# FY16: What will be shaping the economy

*Economic Views Australia*

## View from the top

The Australian economy grew by a better-than-expected 0.9% (2.3% over the year) in the March quarter; however the result – underpinned by seasonally strong iron ore export volumes and moderate growth in household spending – masks a sustained pattern of weak investment and income growth.

Looking forward, the external outlook will be shaped by imminent decisions on Greek debt and US monetary policy, presenting key risks to global financial markets and the Australian dollar. Domestically, record low interest rates and a prolonged period of subdued wage growth is expected to see a gradual pick-up in employment and business investment. However, growth could remain below average for some time, with a sustained pick up in productivity required to support a recovery in income growth and living standards.

| Indicator | March | FY14 | FY-15$^{e}$ | FY-16$^{f}$ | FY-17$^{f}$ |
|---|---|---|---|---|---|
| Real GDP Growth | 0.9% | 2.5% | 2.5% | 2.7% | 3.1% |
| Inflation | 1.3% | 3.0% | 1.5% | 2.5% | 2.5% |
| Unemployment rate | 6.2% | 5.9% | 6.1% | 6.4% | 6.2% |
| RBA cash rate | 2.25% | 2.50% | 2% | - | ▲ |
| General outlook | - | - | Positive | Negative | Stable |

Source: ABS; RBA; PricewaterhouseCoopers forecast (f), estimate (e). GDP Growth expressed as a year average rate, Inflation is through-the-year to June and the unemployment rate and interest rates are end of year.

## Potential forces shaping FY16

***Greek debt crisis and US monetary policy to shape global markets***

- Developments in Europe are hastily pointing to a possible Greek default and withdrawal from the eurozone. With negotiations ongoing, a decision amongst European leaders and Greek officials is expected within days.
- Elsewhere, all eyes (especially the RBA's) are on US monetary policy. Strong inflation figures and the latest US Federal Reserve chair's statement have increased the chance of interest rates rising from the zero bound during 2015.
- Increased US interest rates combined with subdued commodity prices will put further downward pressure on the Australian dollar. The foreign exchange futures market is pricing a 2% fall in the Australian dollar by mid-2016.

***Business investment to remain subdued, while housing investment continues to surge***

- Domestically, the pipeline of work on large LNG projects – the major driver of recent mining investment activity – will begin to recede over the next two years, meaning that investment by non-mining businesses will need to support growth. However, this requires a sustained pick-up in confidence and domestic demand.
- While a large pipeline of building approvals points to further strong growth in (largely high density) housing construction, this alone cannot support growth.
- Conditions for consumers are less clear. While economists expect households to gradually deleverage, subdued income growth, combined with uncertainties over house prices point to risks for spending.

***More output but less income***

- While real GDP has been growing modestly, growth in nominal (or the value of) GDP has been exceptionally low. In the near term, further expected falls in bulk commodity prices and subdued wage growth will place continued pressure on per capita incomes and government tax receipts.
- Lower per capita incomes and government tax receipts will place long-term pressure on all levels of government to balance their fiscal positions and reduce their ability to deal with the implications of structural and demographic change in the economy.

pwc

# FY16: What will be shaping the economy

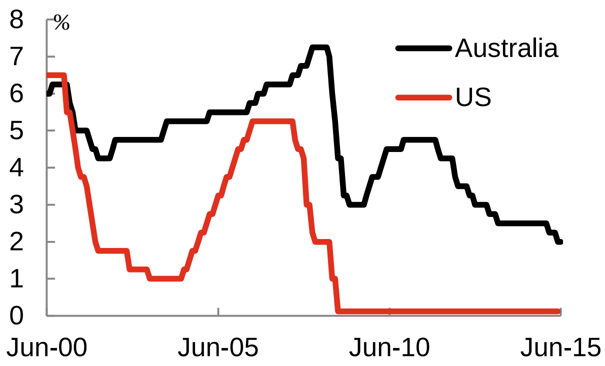
*Economic Views Australia*

## *The world is focussed on developments in Europe and the US...*

Following a 3 month stalemate over its €7.2 billion ECB/IMF bailout fund, the risk of a Greek default and withdrawal from the Eurozone has intensified. A decision between European and Greek officials over the debt (over 170% of GDP) is expected within days, with the potential for default within weeks.

Outside of Europe all eyes (especially the RBA's) are on US monetary policy. Strong domestic inflation figures and the latest US Federal Reserve chair's statement have increased the likelihood of interest rates soon rising from the zero bound (see Figure 1).

**Figure 1 Benchmark interest rates**




Source: RBA

Increased US interest rates, particularly if combined with subdued commodity prices and global market volatility will put further downward pressure on the Australian dollar. Combined with subdued domestic price growth, this should provide much needed support to trade-exposed industries such as tourism, education, agriculture and manufacturing.

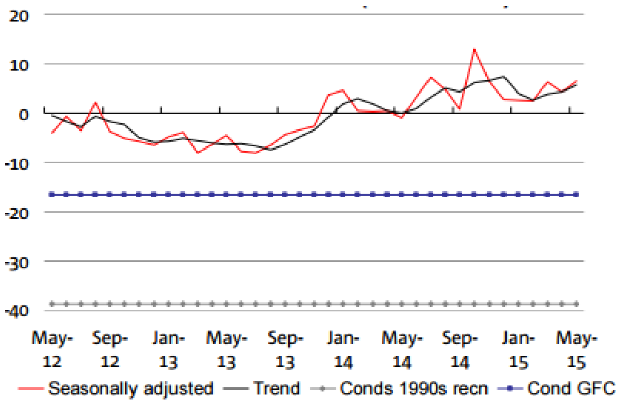
## *...while Australian firms restrain investment plans*

Waning investment in the resources industries weighed heavily on growth in the March quarter, and will continue to do so over the outlook. In addition, investment activity in non-mining industries is also particularly weak. As a share of total output, non-mining investment is at similar levels seen in the 1990's recession.

The outlook for FY16 remains subdued, with the latest ABS capital expenditure survey pointing to further restraint. While survey measures of business confidence and conditions have picked up from recent lows (Figure 2), shaky prospects for a broad-based pickup in domestic spending mean that this may not translate into long-term investment plans.

On the other hand, a solid pipeline of housing approvals points to continued strong growth in high density housing construction. However, at only 5 per cent of GDP, the sector is not large enough to counter the effects of a waning mining sector.

**Figure 2 Business confidence (index)**



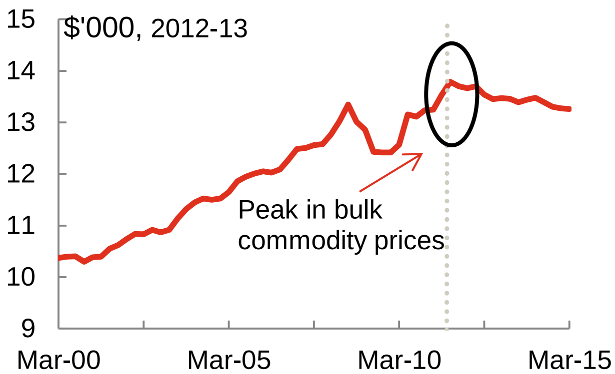

Source: NAB.

Strong growth in housing prices, particularly in Sydney and Melbourne has spurred much of this construction and boosted household wealth, allowing households to increase spending.

## *Incomes and taxation revenue to remain subdued a little longer*

Despite modest growth in real GDP, Australians are experiencing record low income growth. Indeed, since bulk commodity prices peaked in 2011, per capita real incomes – a measure of living standards – have actually fallen (Figure 3).

**Figure 3 Real per capita national income**

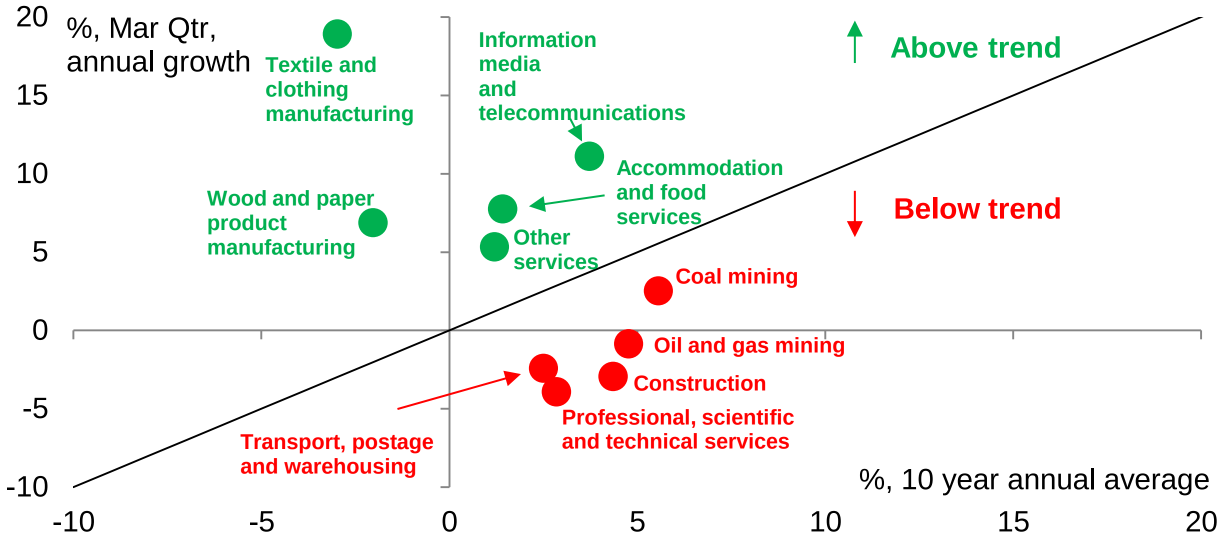



Note: Real net disposable income per capita
Source: ABS.

This trend is part of a longer term macroeconomic adjustment as the mining boom unwinds, and will put continued pressure on household spending and government tax receipts. However, commodity prices are expected to flatten as supply and demand equalise, and wage restraint will help drive employment. Combined with a lower exchange rate and productivity improvements, this will provide support for non-mining exporters and broader-based growth.

## *Best and worst industry performers – March quarter 2015*

To understand industry performance in the March quarter, it is worth looking at how growth has compared with historical averages. The chart below illustrates the performance of the top five and bottom five industries in the March quarter against performance over the past 10 years. Industries above the diagonal line have exceeded historical averages and those below have recorded below average growth in the quarter.




Note: Displays the five industries that grew slowest/fastest in the March 2015 quarter relative to a 10 year history; above the line indicates above trend growth while below the line indicates below trend growth.
Source: ABS

## *GEM spotlight: manufacturing*

Recent debate surrounding the declines in Australian manufacturing gloss over the diversity and performance within the sector. Using PwC's Geospatial Economic Model (GEM) we take a granular view of Australian manufacturing, measuring the performance of the sector in 2,214 locations across Australia since 2001.

The table below shows the performance of four locations currently under the spotlight. As can be seen, there is a stark divergence in historical perfomance across these locations. Why is this important? Given the major disruption the industry will face over the next two years, understanding the actual performance of each location is critical to identifying remaining pockets of strength and comparative advantage. In areas where there is prolonged decline, it becomes crucial to ensuring the correct policy response and providing the appropriate support to impacted communities.

| Region | Manufacturing as a % of region's economy | Short Term Growth | Long Term Growth |
|---|---|---|---|
| Dandenong* (Vic) | 29.0% | 1.9% | 0.9% |
| Geelong† (Vic) | 12.9% | -0.4% | -2.9% |
| Lara/Avalon* (Vic) | 24.4% | -1.2% | -6.3% |
| Elizabeth* (SA) | 27.4% | -4.7% | -11.4% |

* SA2, † Urban Area
Source: PwC GEM, http://www.pwc.com.au/consulting/analytics/gem.htm

### *Definitions*

Base interest rate forecasts – ▲ increase; ▼ decrease; ◄► no change
General outlook – In the Key Metrics table on page 1, the economic environment is assessed as being Positive, Stable or Negative.

# FY16: What will be shaping the economy

*Economic Views Australia*

## PwC Economic and Policy consulting

The Economic Views reports are produced by PwC's Economic and Policy Consulting team. Working at the nexus of economics, policy, strategy and finance, we provide practical and empirically-supported solutions using the latest economic tools and industry leading expertise.

Our macroeconomic efforts have recently been focused on helping businesses to assess the most pressing risks and opportunities in their markets, understand the effectiveness of their forecasts and test their businesses' sensitivity to a range of economic scenarios. All these factors are essential to establishing the best strategy for business during times of economic turmoil.

We also provide microeconomic advice to a range of industry sectors, with a particular focus on transport, Government, health and social services, energy, water, and natural resources.

For more information about any of our services please contact one of the members of the team below.

How our macroeconomic team can support you:

- Prepare economic outlook reports on the country or industry you are interested in;
- Prepare short term and long term forecasts of macroeconomic variables such as GDP, inflation, average earnings, consumer demand and interest rates;
- Review and advise and develop short and long term forecasting methods for businesses based on key macroeconomic and industry sensitivities;
- Advise on the impact of key events, such as the global financial crisis, emissions trading schemes or major changes in regulation, on your markets;
- Assess the contribution your company or industry makes to the local economy in terms of economic variables such as employment, tax revenue and output; and
- Construct models to forecast prices and key market trends.

## Contact Details

For more information about our services please contact one of the members of the macroeconomic consulting team below:


| | | | |
|---|---|---|---|
| **Craig Fenton** | Partner | +61 (0)7 3257 8851 | craig.fenton@au.pwc.com |
| **Jeremy Thorpe** | Partner | +61 (0)2 8266 4611 | jeremy.thorpe@au.pwc.com |
| **Rob Tyson** | Director | +61 (0)2 6271 3260 | rob.tyson@au.pwc.com |
| **Iain Bain** | Senior Manager | +61 (0)2 6271 3213 | iain.bain@au.pwc.com |
| **Ben Greig** | Senior Consultant | +61 (0)2 6271 3135 | ben.greig@au.pwc.com |
| **Rhett Wilcox** | Senior Consultant | +61 (0)2 8266 2463 | rhett.wilcox@au.pwc.com |


## PwC Economics and Policy