Economic Views Australia

FY16: What will be shaping the economy?

View from the top

The economy grew by a paltry 0.2% in the June 2015 quarter, subdued by a large fall in resources exports but supported by lumpy government capital purchases. GDP grew by 2.4% in 2014-15, completing 24 consecutive years of growth, but with six out of the last seven below-trend.

This news was set against heightened fears of a 'hard landing' for the Chinese economy, with markets spooked by indicators firming up prospects of an economic slowdown – an inevitable consequence of China's transition to consumption led growth. While this bodes poorly for financial market stability, it presents opportunities for Australian industry.

Domestic indicators continue to reflect below-trend growth prospects, with record low-interest rates and wages growth, and a lower Australian dollar supporting the economic transition post-mining boom. A sustained pick-up in industry productivity growth would further support this transition.

Indicator	June quarter	FY-15	FY-16f	FY-17f	FY-18f
Real GDP Growth	2.0%	2.4%	2.8%	2.8%	3%
Inflation	1.5%	1.5%	2.50%	2.50%	2.50%
Unemployment rate	6.1%	6.1%	6.50%	6.25%	6%
RBA cash rate	2.00%	2.00%	2.00%	▲	▲
General outlook	-	-	Negative	Stable	Stable

Source: ABS; RBA; PwC forecast (f), 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.

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Potential forces shaping FY16

China adds to the global volatility mix

- Over the past month, we have witnessed significant volatility in Chinese equity markets. The Shanghai Composite Index has fallen almost 40% since its peak in June to levels seen in early 2015.
- The Shanghai Composite has historically shown signs of volatility, with this bout driven by investor fears at slowing Chinese economic growth and concerns around the Government's ability to unwind built up risks in the property and banking sector.
- Volatility in China is a significant concern given China is Australia's largest export partner (importing around one third of merchandise exports).
- It is unlikely that developments in the Chinese economy will delay the US Federal Reserve tightening monetary policy over the next six months.

Consumers feel under the pinch

- Consumer confidence has been rocked by the economic volatility abroad, which comes at a time when consumers feel the pinch of a stagnant labour market.
- While consumer confidence recorded a surprise jump in August, the number of pessimists still outnumber the optimists – evident in all but two of the past 18 months.
- A key factor is a subdued labour market, with elevated levels of unemployment and poor domestic demand leaving wages growth at record lows over the past year. This is weighing on household spending, with consumers maintaining a historically high rate of saving.
- Employment prospects in the mining, construction, wholesale trade and government-related industries are driving the downturn, with earnings stagnating or falling in WA, NT, TAS and the ACT.

Exporters benefit from a lower AUD.... Slowly

- The export sector displayed significant signs of weakness in the June quarter, reducing its contribution to 2014-15 growth by ¼ of a percentage point from what was forecast in the Budget.
- While the detraction in resources exports in June caused some alarm, it reflected a number of isolated factors– including unplanned outages which impacted oil and gas, and flooding in NSW which impaired coal exports.
- A rebound in resource exports is expected in the September quarter, and the lower Australian dollar (AUD) should continue to boost trade exposed sectors.
- The AUD has fallen to around 70 US cents, contributing to a rebound in services exports. Travel exports have increased by over 6% over the last year, driven by arrivals from China, New Zealand and the United States.

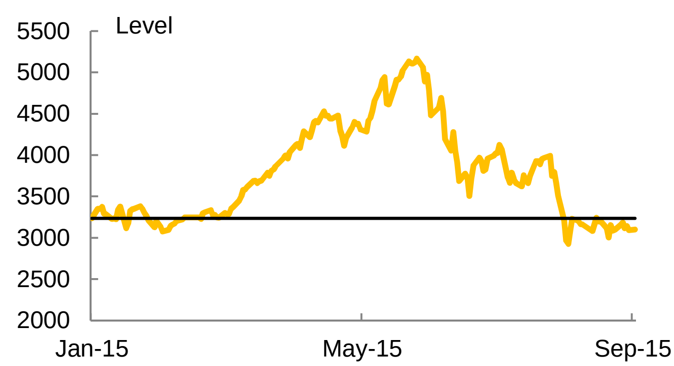
Chinese outlook remains subdued, while the US continues to look rosy

Internationally, all eyes have been on developments in the Chinese economy. Volatility in equity markets (see Figure 1) weaker than anticipated economic growth and conditions in the property sector have seen investors react skittishly to data releases and statements from Chinese authorities.

At August's G20 Finance Ministers' Meeting, China announced an escalation in government expenditure and an increase in dividend payments from state-owned enterprises. These measures were announced in a bid to keep year-ahead growth around 7%.

The People's Bank of China also acted to stimulate the economy in August, lowering interest rates and devaluing the Yuan. The timing of the devaluation came just days after the release of weak Chinese trade data.

Figure 1: Shanghai Stock Exchange Composite Index



Source: Yahoo Finance

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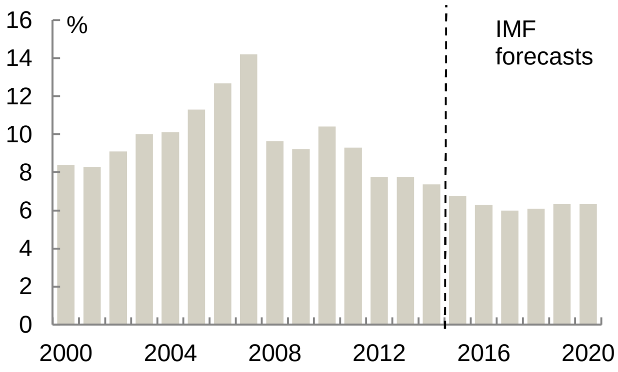
On a relative basis, the AUD has declined further than the Yuan this year. This is good news for Australian export markets reliant on Chinese demand; however, whether demand is sustained will depend on China's ability to reach longer-term growth targets.

Over the longer term, China remains committed to structural reform and its transition towards slower, more sustainable growth. The IMF is forecasting Chinese GDP growth of 6.8% this year, before slowing to 6% by 2017 (see Figure 2).

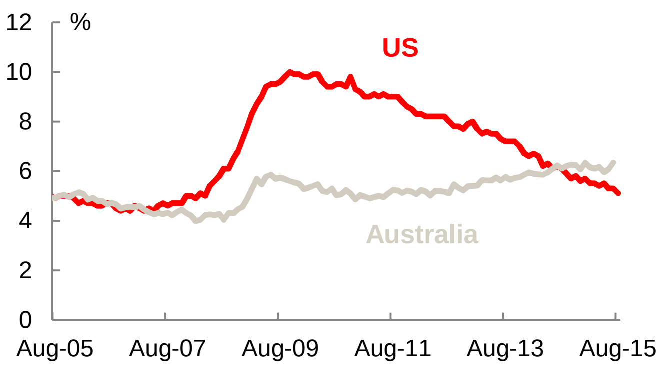
Figure 2: China GDP Growth



Source: IMF

While markets remain skittish on the Chinese outlook, recent US data releases point to a strengthening US economy despite global volatility. In August, the US unemployment rate fell to its lowest level since April 2008 (5.1%), with over 173,000 jobs added. The steady decline in the US unemployment rate has occurred as the Australian labour market has gradually deteriorated (see Figure 3).

Figure 3: US and Australian unemployment rates



Source: Bureau of Labor Statistics and ABS catalogue 6202.0

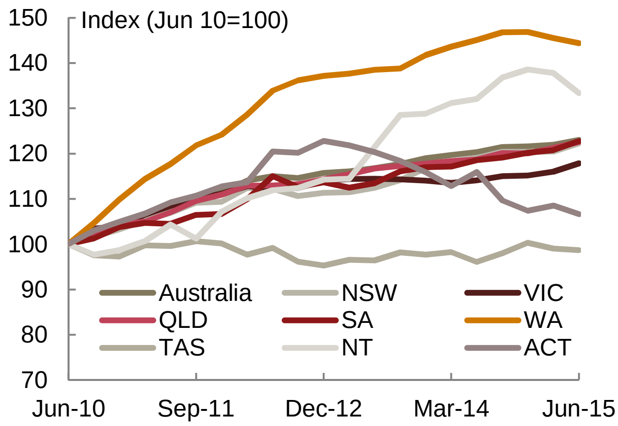
Last week, the US Federal Reserve kept monetary policy unchanged, as concerns about an increasingly fragile world economy eclipsed strong US jobs data. Futures markets still point to a tightening of monetary policy in the next six months; however the likelihood of a move has fallen.

Wage earners continue to feel the pinch…

Domestic indicators point to a downturn in consumer confidence, with global equity market volatility and weak economic data in Australia and China stoking fear about jobs and future returns.

However, household spending is also weakened by current conditions, with heightened unemployment and record low wages growth weighing on incomes as the economy adjusts to the end of the mining boom. This has hit some states worse than others, with labour income in WA and NT – states with large mining projects – falling from growth of nearly 40% and incomes in the ACT and Tasmania broadly unchanged since 2010 (see Figure 4)

Figure 4: Labour income by state



Note: Compensation of employees (private and public)
Source: ABS catalogue number 5206, PwC calculations

This highlights significant disparities in economic growth prospects across different regions; a reversal of the two-speed economy observed throughout much of decade. Retailers are feeling the effects – discretionary retail spending in NSW grew by 8% over the last year, 3% above its 10 year average, but grew by less than 3% in WA, 4% below its average (see Figure 5).

With downward pressure on commodity prices impacting profitability of companies in the mining states, this pattern is expected to continue for some time.

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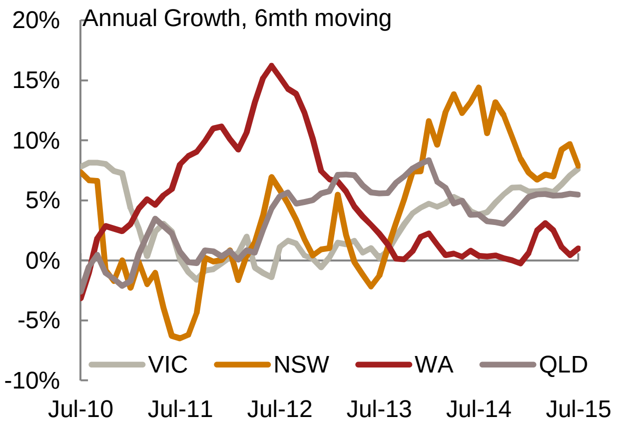
Figure 5: Discretionary retail trade

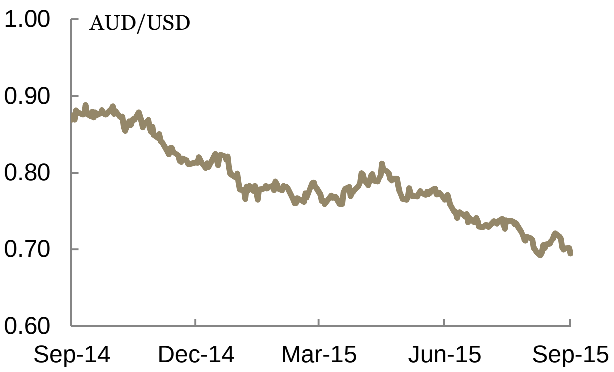


Note: Discretionary retail trade excludes food, and 'other' retailing.
Source: ABS catalogue 8501.0

Exporters benefit from a lower AUD…. slowly

The AUD/USD is currently at levels unseen since mid-2009, falling over 20% in the past 12 months (see Figure 6). Futures markets currently point to a stabilisation of the AUD/USD at this new level, with the exchange rate priced to hover between 65-70 US cents over the medium to long-term.

Figure 6: AUD/USD Exchange rate



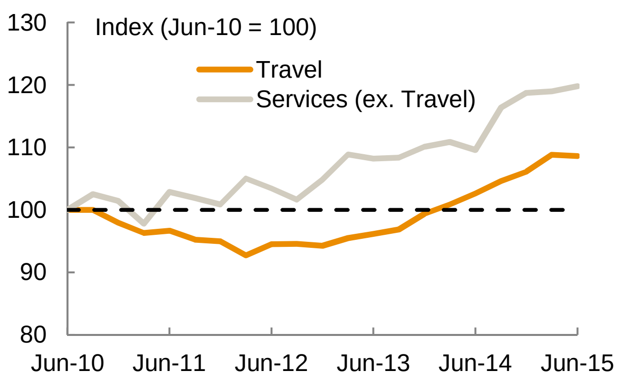
Source: RBA

The relative strength of the USD has been the primary driver of this decline, compounded by subdued domestic growth and falling commodity prices.

The lower AUD has softened the blow of reduced commodity prices on the mining sector, and is also beginning to benefit Australia's export sector more broadly. These benefits should continue to manifest over the medium to long term, as the lower exchange rate fully passes through to prices and restores international competitiveness.

The tourism sector has been a key beneficiary of the fall in the AUD (see Figure 7). The lower AUD has made Australia a more attractive destination for Asian, European and American tourists. Tourist arrivals, a key measure of growth in the sector, have increased by over 9% since the beginning of 2014.

Figure 7: Services export volumes (2010-2015)



Source: ABS catalogue number 5302.0

Over the past 18 months, the number of short term overseas arrivals has increased at an annual average rate of over 7%. This compares to 3.6% per annum during the GFC and over the period where the AUD remained well above 95 US cents. (2008-2012).

The majority of this increase in short-term passenger arrivals has been driven by North-East Asia (33%) and the Oceania Region (30%). These two regions are dominated by passenger movements from China and New Zealand respectively.

Education has also been another major beneficiary. In 2014, education related personal travel grew 13.5%. Growth was spurred by an increased number of students from China (up 9.1%), India (up 39.6%) and Vietnam (up 17.7%). This trend is expected to continue, as the lower AUD lifts the Australian education sector's international competitiveness.

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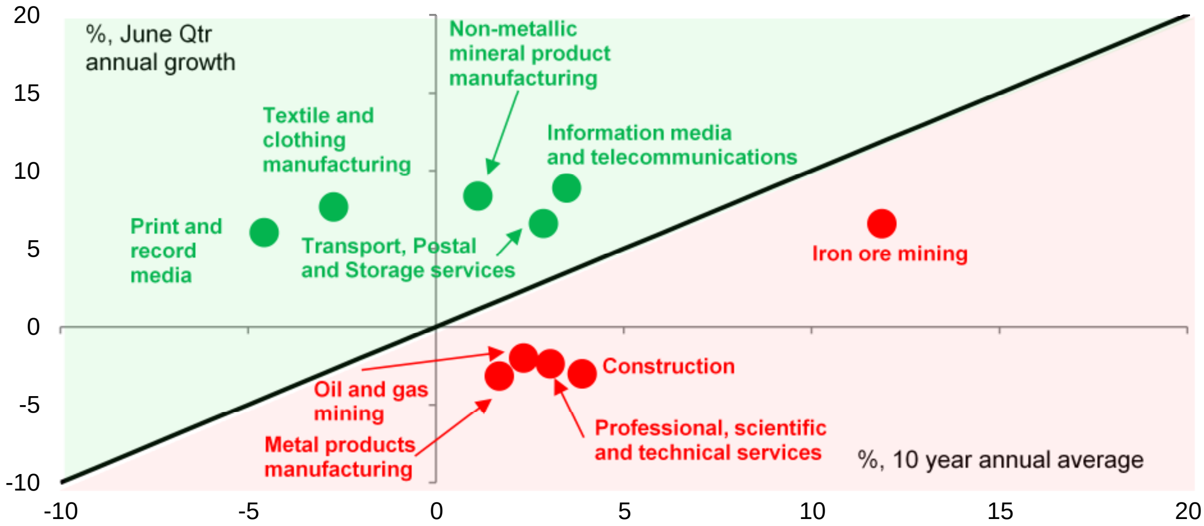
Best and worst industry performers – June quarter 2015

To understand industry performance in the June 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 June 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 June quarter 2015 relative to a 10 year history; above the line indicates above trend growth while below the line indicates below rend growth.
Source: ABS catalogue number 5206.0

GEM spotlight: two-speed or ten-speed economy?

The gradual transition from mining to non-mining led growth is becoming evident in the disparate performance of across states. Assisted in-part by a surging property market, wages and spending in Victoria and NSW are on the way up, but have flat-lined in Queensland and WA.

However, at a more granular level economic performance is more highly fragmented. This is highlighted in recent analysis using PwC's Geospatial Economic Model, which found that one-in-three locations (out of 2,214 locations) are in recession, and that activity is become increasingly concentrated in the top 10 largest locations. This result is driven by variations in either seasonal (agricultural reasons), cyclical (for example, investment-led) or structural growth (for example, declining manufacturing).

The table below shows the five largest areas for growth and decline since the start of this century (FY01 –FY14). These trends are expected to continue as a result of economic agglomeration, manufacturing closures, and falling mining capital investment, posing important considerations for investment and policy decisions.

Location	Change in output, $m	% FY01 output	Location	Change in output, $m	% FY01 output
Melbourne CBD	24,420	76%	**Nanango (Qld)**	-1,219	-61%
Sydney CBD	18,560	37%	**Churchill (VIC)**	-1,189	-21%
Ashburton (WA)	17,253	611%	**Moe (VIC)**	17,253	-20%
East Pilbara	17,201	776%	**Condell Park (NSW)**	17,201	-20%
Perth City	12,196	73%	**Wetherill Park (NSW**	12,196	-10%

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.

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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.

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- Review and advise and develop short and long term forecasting methods for businesses based on key macroeconomic and industry sensitivities
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- Assess the contribution your company or industry makes to the local economy in terms of economic variables such as employment, tax revenue and output
- Construct models to forecast prices and key market trends.

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