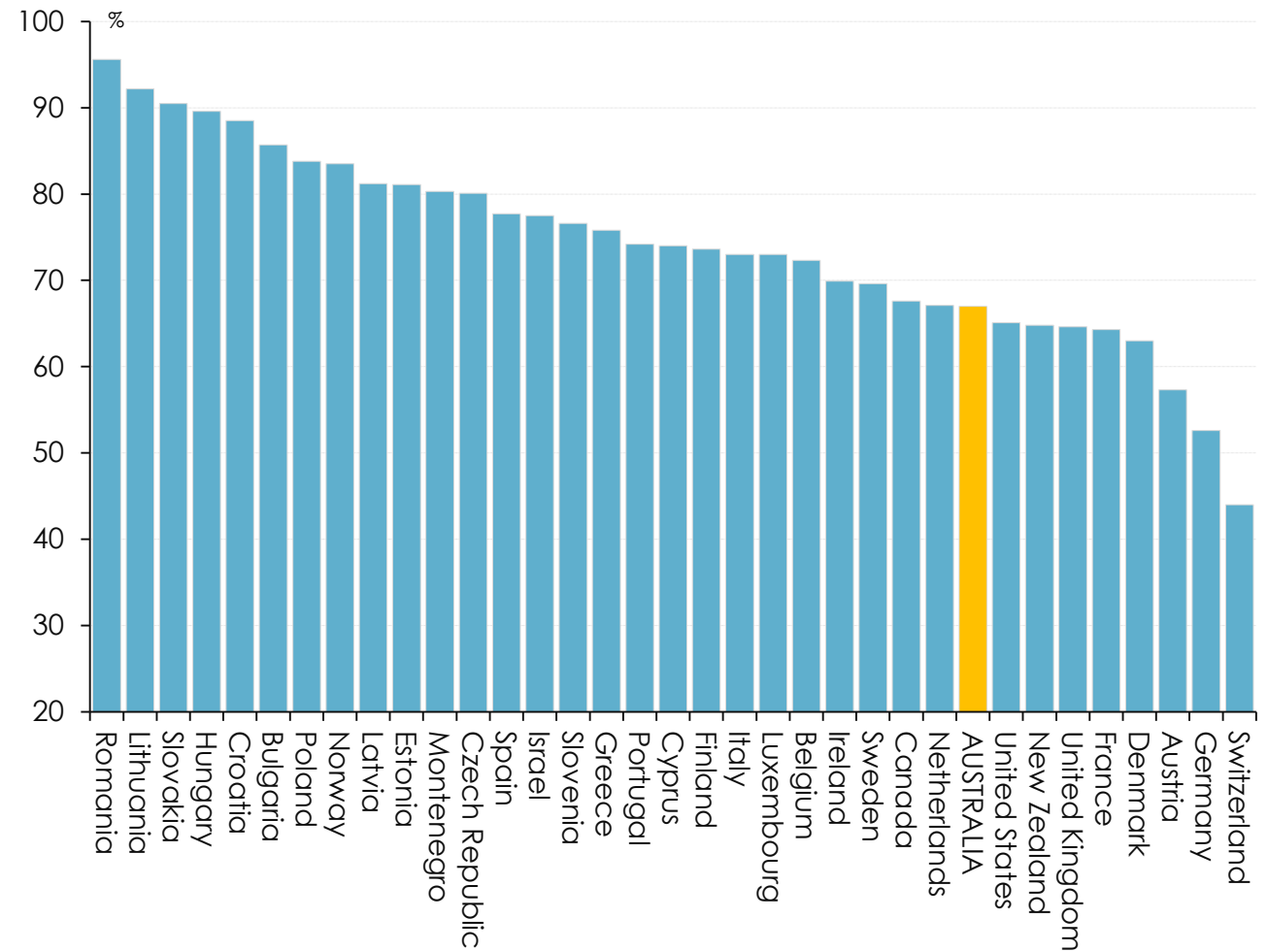
Source: ABS.

Australia's home ownership rate is no longer high, either by our own historical standards – or by international standards

Australia's home ownership rate, 1947-2016



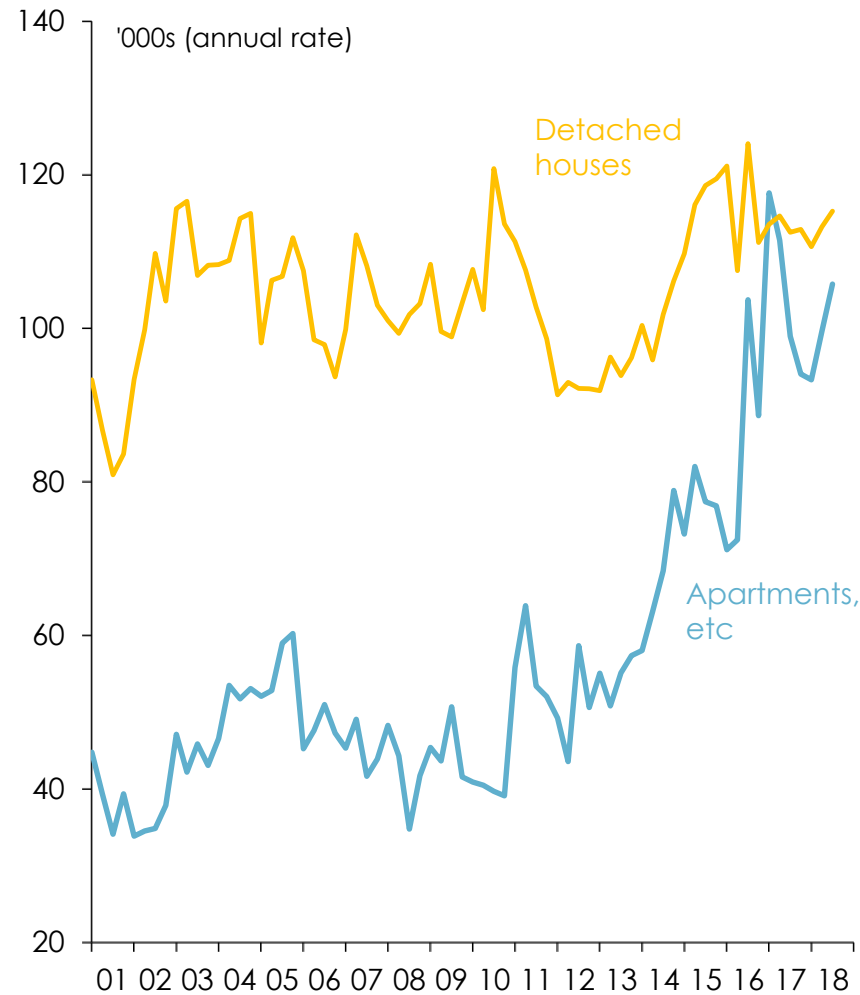
Home ownership rates among OECD countries, 2015



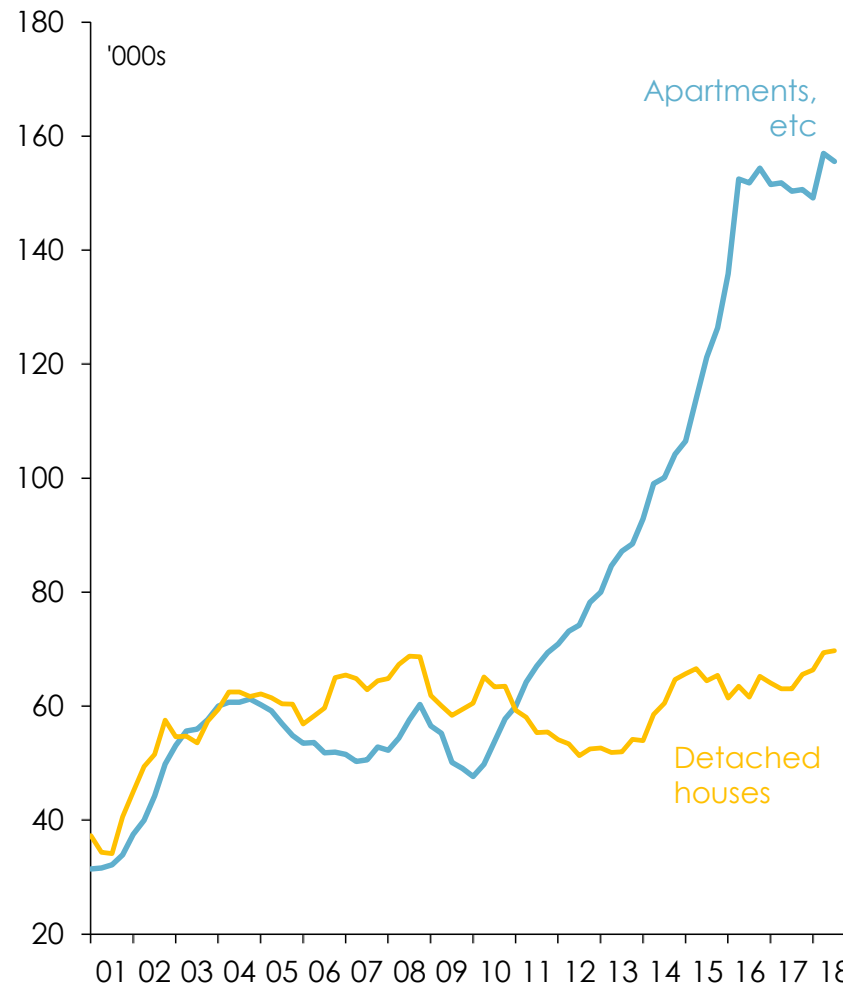
Sources: ABS ; RBA and OECD.

Increased housing supply is also likely to exert some downward pressure on property prices – but mainly for apartments, not houses

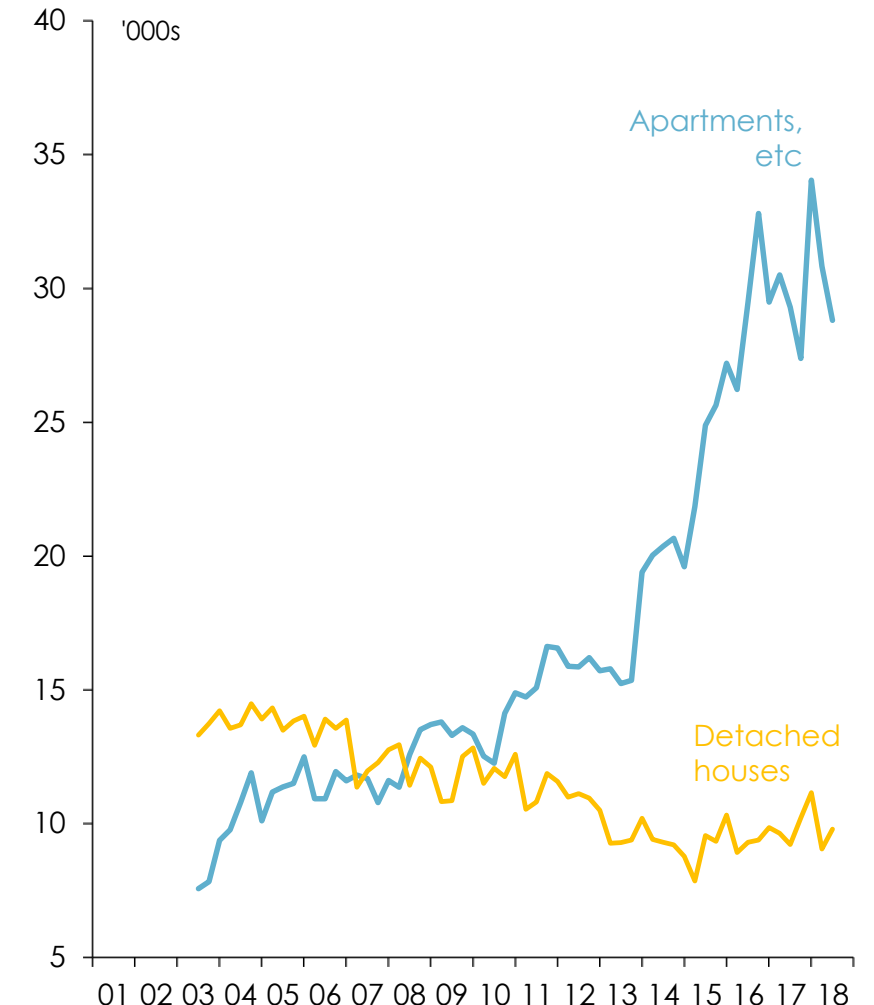
Housing completions



Housing commencements



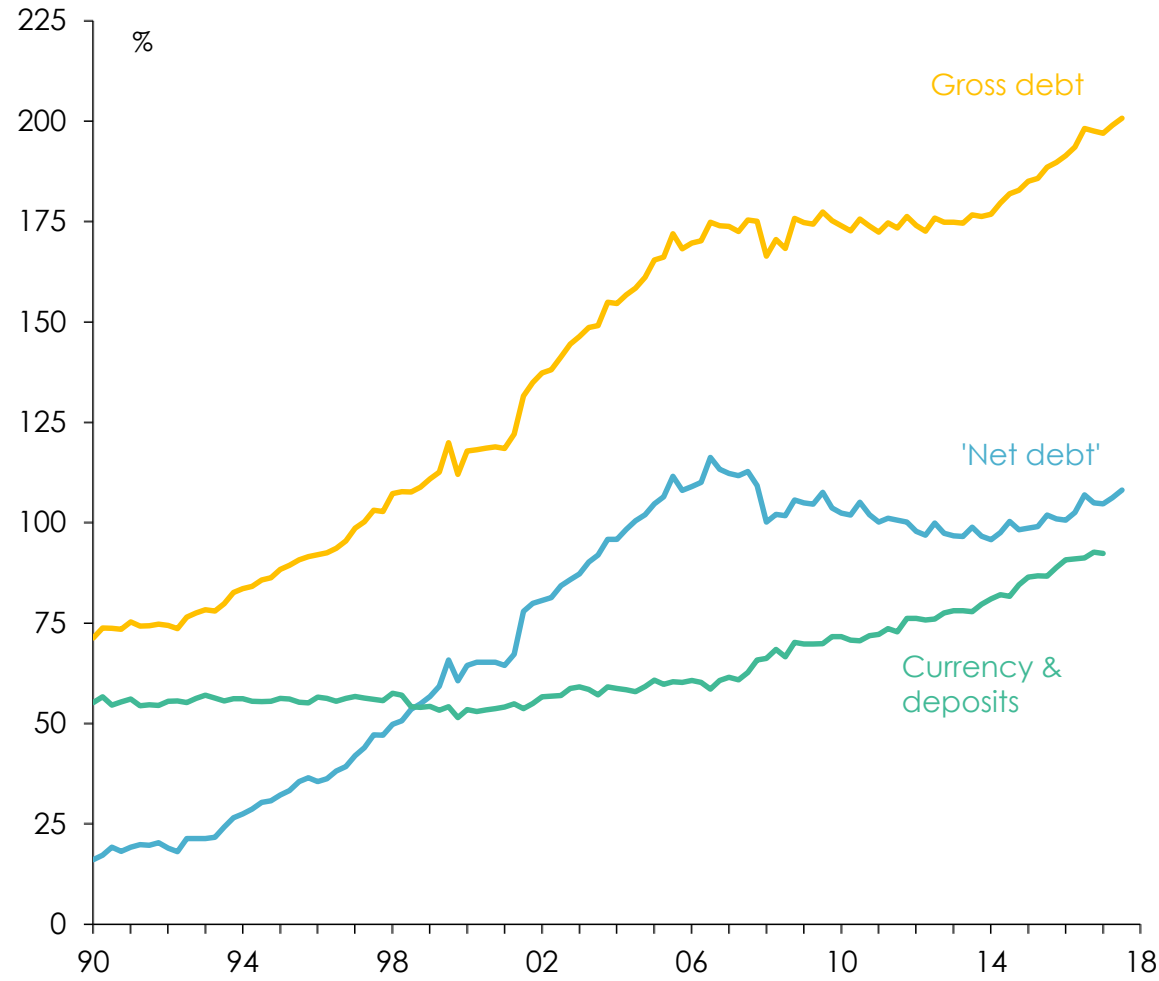
Housing approved but not yet commenced



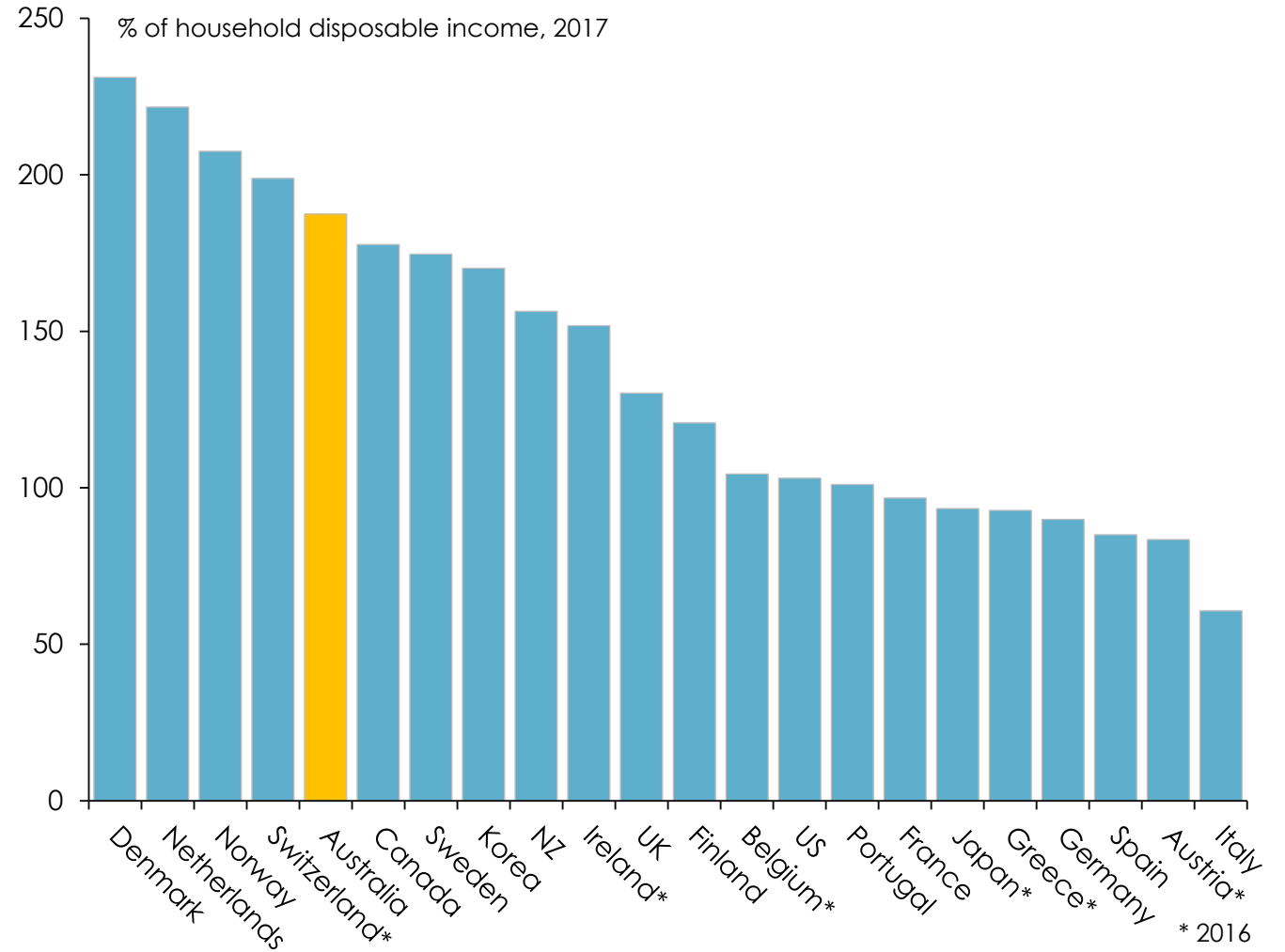
Source: ABS.

Australian household debt is at a record high by historical standards – and also by international standards

Australian household debt-to-income ratio, 1990-2018



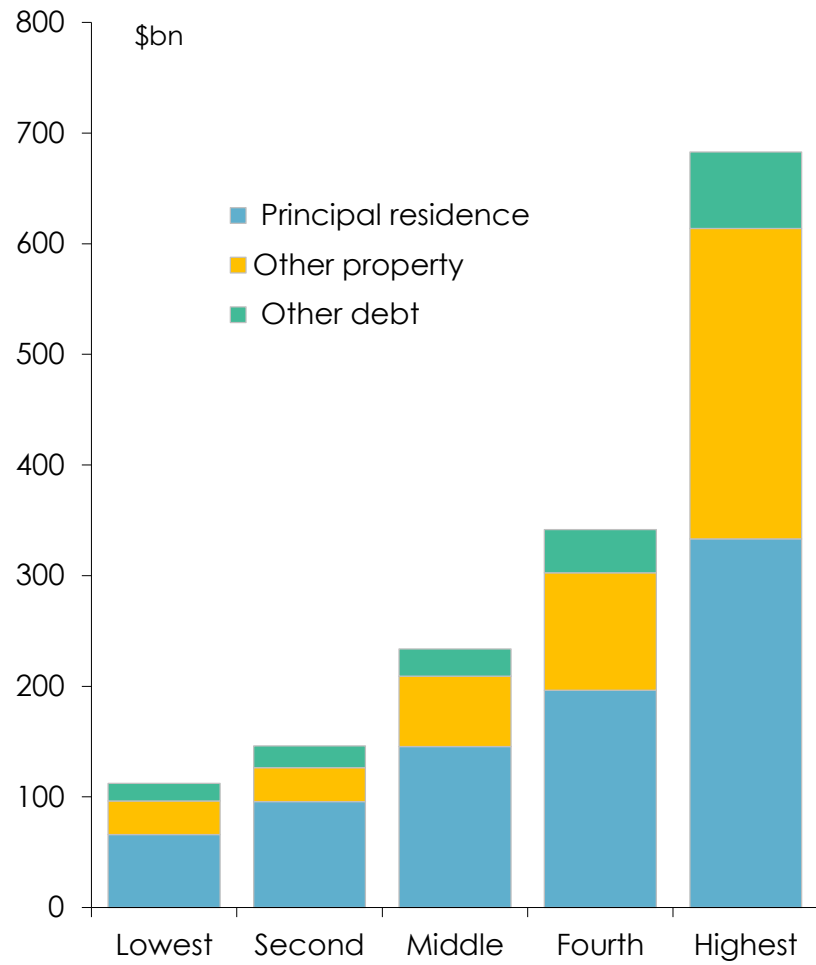
Household debt-to-income ratios, 'advanced' economies, 2017



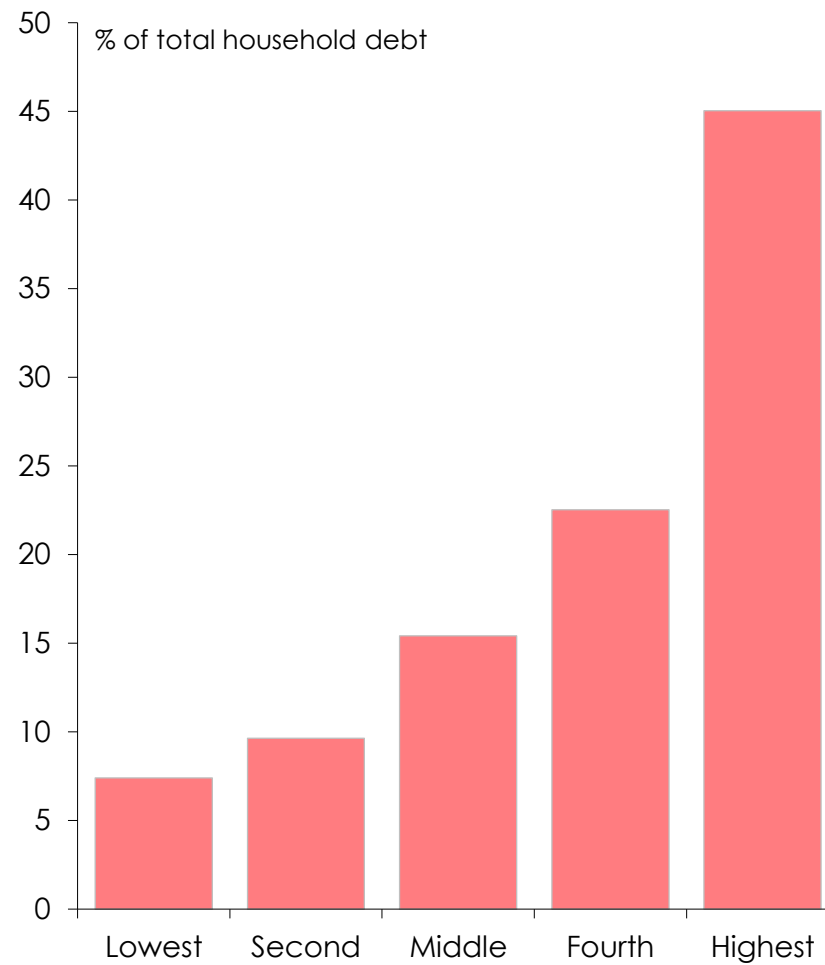
Sources: ABS ; Bank for International Settlements and OECD.

Two-thirds of Australian household debt is owed by the richest 40% of households – and that has barely changed over the past dozen years

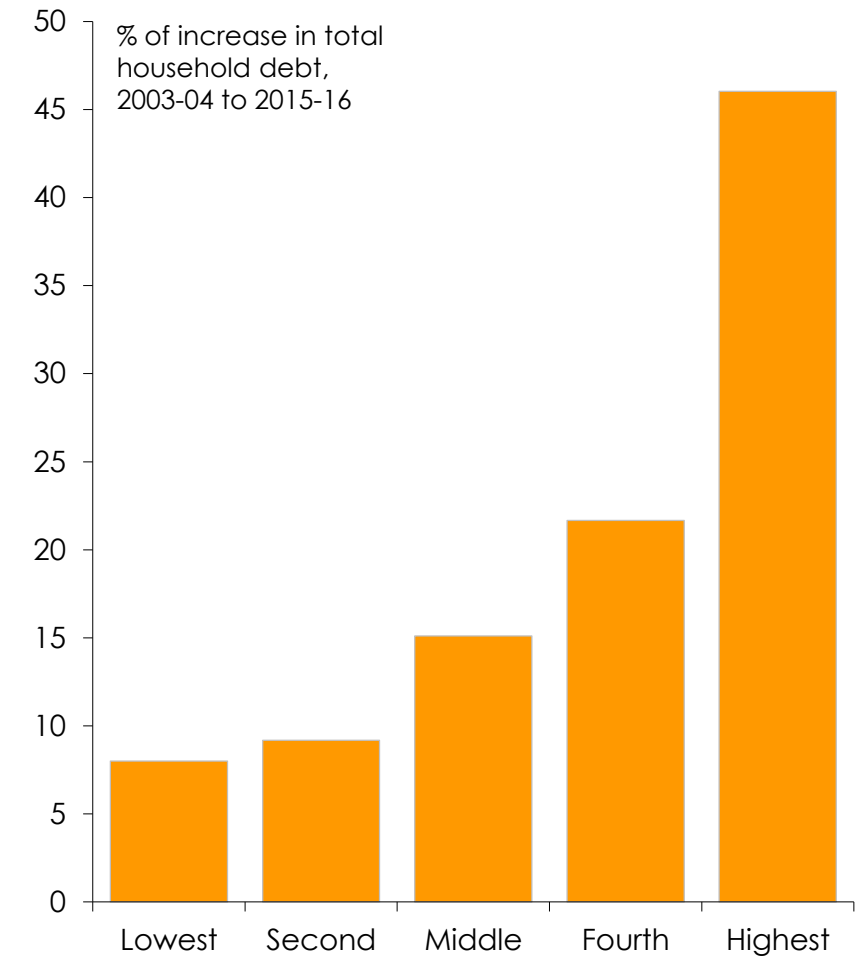
Household debt by income quintile, 2015-16



Share of total debt by income quintile, 2015-16



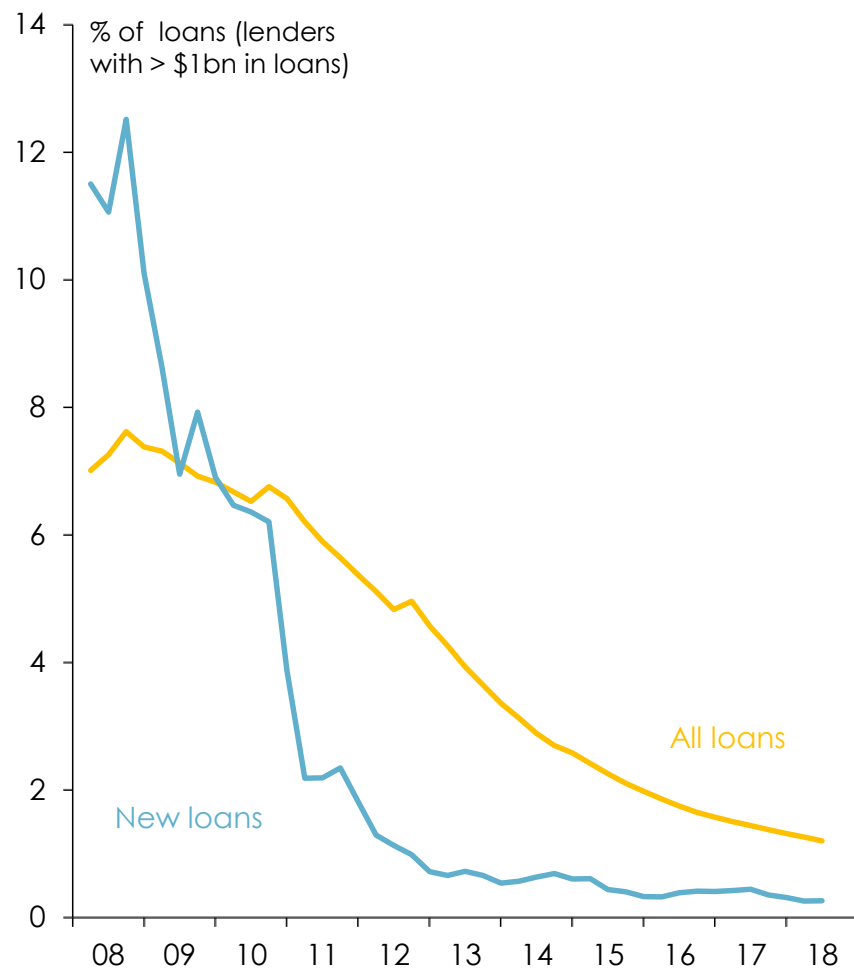
Share of increase in debt by quintile, 2003-04 to 2015-16



Source: ABS.

Most of the riskier forms of lending have been curtailed since the financial crisis – although the crack-down on interest-only loans is more recent

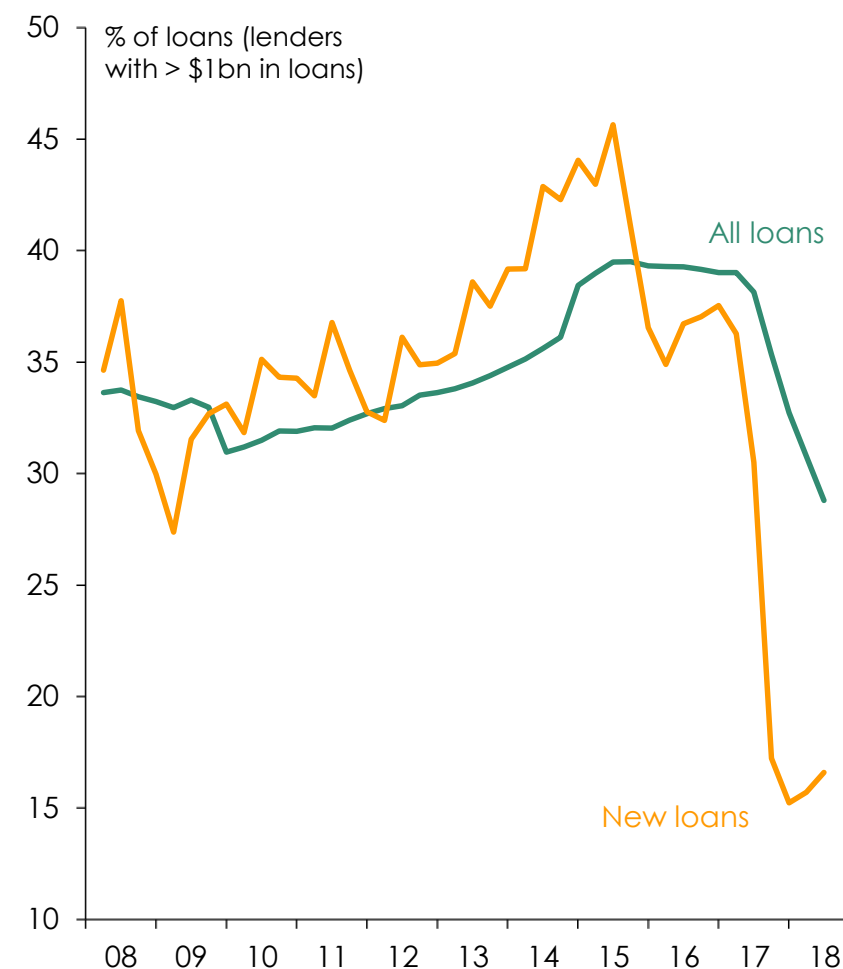
Low-doc loans as a pc of total mortgages



High LVR loans as a pc of new mortgages



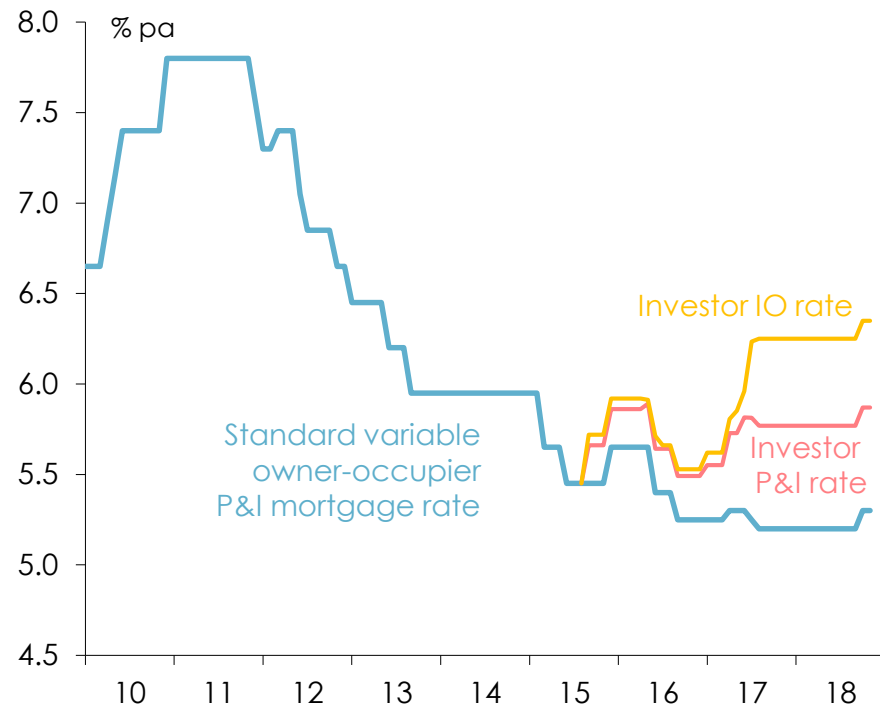
Interest-only loans as a pc of mortgages



Source: Australian Prudential Regulation Authority.

The risks associated with the clamp-down on interest-only lending appear to be relatively small

Interest rates for investor and owner-occupier mortgages



Source: Reserve Bank of Australia.

- ❑ **The RBA estimates that interest-only (IO) loans averaging about \$120bn a year are due to convert to principal-and-interest (P&I) loans between 2018 and 2021**
 - in total this represents about 30% of the total outstanding stock of mortgage debt
 - the 'step up' in mortgage payments when IO loans convert to P&I can be in the range of 30-40%
- ❑ **However the RBA believes that “any resulting increase in financial stress should not be widespread”**
 - many IO borrowers have accumulated substantial pre-payments on their loans
 - some borrowers have switched to P&I repayments ahead of schedule in order to avoid the higher rates which have applied to IO loans since 2016 – and “these borrowers appear well placed to handle the higher repayments”
 - the 'buffers' incorporated into the serviceability assessments used to write IO loans include potential for future interest rate increases and the step-up in payments at the end of the IO period
 - this latter aspect of loan serviceability standards was tightened by APRA in 2014

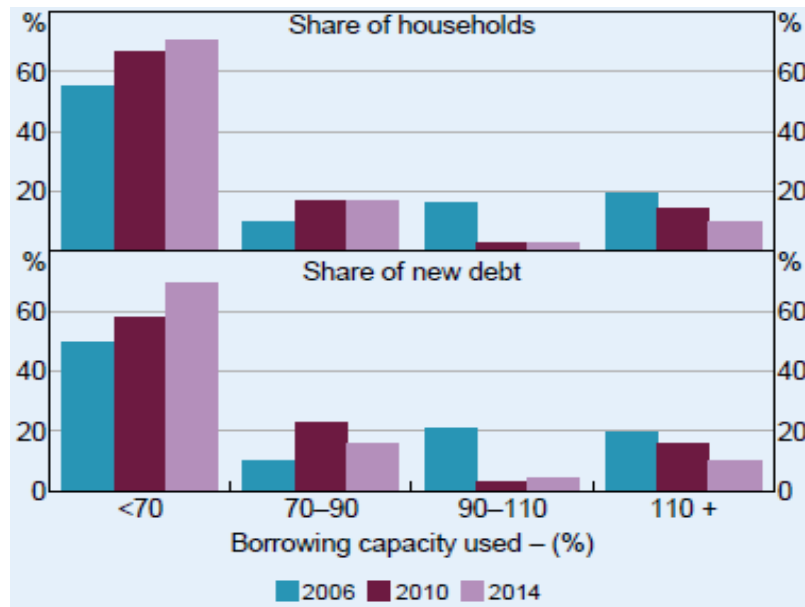
❑ **The RBA’s latest *Financial Stability Review* acknowledges that “a small share of borrowers could encounter financial stress” as a result of switching from IO to P&I terms**

- It reports that “some borrowers have encountered repayment difficulties ... but many have subsequently been able to adjust to higher payments within a year

Will the Banking Royal Commission lead to a 'credit squeeze'?

- ❑ The Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry was scathing in its assessment of the 'culture' in financial institutions, and of the perverse incentives created by remuneration practices – and of the unwillingness of regulators to take firm action, quickly, in responses to breaches of laws or regulations by financial institutions
- ❑ However, the Royal Commission hasn't uncovered anything pointing to widespread imprudent lending or borrowing on the scale evident, for example, in the US in the early 2000s
 - the failure of lenders to ascertain and verify borrowers' expenses had been 'called out' by ASIC and APRA between 2015 and 2017

Household use of maximum borrowing capacity



Note: Estimated maximum borrowing amount based on current lending standards and income-adjusted household expenditure measure.

Source: RBA, *Financial Stability Review*, October 2018,

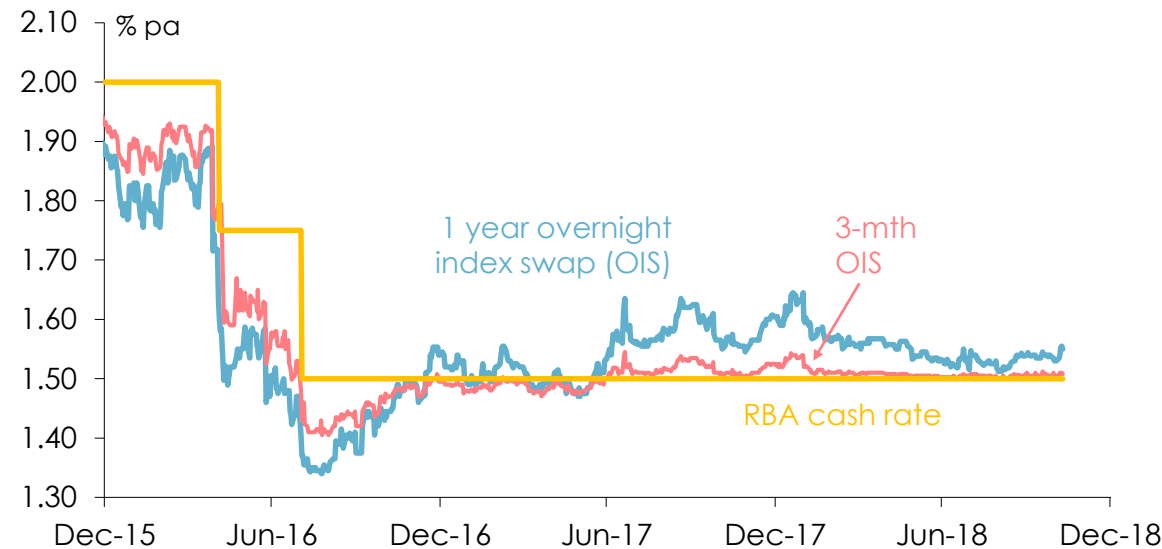
- ❑ Concerns that the Royal Commission's recommendations – or actions by lenders in anticipation of those recommendations – may lead to a 'credit squeeze' seem exaggerated
- ❑ RBA research indicates that not many households borrow the maximum amount offered by lenders
 - the median home-buyer borrowed about half the maximum loan obtainable
 - more than two-thirds of households borrowed less than 70% of their maximum loan size
 - only around 13% of newly-indebted home-buyers borrowed 90% or more of the maximum loan size
- ❑ The average owner-occupier loan has increased from \$350K to \$410K since lending standards were first tightened in mid-2015 – but that is still well under the maximum loan of \$530-\$630K that would be offered to the median borrower under current lending standards

The RBA is in no hurry to begin lifting official interest rates, no matter what other central banks do

RBA forecasts

	Year-ended					
	Jun 2018	Dec 2018	Jun 2019	Dec 2019	Jun 2020	Dec 2020
GDP growth	3.4	3½	3¼	3¼	3¼	3
Unemployment rate ^(b)	5.4	5	5	5	4¾	4¾
CPI inflation	2.1	2	2	2¼	2¼	2¼
Underlying inflation	1¾	1¾	2	2¼	2¼	2¼

Market pricing of the RBA cash rate

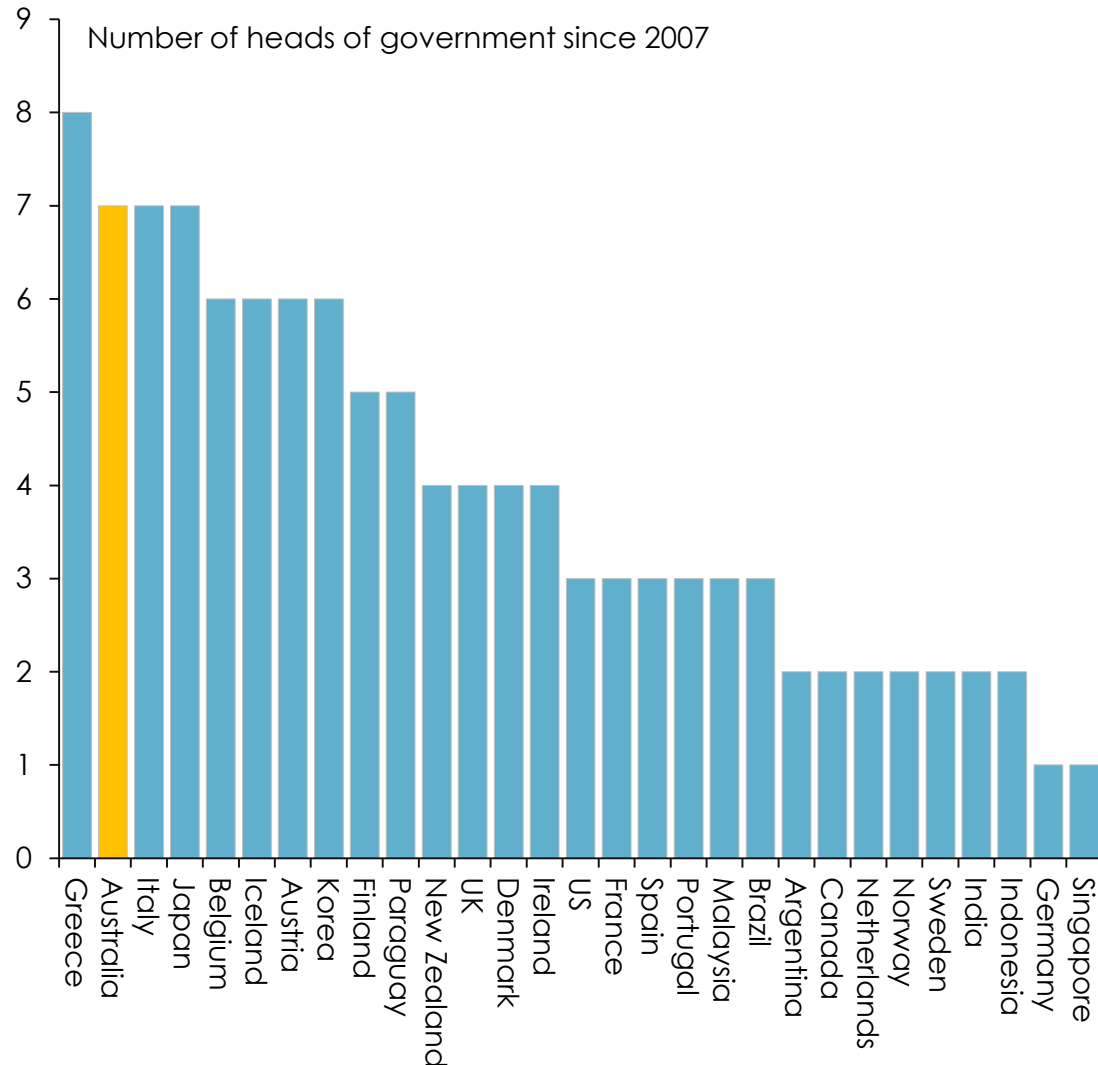


Source: RBA, Statement on Monetary Policy, August 2018.

- ❑ The RBA expects economic growth to be ‘a bit above trend’ this year and next – but the unemployment rate isn’t expected to drop below 5% until the first half of 2020
- ❑ ... while progress in ‘having inflation return to target is expected ... to be gradual’, with ‘underlying’ inflation not hitting 2% until mid-2019, and remaining below the mid-point of the target band through 2020
- ❑ These are not the forecasts of a central bank that is on the cusp of tightening monetary policy
- ❑ A particular source of uncertainty is whether, as in other ‘advanced’ economies, unemployment will need to be a lot lower than the level historically regarded as consistent with ‘full employment’ for a lot longer before wages growth begins to accelerate
- ❑ The RBA would be delighted to see [further] increases in foreign interest rates while it ‘stands pat’ reflected in a further decline in the A\$
- ❑ Financial markets and economists have been pushing out their expectations for the timing of the first increase in the RBA cash rate – it may well not be until the second half of next year, or even the first half of 2020

Political instability in Australia continues ...

Number of heads of government since 2007, selected democracies



- ❑ Australia has experienced its sixth change of Prime Minister (and its fourth other than as the result of an election) since 2007 – only one other democracy has had more in that time
- ❑ Malcolm Turnbull was defenestrated by his own side, partly out of ‘revenge’ for his overthrow of Tony Abbott in 2015, but also partly reflecting a belief that the Liberal Party could not win the next election under his leadership
- ❑ And now following the Wentworth by-election, Prime Minister Morrison is leading a minority government – albeit an early election triggered by a Parliamentary no-confidence motion still looks unlikely
- ❑ Morrison is likely to seek to differentiate the L-NP Coalition Government more sharply from Labor on issues such as energy, workplace relations, taxation and (possibly) immigration
- ❑ State elections in Victoria (24th November) and New South Wales (23rd March 2019) complicate Morrison’s choice of the date of the next election – which must be held no later than 18th May 2019

The key risks to the outlook for the Australian economy

❑ **Rising US interest rates**

- risk exacerbated by Trump Administration's fiscal and trade policies, and rhetorical attacks on central bank
- potential to trigger sharp reversals in financial markets,
- and/or downturn in US economy and highly indebted 'emerging markets'

❑ **'Hard landing' in China**

- risk of domestic financial crisis now less than 2-3 years ago, but hasn't been completely eliminated
- protracted 'trade war' could inflict damage, including through stock and currency markets
- Australia more exposed to China as an export market than it has been to any single country since the 1950s

❑ **Prolonged and/or widespread 'trade war'**

- impact on business confidence and investment probably more important than direct impact on trade volumes

❑ **A sharp reduction in Australia's immigration intake**

- Australia's overall economic growth has been more dependent on population growth during the current decade than in any decade since the 1920s
- there is increasing agitation on both the left and right of the Australian political spectrum for a cut in Australia's migration intake – although it isn't 'mainstream' (yet)

❑ **An abrupt and/or large decline in residential property prices**

- low-probability scenario unless Australian interest rates and/or unemployment rise sharply
- but a protracted gradual decline (more likely) will still see 'wealth effects' weighing on household spending and economic activity

❑ **Ongoing political instability**