



Australian Economy – sharp slowdown underway

December 2008

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Key Points:

- The Australian economy will come dangerously close to a recession in 2009, but it is not the forgone conclusion being suggested in some quarters.
- Clearly the risk is only weighted one way at present. That is that Australia fails in its bid to avoid recession, a risk we have been highlighting for some months.
- For the household sector, retail sales are likely to remain subdued in the short term but there remains the prospect of a recovery in leading housing indicators from the first quarter of 2009.

There are clear signs of a significant weakening in the domestic Australian economy. Given the aggressive rise in interest rates endured over 2007/08 (and into July 2008), both by the Reserve Bank of Australia (RBA) and independently by financial institutions, this slowdown comes as no surprise.

The slowdown has, however, been met with a further hit from a rapidly deteriorating global economy and the positive impacts from Australia's terms of trade evaporating. As such, what was an outlook for softer growth in Australia into 2009 very quickly became an outlook for very weak growth at best, and recession at worst.

The annual rate of growth in Gross Domestic Product (GDP) reached a four year high of 4.7 per cent in the September 2007 quarter but had slipped back to just 1.9 per cent by the September 2008 quarter. Annual growth in domestic final demand reached its highest rate in four years, 5.5 per cent, in the December 2007 quarter, but slipped to 4.1 per cent in the September 2008 quarter and would have slipped further than it did were it not for business investment countering a marked weakening in the household sector.

The Westpac-Melbourne Institute Leading Index (which incorporates monthly variables such as dwelling approvals and share prices and quarterly variables such as manufacturing materials prices) indicates the likely pace of economic activity three to nine months ahead. The annualised growth rate of the index was a meagre 0.6 per cent in October, well below its long term trend rate of 3.8 per cent. This index and most other economic indicators suggest that Australia will only just avoid a contraction in economic activity (as measured by GDP) in 2008/09.

Westpac-MI Leading Index



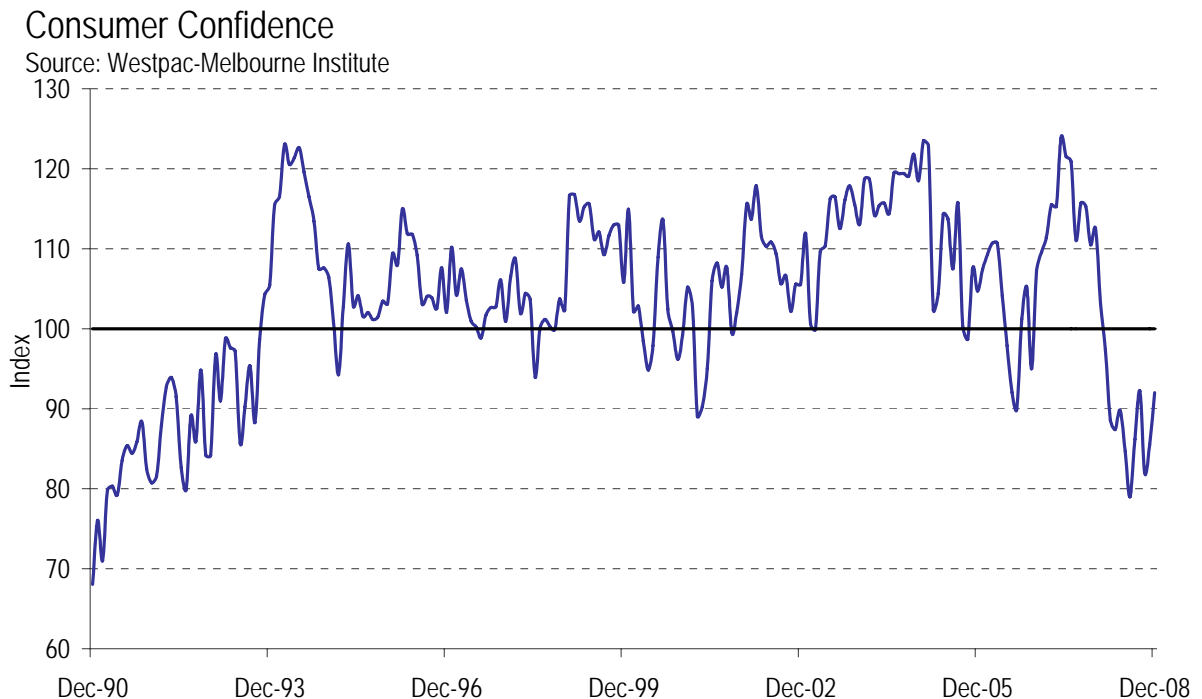
Clearly there is little 'wriggle room' for the Australian economy in escaping the fate of going backwards (i.e. avoiding a recession). Even if the somewhat cumbersome and not always accurate definition of a recession being two consecutive quarters of contraction in GDP is avoided, an unemployment rate climbing steadily past the 6.5 per cent mark would mean the escape attempt had failed.

We began noting in July the risk of Australia 'talking itself into recession'. This risk intensified as the second half of 2008 wore on, given the hoopla and headline grabbing that accompanied what was clearly a substantial deterioration in global economic conditions. It is indisputable that the economic prospects for Australia needed to be heavily marked down as the second half of the year wore on. Indeed the final point for our economy at the end of 2008 is probably little different to that which would have prevailed minus the media frenzy. Nevertheless, some element of the doom and gloom that has increasingly enveloped the psyche of Australian households and businesses in recent months can justifiably be laid at the door marked 'bad news sells'.

The title of our earlier Research Note on the Australian Economy - 'Household Sector Bearing Brunt of Economic Slowdown Jul 08' – unfortunately still holds true given that the household sector has softened further in the second half of the year, but hard evidence of a sustained and significant weakening in business investment has yet to emerge.

There has been a significant weakening in retail sales in 2008 to date. Annual trend growth in the value of retail sales (through to October) is softening again. Retail sales volumes grew by only 0.1 per cent in the September 2008 quarter. Sales volumes contracted over the preceding two quarters, the first such occurrence since 1996. Annual growth in the September quarter was a miserly 1 per cent, the slowest in three years.

In December 2008 the Westpac-Melbourne Institute Consumer Sentiment Index is still at a historically low level, although at least there has been some recovery (an aggregate 12 per cent over November – December, which still only gets us back to the September level). Consumers have been buoyed by lower interest rates and petrol prices (the exact opposite to the situation prevailing in July) combining with a strong federal fiscal stimulus, but spooked by concerns over the economy, falling asset prices, and job security. Regardless of the encouraging improvement in consumer confidence over November and December, the index had not lingered at such low levels over a sustained period of time since the early 1990's recession.



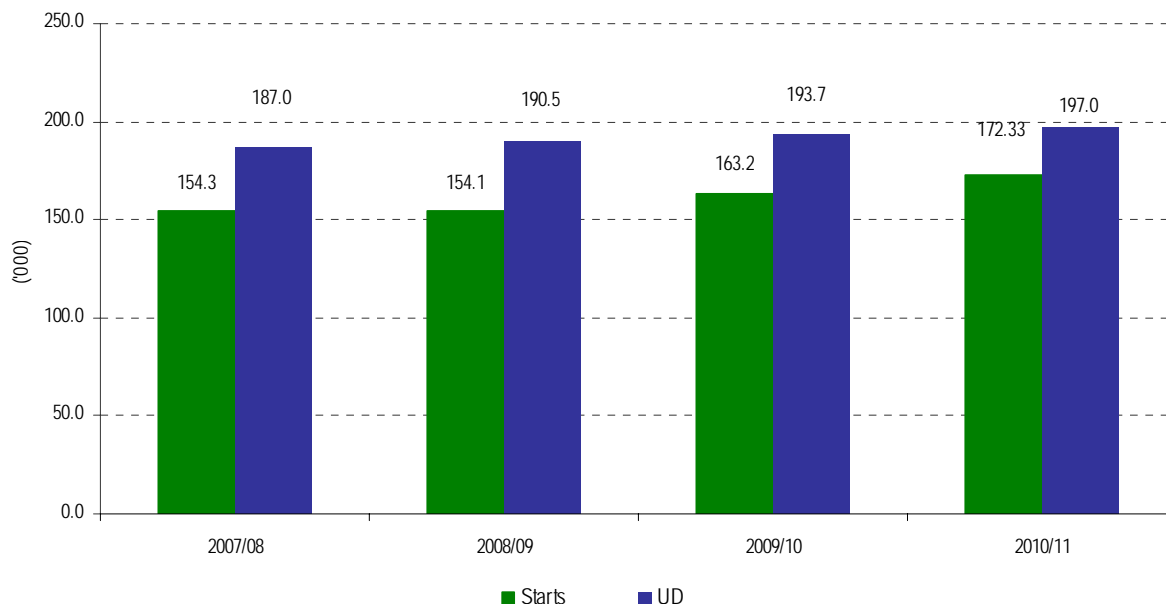
There is not a close historical relationship between consumer confidence and actual consumption expenditure. However, the low level of confidence does not auger well for a short term turnaround in the downward trend evident for consumer spending.

On the residential construction front, leading indicators of new housing – building approvals, HIA new home sales, housing finance – have all displayed a strong downward trend, on what were already weak numbers, in the second half of 2008. The clear downward trend in these data sets points to a retention of the current large gap between the supply of new stock and the underlying demand for new housing.

In 2009 the housing sector will be relying on the federal government's fiscal stimulus and lower interest rates to lead it back into recovery and to soak up the yawning gap in housing supply. If the recovery is to happen there must be a dramatic improvement in the leading indicators for new housing in the new year. Failure on this front will condemn new housing to yet another year of decline in the 2009 calendar year as well as in the 2008/09 financial year.

Underlying Demand for Housing - Australia

Source: HIA



The Westpac-Melbourne Institute Index of Time to Buy a Dwelling fell over six consecutive quarters to June 2008, the longest sustained period of weakness since 1984/85. The index did, however, recover strongly in the September and December quarters.

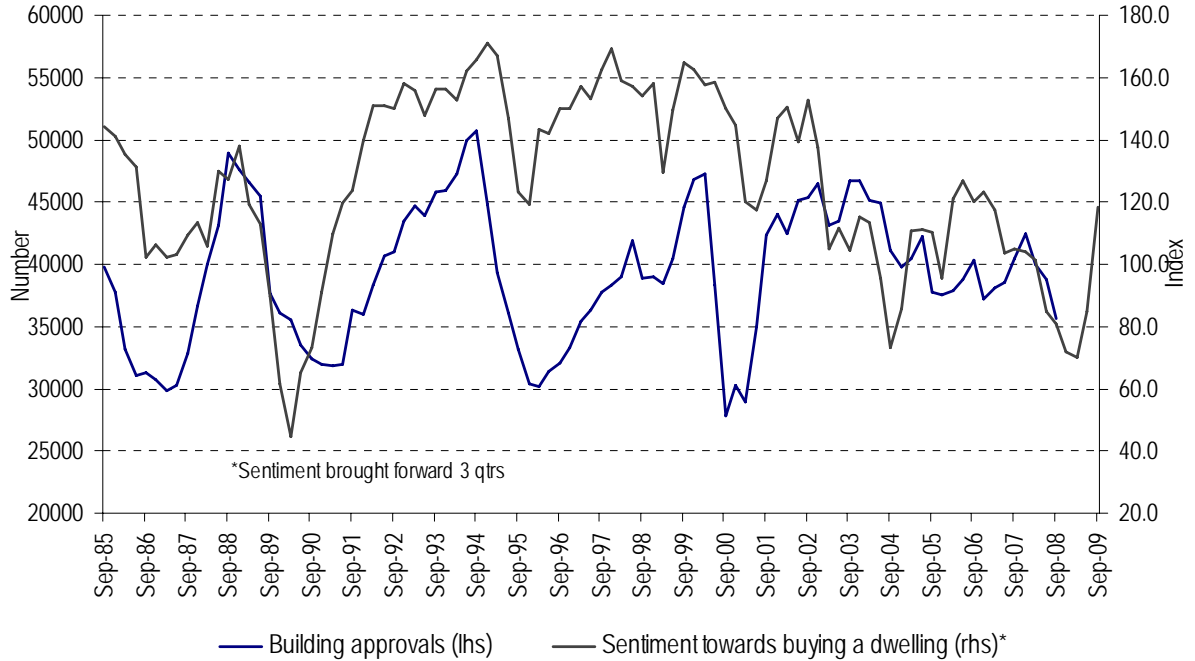
The long run statistical relationship between this index and housing indicators is weak. Nevertheless, in the 2000's the index has provided a reasonable forward indication of building approval levels, and to a lesser extent real house price growth.

At present the index is highlighting the risk that the December 2008 quarter will prove to be yet another period where there are falls in both the level of building approvals and in the annual growth in house prices. To date, the weight of evidence from other indicators supports this indication.

However, the home buying index does suggest the prospect of a recovery in building approvals from 2009Q1 and a turnaround in the rate at which home values are eroding. That is a positive to take away, albeit one not backed up by hard evidence at this point in time.

Sentiment Towards Home Buying & Building Approvals

Source: Westpac-Melbourne Institute; ABS; HIA



Sentiment Towards Home Buying & Real House Prices

Source: Westpac-Melbourne Institute; ABS; HIA

