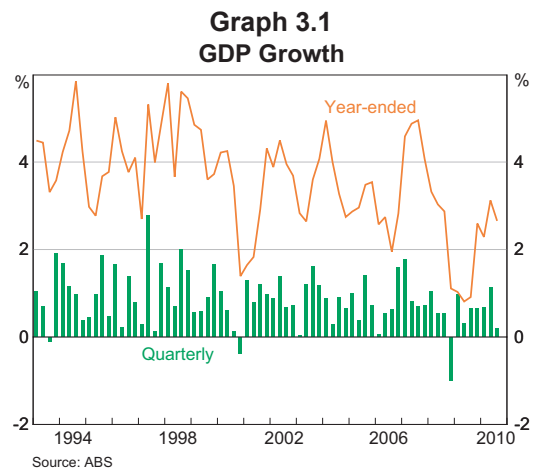


3. Domestic Economic Conditions

Activity in the Australian economy grew at a solid pace over the second half of 2010. Strong demand for Australian commodities is underpinning growth in national income and a high level of business investment, while growth in household consumption remains relatively subdued. The latest available data for real GDP show growth of 2.7 per cent over the year to September, with nominal income up by nearly 10 per cent over the year due to the increase in the terms of trade (Graph 3.1, Table 3.1). Employment growth continues to be strong and business conditions – as measured by surveys – remain generally positive.

Heavy rainfall and the associated widespread floods across eastern Australia in December and January will have a noticeable effect on output in the December, March and June quarters. In particular, coal production has declined significantly over recent months, and economic activity has been disrupted



in the flood-affected areas. It is expected that coal production will recover over coming months and the rebuilding of flood-damaged property and infrastructure will provide a mild boost to demand from the middle of 2011. The effects will be most

Table 3.1: Demand and Output Growth
Per cent

	September quarter 2010	Year to September quarter 2010
Domestic final demand	0.6	4.4
– Private demand	0.6	3.0
– Public demand	0.9	8.9
Change in inventories ^(a)	–0.2	–0.1
GNE	0.4	4.3
Net exports ^(a)	–0.4	–1.8
GDP	0.2	2.7
Nominal GDP	1.2	9.6

(a) Contribution to GDP growth
Source: ABS

evident in Queensland, where the severest flooding has occurred (see 'Box A: The Impact of the Recent Floods on the Australian Economy').

Household Sector

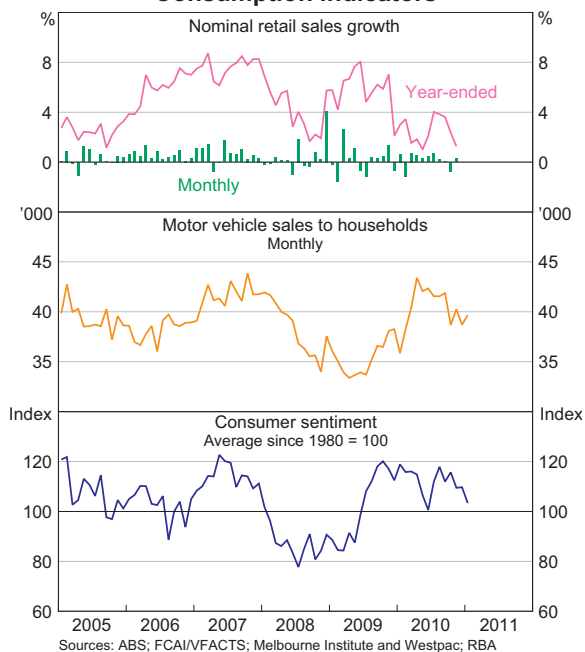
Indicators of household consumption suggest that households remained cautious in their spending behaviour in the December quarter. Data to

November showed only modest growth in retail sales, while motor vehicle sales to households have also softened recently, after a boost in early 2010 due to the replacement of hail-damaged cars (Graph 3.2). Liaison with retailers suggests sales improved for some firms in December and January, but there are few signs that consumers are becoming less cautious. Retailers note that households continue to display a reduced willingness to buy products that are not on sale and have been trading down to less premium brands. While growth in most components of household consumption has been modest, there has been strong growth in online purchases of goods, although this type of spending is still relatively small in comparison to total consumption. For further discussion, see 'Box B: Online Spending by Households'.

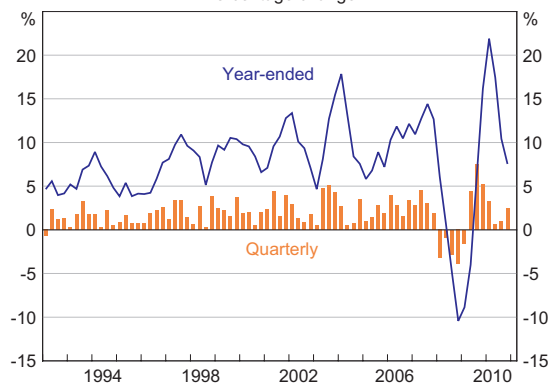
This restraint in household spending is occurring despite around-average levels of consumer sentiment and solid growth in household income. Recent revisions to income and consumption have led to a significant upward revision to the household saving ratio, which is now at levels last seen in the late 1980s. A more detailed discussion of the household saving ratio is provided in 'Box C: The Increase in the Household Saving Ratio'. Other indicators of savings have also shown an increase, although generally not to the same extent as the saving ratio; for example, housing equity injection is estimated at around 4 per cent of household disposable income, which is around levels recorded over the second half of the 1990s but below the 6 per cent recorded in the late 1980s.

Household net worth is estimated to have increased by around 2½ per cent in the December quarter and 7½ per cent over the year, with growth in the December quarter driven by a moderate increase in equity prices (Graph 3.3). Net worth remains around six times annual household disposable income. Household interest payments are estimated to have increased slightly to 12 per cent of disposable income in the December quarter, reflecting the

Graph 3.2
Consumption Indicators



Graph 3.3
Household Net Worth*
Percentage change

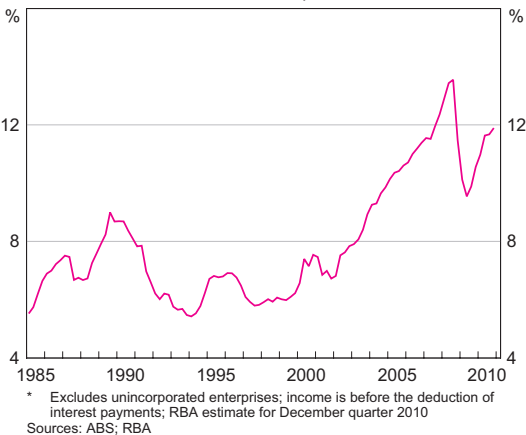


increase in mortgage rates (Graph 3.4). Household debt has continued to grow at a much slower rate than in earlier years, and the household debt to income ratio has fallen modestly recently.

Housing prices have been largely unchanged over the past few months, with data from private-sector providers showing nationwide prices broadly flat in the December quarter. By city, prices have increased modestly in Sydney and Melbourne, while prices have continued to fall in Perth and Brisbane (Graph 3.5, Table 3.2). Overall, prices were around 5 per cent higher over the year. Auction clearance rates, which are a timely indicator of housing market conditions, are currently a little above long-run average levels in Sydney and a little below average levels in Melbourne.

Indicators of house building have softened over the past year, as the effects from higher grants for first-home buyers have been unwinding and borrowing rates have increased. However, building approvals for apartments have increased significantly, led by growth in Victoria (Graph 3.6). Public residential approvals have fallen as the impetus from the Social and Defence Housing Initiative has faded. If maintained, the flow of monthly approvals in late 2010 implies around 160 000 commencements a year, which is around average levels seen over the past two decades, at a time when population growth remains above

Graph 3.4
Household Interest Payments*
Per cent of household disposable income



Graph 3.5
Median Dwelling Prices

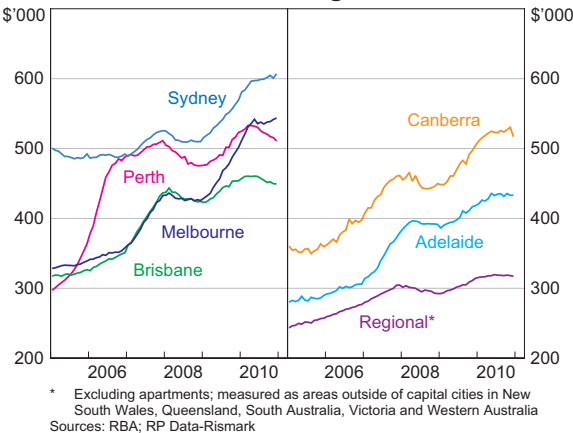


Table 3.2 National Housing Price Growth
Per cent

	3 months to September 2010	3 months to December 2010	Year to December 2010
Capital cities			
ABS ^(a) (b)	-0.3	0.7	5.8
APM	0.9	-0.4	4.7
RP Data-Rismark	-0.1	0.4	4.7
Regional areas			
APM ^(b)	-0.4	0.2	1.2
RP Data-Rismark ^(a)	-0.4	-0.4	0.8

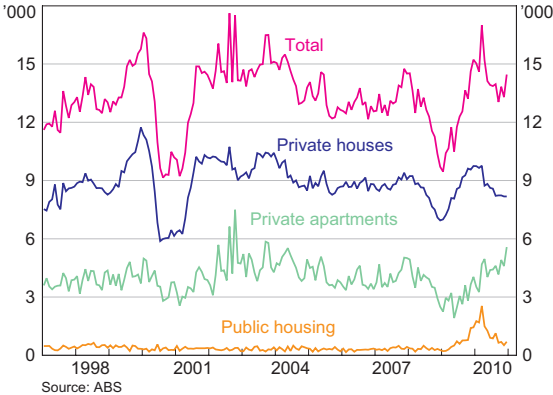
(a) Detached houses only

(b) Quarter-on-quarter growth rate

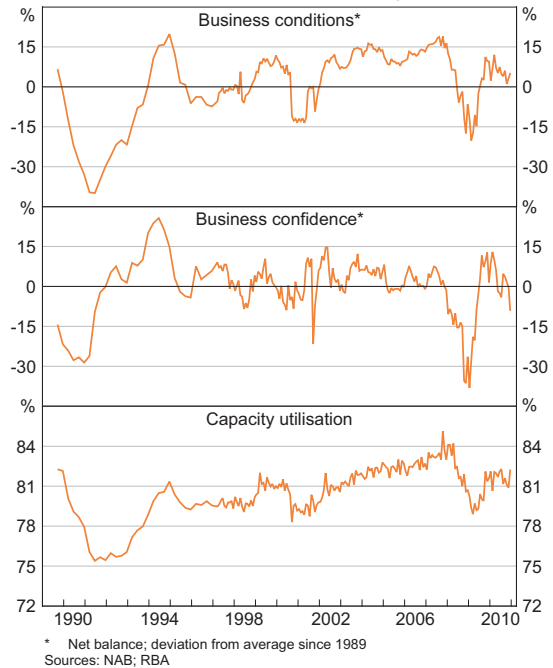
Sources: ABS; APM; RBA; RP Data-Rismark

average. Partly reflecting softness in homebuilding in recent years, rental vacancy rates are tight in a number of cities, with the national vacancy rate estimated to have fallen to a little below 2 per cent in the September quarter.

Graph 3.6
Residential Building Approvals
Monthly



Graph 3.7
NAB Business Survey



Business Sector

Measures of business conditions are around average levels, although down somewhat from early 2010 (Graph 3.7). Expectations of future conditions vary significantly across industries, with confidence highest in the resources sector. In contrast, both survey data and liaison suggest that the strong Australian dollar is weighing on the manufacturing and tourism industries, while subdued consumer spending is weighing on retailing (Graph 3.8). Surveys suggest that overall capacity utilisation is around average levels.

Mining sector investment is at a historically high level and is expected to increase significantly in coming years (Graph 3.9). There is a large stock of work in the pipeline, with work on the \$43 billion Gorgon LNG project and a range of other projects, including in the iron ore sector, now underway. In addition, plans for a number of large resource projects have advanced significantly in the past few months. Notably, two large coal-seam methane projects in Queensland have recently received final investment approval; the \$15 billion Curtis Queensland LNG project at the end of October and the \$16 billion Gladstone LNG project in mid January. While the recent floods are likely to cause some delays to coal mining construction activity in the near term, the high level of commodity prices and robust outlook for growth in China and other trading partners in Asia are contributing to a strong medium-term outlook for investment in the mining sector.

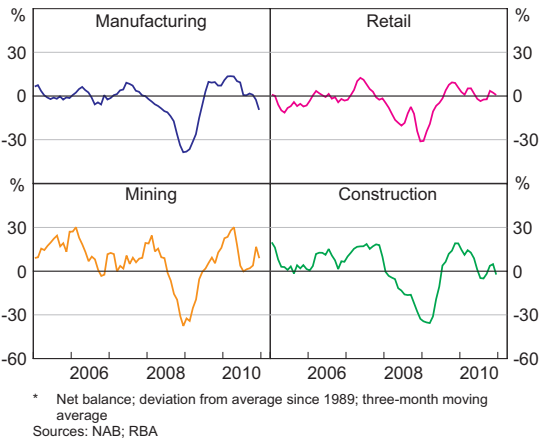
Outside the mining sector, liaison suggests that firms remain cautious in their investment decisions. The tourism industry has experienced a marked decline in domestic visitor travel as short-term overseas departures have risen steadily in response to the

lower relative cost of holidays abroad (Graph 3.10). While the number of short-term overseas arrivals into Australia has remained broadly steady, average real expenditure by overseas visitors has declined. In the manufacturing industry, the high Australian dollar is weighing on import-competing and export-oriented businesses, while manufacturers focused on the domestic market (particularly those servicing the mining sector) report that they have experienced solid demand.

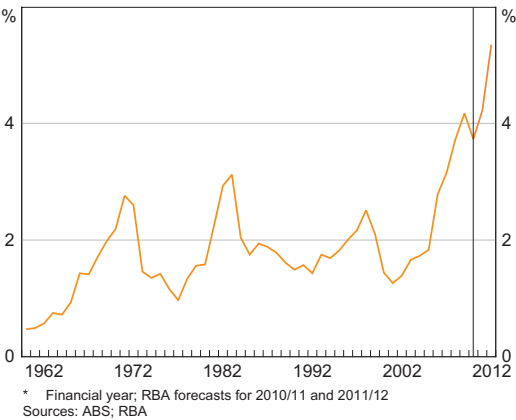
Non-residential construction activity remains relatively subdued. Excluding public spending on education facilities, the value of private non-residential building approvals remains below the peak levels seen in 2007, although it has risen somewhat from the low levels seen in 2009 and early 2010. The Bank's liaison program continues to report that some developers are experiencing difficulty in gaining access to finance for new projects and private demand for non-residential construction projects remains weak overall. However, there are reports that demand is beginning to recover in some areas, and office markets in some capital cities are likely to tighten over the next few years, due to strong tenant demand and modest planned additions to the existing stock.

Company profits remained broadly unchanged at a high level in the September quarter. Over the year to September 2010 profits increased by 20 per cent, to around 19 per cent of GDP, only slightly below the peak reached in September 2008. The recent growth in profits has been driven by the mining sector, which saw profits rise by over 60 per cent over the year (Graph 3.11). The strong profit figures have translated to robust internal funding, which coupled with solid equity raisings has partly offset declining business credit.

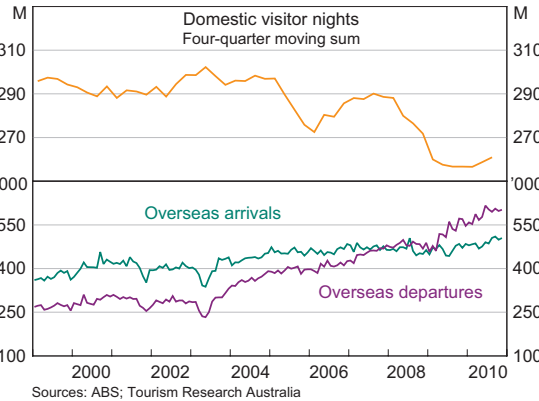
Graph 3.8
Business Confidence – Selected Industries*



Graph 3.9
Mining Investment*
Share of nominal GDP

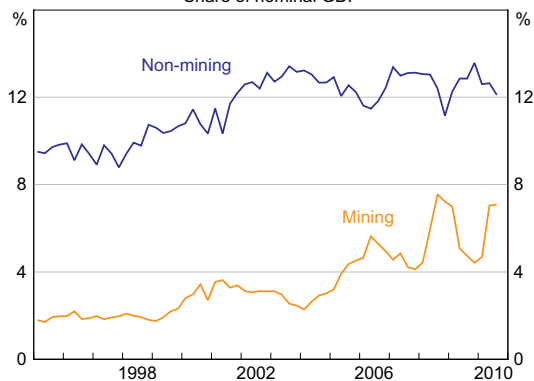


Graph 3.10
Tourism Indicators



Graph 3.11

Private Non-financial Corporation Profits*
Share of nominal GDP



* Gross operating profits; inventory valuation adjusted
Sources: ABS; RBA

Government Spending

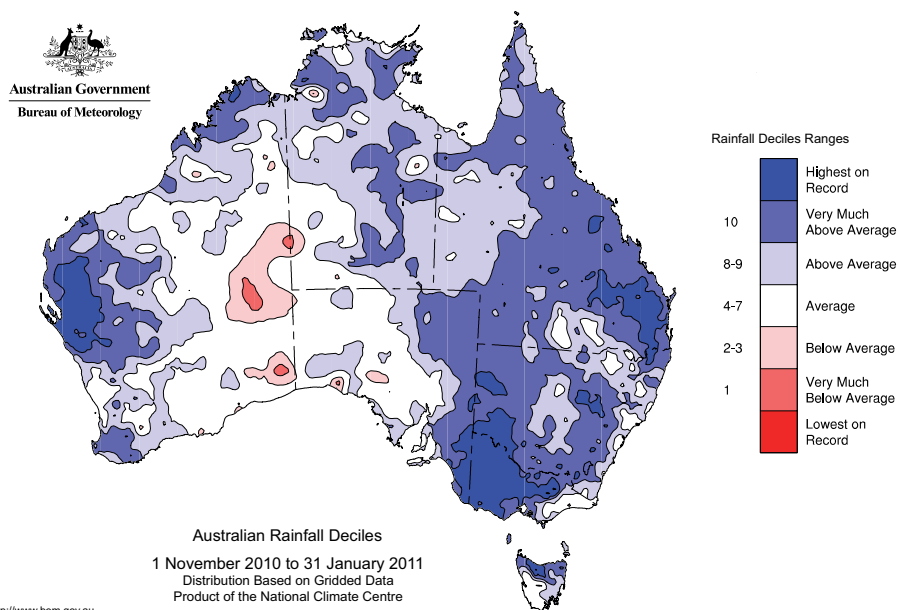
The expected rebalancing of growth from public to private demand has started, with the effect of the earlier fiscal stimulus likely to unwind over the next few quarters. Public demand was broadly unchanged over the middle quarters of 2010, after contributing

significantly to GDP growth in 2009 and early 2010. The expected decline in public investment, as stimulus-related projects draw to completion, is likely to be partly offset by an increase in government expenditure associated with replacing and repairing flood-damaged infrastructure.

Farm Sector

The outlook for the farm sector has been affected by the heavy rainfall in the eastern states in recent months. A La Niña weather pattern is well established, as indicated by the Southern Oscillation Index which is at extremely high levels. Consistent with this, there has been record or well above-average rainfall in most parts of eastern and northern Australia in recent months (Graph 3.12). This weather pattern has brought widespread flooding to central and southern Queensland, New South Wales and Victoria which has resulted in heavy damage to crops.

Graph 3.12
Australian Rainfall
1 November 2010 to 31 January 2011



Crop growing conditions had been favourable up until the end of November, but heavy rain and flooding in December caused delays in the harvest of wheat and other winter crops. In contrast, damage to crops from plague locusts appears to be smaller than expected as a result of the combination of spraying of insecticides and wet and cool weather. The national wheat crop is estimated at close to 25 million tonnes, up from 22 million tonnes in 2009, although up to 50 per cent of this year's crop has been downgraded from milling to feed wheat (Graph 3.13). In Queensland, protracted wet conditions have prevented the harvesting of some cane and reduced the sugar content of the harvest. Fruit and vegetable production in Queensland and Victoria will also be significantly affected in coming months. Meat production has been constrained by difficulties in delivering livestock to market, as well as by farmers reducing sales of livestock in response to improved pasture which allows them to rebuild herds.

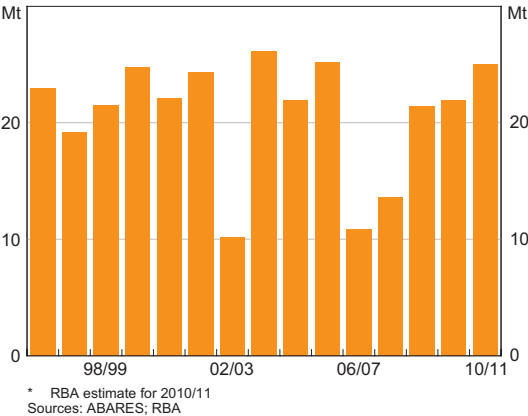
Inflows into the Murray-Darling basin in December were the highest December reading in 130 years of records, and total inflows in 2010 were the highest in a calendar year since 1996. In aggregate, non-metropolitan dams in Victoria and New South Wales are at about 80 per cent of capacity, while most dams in Queensland are full.

External Sector

Export revenues have been boosted by a significant increase in commodity prices, contributing to trade surpluses over the past year. Higher commodity prices have taken the terms of trade to record levels and a further increase is likely in the near term as weather-related supply constraints and strong demand increase the price of Australian exports. Although the terms of trade are expected to ease over the medium term as additional supply comes

online, they are expected to remain at high levels. The increase in the terms of trade, as well as the large interest rate differential between Australia and most other advanced economies, has been associated with an appreciation of the exchange rate. In real terms the exchange rate is at a multi-decade high and around 37 per cent above its post-float average (Graph 3.14).

Graph 3.13
Wheat Production*



Graph 3.14
Real Exchange Rate
Post-float average = 100

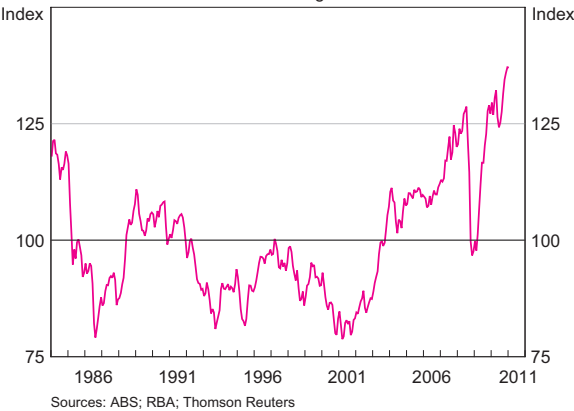


Table 3.3: Components of Exports
Per cent; current prices

	Share of total exports 2010	Growth over year to December 2010
Resources	56	44
– Iron ore ^(a)	17	105
– Coal ^(a)	15	35
Rural	10	19
Services	19	1
Manufacturing	11	2
Total	100	25

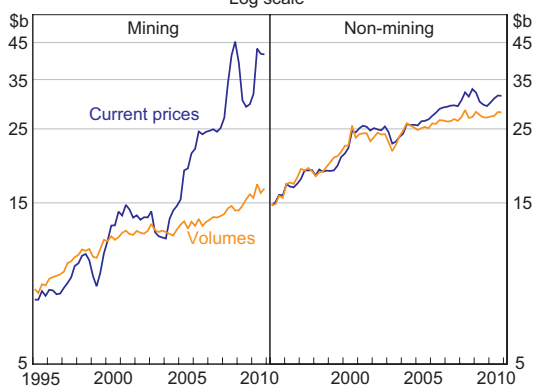
(a) RBA estimates
Sources: ABS; RBA

Export values grew strongly through 2010, with particularly strong growth in the value of iron ore exports (Table 3.3). Coal exports, which accounted for 15 per cent of the value of exports of goods and services in 2010, also grew strongly but heavy rain in Queensland in late 2010 severely disrupted coal production at the end of the year. As discussed in

Box A, flooding forced the temporary closure of a number of Queensland mines and rail lines in December and January. While inventories were used to continue shipments in December, it is likely coal export volumes will decline sharply in the March quarter. Assuming no significant damage to infrastructure or further adverse weather, coal production and exports are expected to recover in the June and September quarters. In contrast, the volume of iron ore exports increased by around 10 per cent over 2010 as capacity has continued to expand. Looking ahead, significant expansions to mines and infrastructure capacity are expected to provide a substantial boost to exports in coming years, particularly in iron ore, coal and LNG (Graph 3.15).

Rural export revenues also increased strongly over the year, reflecting higher global prices and strong growth in cereal exports. Rural export volumes are estimated to have been roughly flat in the December quarter, following very strong growth in the September quarter driven by higher wheat exports. Services exports are estimated to have

Graph 3.15
Exports*
Log scale



* Volumes data referenced to 2003/04 prices; RBA estimates for December quarter 2010
Sources: ABS; RBA

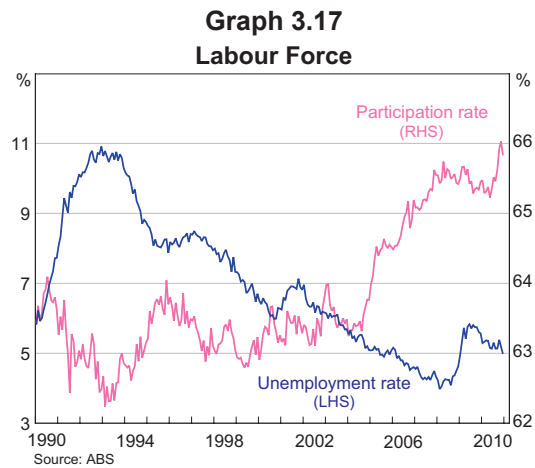
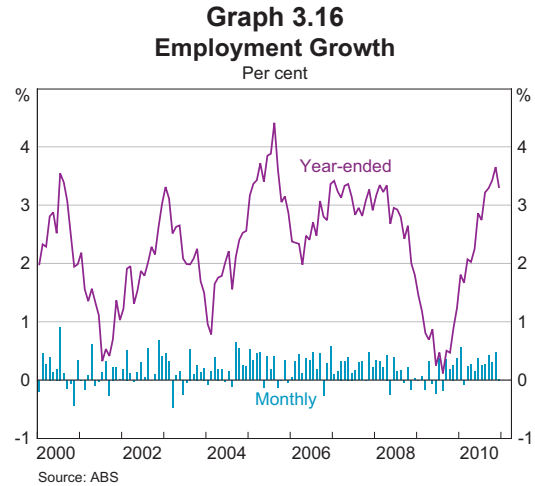
declined in the December quarter, partly reflecting the high Australian dollar which is depressing tourist arrivals and boosting overseas departures.

After rebounding sharply in 2009/10, growth in import volumes slowed in the second half of 2010. Imports are expected to grow at an above-average pace going forward, reflecting the relatively high exchange rate and expected growth in domestic demand, with particular strength in imports of equipment for the mining sector.

Labour Market

Labour market conditions have remained positive in recent months. Employment has continued to grow strongly, increasing by 1.0 per cent in the December quarter, to be 3.3 per cent higher over 2010 (Graph 3.16). This compares with average annual growth of 2.4 per cent over the past decade. The unemployment rate declined to 5 per cent in December, to be $\frac{3}{4}$ percentage point below its peak in mid 2009 and around the levels recorded between mid 2005 and early 2006 (Graph 3.17). By state, the lowest unemployment rates were recorded in Western Australia and New South Wales, while the highest were recorded in Queensland and South Australia.

The modest decline in the unemployment rate over late 2010 occurred alongside a large increase in the labour force. The participation rate reached 66 per cent in November – the highest level recorded since the labour force survey began in 1960 – before declining modestly in December. All age groups recorded an increase in participation over the second half of 2010. The participation rate has been trending upwards since the 1980s, particularly for females and older workers. The trend increase in female participation has been associated with a range of factors,



including increased educational attainment, lower fertility rates (until recently), improved access to childcare, more flexible work arrangements, an increase in part-time employment opportunities and the expansion of the services sector. The increase in the participation rate of older workers is consistent with improved employment opportunities, reduced retirement rates and the rise in longevity.

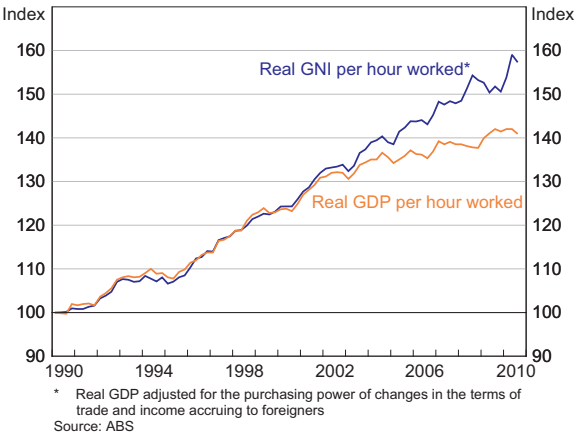
The effect of the recent rise in the participation rate on labour force growth appears to have been partially offset by a moderation in working-age population growth. Available data suggest that population growth continued to ease over 2010, following rapid growth over 2008 and early 2009. However, this easing was not reflected in the labour force survey until the December quarter – when the ABS adjusted the method for population

benchmarking – suggesting that employment growth may have been somewhat overstated earlier in 2010.

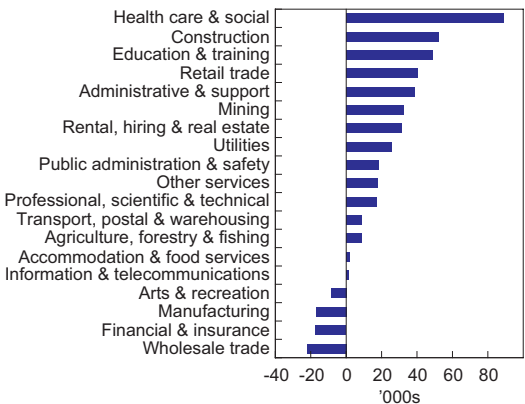
Measurement issues aside, growth in employment over 2010 still appears to have been strong relative to that in output, with labour productivity (output per hour worked) estimated to have declined. One possibility that would be consistent with strong growth in the number of people employed and subdued growth in average hours worked per employee (although compositional changes in the labour force are also relevant) is that firms may be hiring workers in anticipation of future demand and labour shortages, based on their experience prior to the recent downturn when skills shortages were widespread and vacant positions were difficult to fill. While there is some anecdotal evidence of firms hiring pre-emptively, this appears at best a partial explanation for the divergence in output and employment growth. More generally, productivity growth has been relatively weak in Australia over the 2000s, although real incomes per hour worked have risen strongly due to the large increase in the terms of trade (Graph 3.18).

The strength in employment growth has been fairly broad-based. Employment expanded in the majority of industries over 2010, with the largest contributions coming from the health care, construction and education industries (Graph 3.19). Particularly rapid growth was recorded in the utilities, mining and rental, hiring & real estate services industries (17 to 20 per cent in trend terms), although these industries are a relatively small share of total employment. By state, employment growth over 2010 was at or above its decade average in all states except South Australia, with New South Wales recording the strongest growth.

Graph 3.18
Productivity and Income
March 1990 = 100



Graph 3.19
Employment Growth by Industry
Year to November 2010, trend



Business surveys and the Bank’s liaison suggest that the labour market has tightened, although firms are generally not currently encountering significant difficulty in hiring suitable labour, except in mining-related industries and for some skilled occupations (Graph 3.20). Looking ahead, indicators of labour demand point to solid employment growth in the near term and some further tightening in labour market conditions. The ABS measure of job vacancies recorded a large increase over the three months to November, to be nearly 30 per cent higher over the year, and vacancies as a proportion of the labour force are now at relatively high levels (Graph 3.21). The ANZ measure of job advertisements also increased significantly over 2010. Business survey measures of hiring intentions remain at above average levels.

