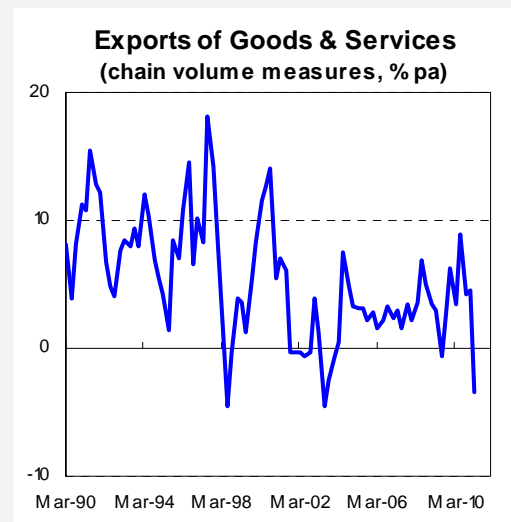
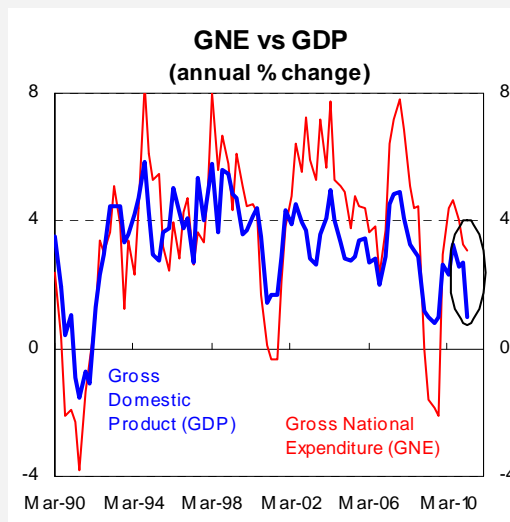


DATA SNAPSHOT

GDP – The Economy Hits a Pothole

Wednesday, 1 June 2011

- The economy hit a pothole in the March quarter. Economic activity contracted by 1.2% – the biggest quarterly fall in 20 years. This setback is temporary, driven by the short-term negative impact from flooding in Queensland and Cyclone Yasi. The natural disasters caused major disruptions to exports, especially coal, which led the trade sector to subtract 2.4 percentage points from Q1 GDP. A build up of inventories also wiped off 0.5 percentage points.
- Excluding the trade sector, economic activity as measured by GNE expanded by 0.8% in the quarter. It indicates that aside from the impact of the natural disasters, the economy is still on a reasonable footing. Excluding the trade sector and inventories, domestic final demand lifted a sharp 1.3% with firm contributions from household consumption and private business investment.
- The trends in the GDP deflators and the data on the compensation of employees keep the worry beads out on inflationary pressures in the economy.
- The terms of trade rose again in Q1 and contributed to another increase in real household disposable incomes.
- But productivity has softened further. This remains an unwelcome trend. GDP per hour worked fell by the most in nearly six years.
- We continue to expect the RBA to leave rates on hold next week. The weak headline GDP number leaves the RBA with a difficult backdrop to tighten rates in. But the strength revealed outside of the short-term impacts from the natural disasters suggests tightening this year remains on the radar.



The Australian economy hit a temporary pothole in the March quarter. The economy contracted by 1.2% in the March quarter, slightly worse than our forecast for a contraction of 1.0%.

It is the first contraction since the December quarter of 2008 (in the wake of the global financial crisis) and it is the biggest contraction in 20 years. This setback is temporary, driven by the short-term negative impact from the floods and Cyclone Yasi.

Indeed, the natural disasters caused coal production ground to a halt and this was reflected in a sharp fall in exports and a large subtraction to GDP from the trade sector. Exports fell by 8.7% while imports rose by 1.3%. It meant net exports subtracted 2.4 percentage points from GDP in the quarter.

The gross national expenditure (GNE) measure excludes the trade sector (i.e. the net exports component). GNE grew by 0.8% in the March quarter, taking the annual growth rate to 3.1% - the slowest rate in five quarters. It indicates that aside from the impact of the natural disasters, the economy is still on a reasonable footing.

We're expecting the economy to bounce back in the June quarter. Economic activity should recover strongly, as coal exports rebound, reconstruction related to the natural disasters boosts activity and the private business investment upswing deepens. That means the economy will avert a technical recession, which is defined as two consecutive quarters of contraction in GDP. We think the chances of a technical recession are very low.

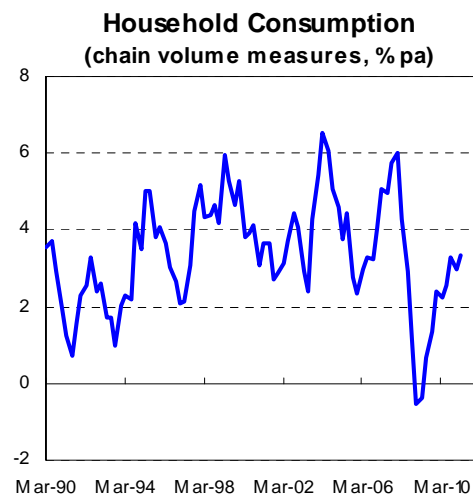
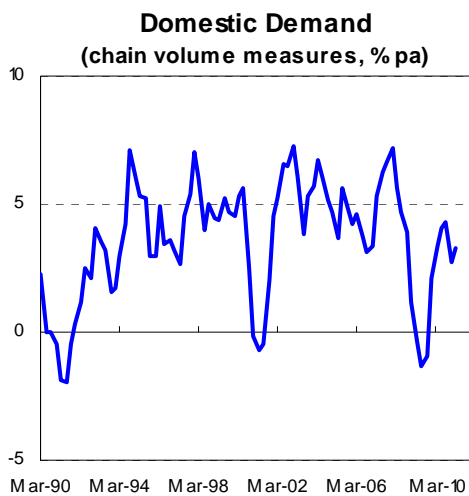
Annual GDP growth stood at 1.0% in the March quarter. We estimate annual growth will accelerate and be above the long-run average in the March quarter of next year.

The trade sector accounted for a big part of the weakness in economic activity in the March quarter. The other key contributor was a build-up in inventories, which detracted 0.5 percentage points from GDP.

Outside of exports and inventories, the rest of the economy was strong; domestic demand lifted by 1.3% in the March quarter, the strongest pace in six quarters, and it rose by 3.3% on a year ago.

The strong lift domestic demand was driven by the other key components of GDP - household consumption and private gross fixed capital formation.

Indeed, household consumption grew by 0.6% in the quarter and added 0.3 percentage points to growth. While retail spending was soft, other areas of consumer spending were relatively firm, such as consumption of rent & other dwelling services and health.



Private gross fixed capital formation was also strong, growing by 3.4% in the quarter and adding 0.7 percentage points to growth. The resources boom and the deepening business-investment upswing was the big driver of the strength in this component. Private business investment grew by 3.1% and added 0.5 percentage points.

Dwelling investment rose 4.6% and added 0.3 percentage points to Q1 GDP. Non-dwelling investment grew by 1.3% and added 0.1 percentage points and machinery & equipment lifted 6% and added 0.4 percentage points.

	TREND			SEASONALLY ADJUSTED		
	% change Dec 10 to Mar 11	% change Mar 10 to Mar 11	% points contributions to growth in GDP Dec 10 to Mar 11	% change Dec 10 to Mar 11	% change Mar 10 to Mar 11	% points contributions to growth in GDP Dec 10 to Mar 11
Final consumption expenditure						
General government	0.9	4.1	0.2	1.4	4.6	0.2
Households	0.6	3.1	0.3	0.6	3.4	0.3
Gross fixed capital formation						
Private						
Dwellings	1.0	2.5	0.1	4.6	6.6	0.3
Ownership transfer costs	-5.4	-19.3	-0.1	0.1	-16.8	—
Non-dwelling construction	0.9	8.6	0.1	1.3	8.7	0.1
Machinery and equipment	3.9	2.6	0.2	6.0	5.7	0.4
Cultivated biological resources	-2.9	2.0	—	-3.4	2.5	—
Intellectual property products	0.4	1.9	—	1.2	2.1	—
Public	-0.2	-0.7	—	-0.7	-6.0	—
Changes in inventories	na	na	0.1	na	na	-0.5
Gross national expenditure	0.9	3.1	0.9	0.8	3.1	0.8
Exports of goods and services	-2.9	-2.3	-0.7	-8.7	-3.4	-2.1
Imports of goods and services	1.9	8.2	-0.5	1.3	9.0	-0.3
Statistical discrepancy (E)	na	na	0.1	na	na	0.4
Gross domestic product	-0.2	1.2	-0.2	-1.2	1.0	-1.2

— nil or rounded to zero (including null cells) na not available

GDP Expenditure, Income and Production Measures:

There are three different measures of GDP – expenditure, income and production. The three measures should equal each other, but often do not. The statistical discrepancy ensures that they do.

The expenditure measure (described above) fell by 1.6% in the quarter (with the statistical discrepancy adding 0.4 percentage points to produce a contraction of 1.2%) but the other two measures were not as weak. The income measure contracted by 1.2% and the production measure contracted by 0.8%.

GDP Income Measure:

GDP using the income measure alone fell by 1.2 % in the March quarter and by 1.0% on a year ago.

A broader measure of change in national economic well-being is real net national disposable income. This measure adjusts the volume measure of GDP for the terms of trade effect, real net incomes from overseas and consumption of fixed capital. This measure rose by only 0.1% in the March quarter and the annual rate is 6.4% (the slowest pace in a year).

Total compensation of employees (includes wages & salaries) rose by 2.9% in Q1 and 8.6% on a year ago. The annual rate of growth is the strongest in more than three years. The tight labour market is clearly helping lift household incomes and has helped put household balance sheets in better shape.

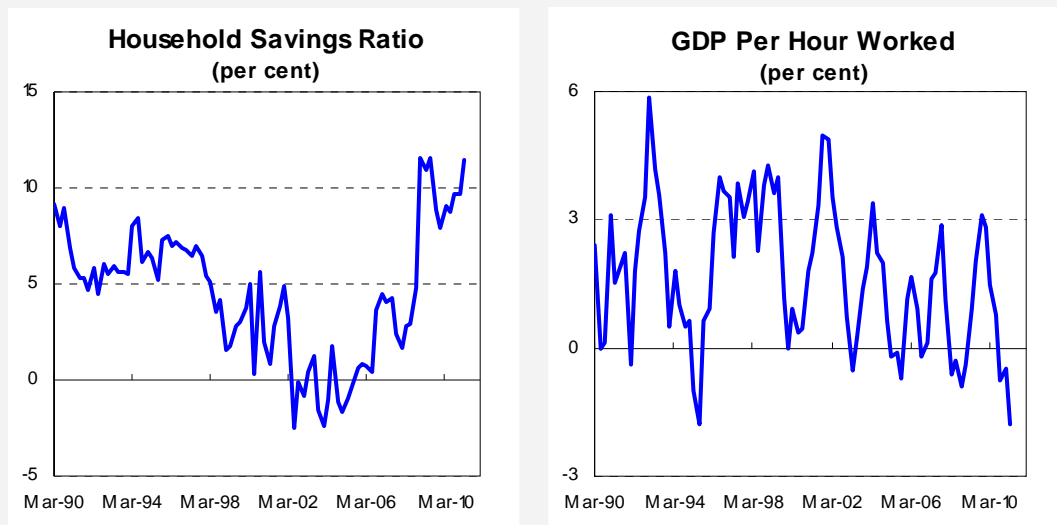
The household savings ratio increased further to a near 24½-year high of 11.5% in the Q1, from 9.7% in the March quarter. This ratio is the highest since Q2 2009 when it stood at 11.6% and which was the highest since 1986. This rising ratio reflects the increased caution of householders and suggests they have the means, but not so much the appetite for spending at the moment.

The terms of trade (the ratio of export prices to import prices) rose 5.8% to new heights of 117.7, reflecting higher commodity prices and deflation in many imported consumer goods. It has increased 22.3% over the past year.

The terms of trade incomes injection is helping lift real household incomes. Real household

disposable income surged strongly, rising 2.5% in Q1 to be up 5.8% on a year ago, well above the long-run average pace of 3.5% per annum.

GDP per hour worked, commonly used as a labour productivity measure, however, fell 1.5% in the March quarter after a flat outcome in the December quarter. On year ago, this measure fell by 1.8%, the worst outcome in nearly six years. It is an unwelcome trend and raises concerns about the risks to the standard of living if the resources boom were to end and with it the terms-of-trade income injection.



GDP Production:

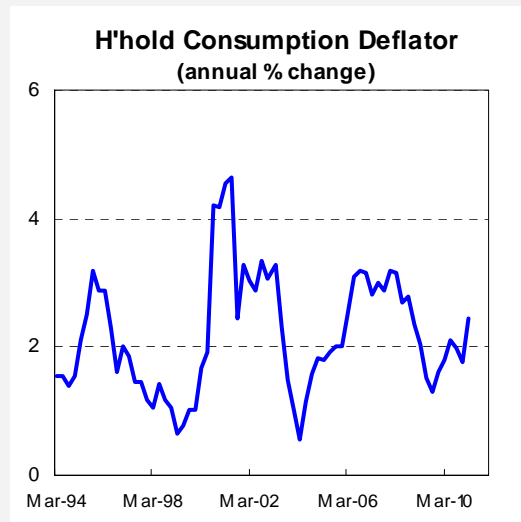
GDP using the production measure alone fell by 0.8% in the March quarter and by 1.4% on a year ago.

Across industries, the top two hardest hit industries in the March quarter were agriculture & fishing (down 8.9% Q/Q) and mining (down 5.7% Q/Q). These two industries subtracted 0.6 and 0.2 percentage points, respectively, from Q1 GDP growth. Mining and agriculture were both affected by weather disruptions in the quarter.

The strongest industries were arts & recreation services (up 2.9% Q/Q) and rental & real estate services (up 2.0% Q/Q).

GDP Deflators:

On the prices front, the household consumption deflator rose by 1.2% in the March quarter, up from a more modest 0.5% rise in Q4. This increase is similar to the increase recorded for the underlying CPI measure (of 0.9%). On a year ago, the household deflator has risen 2.5% while the underlying CPI has lifted by 2.3%.



The GNE deflator (which is unaffected by the terms of trade) rose by 0.5% in Q1 and by 1.5% on a year ago. But the overall GDP implicit price deflator, which highlights the terms-of-trade impact, rose 1.9% in Q1 to be up 6.1% on a year ago.

State Final Demand:

Across the States, Queensland contracted the most in the quarter, by 0.6%. It was the largest contraction in two years. We expect the Queensland economy to improve now that coal production is recovering and reconstruction is starting. Economic activity in SA also fell in the quarter by 0.8%.

Other States recorded expansions, led by WA where growth was 3.2% in the quarter. Tasmania, VIC and NSW recorded quarterly growth rates of 1.7%, 1.6% and 0.4%, respectively. Public spending provided a considerable boost to the Tasmanian and VIC economies in the quarter.

Annual growth is running above trend (i.e. the long-run average) in WA and Tasmania and close to trend in VIC. The other States are recording growth rates under trend.

	TREND			SEASONALLY ADJUSTED		
	% change Dec 10 to Mar 11	% change Mar 10 to Mar 11	% points contributions to growth in GDP Dec 10 to Mar 11	% change Dec 10 to Mar 11	% change Mar 10 to Mar 11	% points contributions to growth in GDP Dec 10 to Mar 11
New South Wales	0.6	2.6	0.1	0.4	2.8	0.1
Victoria	0.6	2.8	0.1	1.6	3.5	0.4
Queensland	-0.1	0.9	—	-0.6	1.2	-0.1
South Australia	0.4	2.0	—	-0.8	1.9	-0.1
Western Australia	1.6	5.6	0.2	3.2	6.8	0.4
Tasmania	1.3	4.5	—	1.7	4.9	—
Northern Territory	-0.2	-0.3	—	-0.7	-1.0	—
Australian Capital Territory	1.7	7.2	0.1	3.3	9.9	0.1
Australia (DFD)(a)	0.8	3.0	0.8	1.3	3.3	1.3

— nil or rounded to zero (including null cells) (a) Domestic final demand.

Implications for the Interest Rate Outlook:

We continue to expect the RBA to leave rates on hold next week. The weak headline GDP number today leaves the RBA with a difficult backdrop to tighten rates in. But today's data highlights that outside of the near-term negative impact from the natural disasters, there was strength in the economy. So tightening this year remains on the radar.

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