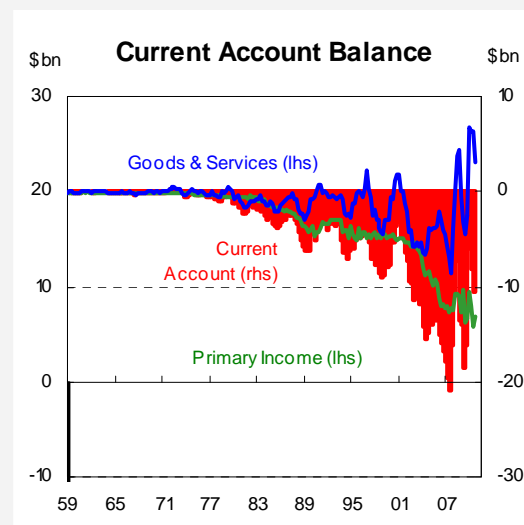
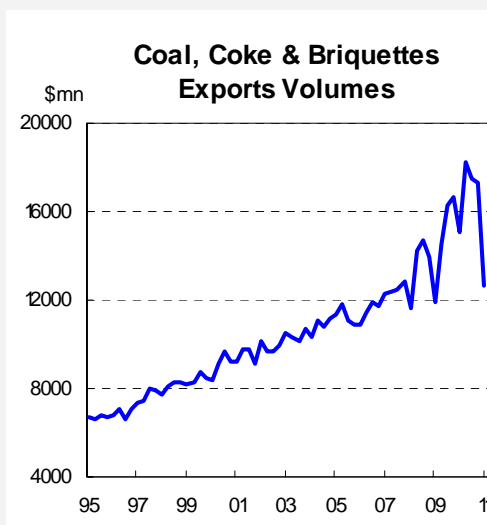


# DATA SNAPSHOT

## Taking a Big Step Backwards

Tuesday 31 May, 2011

- GDP data tomorrow will reveal how the economy performed over the March quarter. The economy is likely to have taken a big step backwards, driven by the temporary negative impact from the natural disasters. This setback in the economy is likely to be temporary. Economic activity should recover strongly, as coal exports rebound, reconstruction related to the natural disasters boosts activity and the private business investment upswing deepens.
- The current account deficit widened to \$10.5 billion in the March quarter. The data also revealed the largest drop in export volumes in 37 years of 8.7%. Disruptions to coal exports from the natural disasters pushed exports considerably lower. Net exports will subtract 2.4 percentage points off GDP in Q1 compared with market expectations and our own for a drag of 1.2 pts. It means Q1 GDP is shaping up to be a bigger contraction than previously expected.
- Separate data released showed that public spending will make only a moderate contribution to GDP of 0.2 percentage points in the March quarter.
- The data today has led analysts to revised downwards the forecasts for Q1 GDP, due for release tomorrow. We had been looking for a contraction in GDP of 0.6% (compared with a contraction of 0.4% expected by consensus). Our final forecast is that the economy contracted by 1% in the March quarter – such an outcome would mark the largest contraction in the Aussie economy in 20 years.
- The Reserve Bank has said it will look through the impact of the floods, but we still expect that such a weak GDP result makes it difficult for the RBA to hike rates as soon as next week. Further, the run of economic data since the last RBA board meeting has generally been on the disappointing side. This disappointing data includes today's data on house prices, building approvals and private sector credit (please refer to our separate release for more detail).
- Our long-held view has been that the RBA will not raise rates until August. Today's data further supports our view.



## **Balance of Payments:**

### **- Current Account Balance (in Current Prices Terms):**

The current account deficit deteriorated by \$2.4bn to \$10.4bn in the March quarter.

The two key components of the current account balance are the trade balance and the net primary income balance.

The trade balance deteriorated by \$3.3bn but remained in surplus at \$3.0bn. The trade component has now been in surplus for four consecutive quarters, the longest run since 2001. The deterioration in the trade balance was driven by a fall in exports and a rise in the imports bill.

The fall in exports in the quarter occurred across goods exports (-3.2%) and services exports (-0.5%). Within these categories, one of the biggest drivers was the fall in coal, coke & briquettes (down 10.5% in Q1). The natural disasters caused disruptions to coal-mine productions in the March quarter and this has showed up in the data. The return to more normal operating conditions, especially in the mining sector in Queensland, will see a marked improvement in exports in coming quarters.

The rise in the import bill in the quarter was 2.7%. An examination of the detail reveals that growth in capital goods (6.2% quarter-on-quarter) and intermediate & other merchandise goods (5.9% quarter-on-quarter) was responsible for the bigger imports bill. The rise in capital goods relates to the upswing in private business investment underway.

Imports of consumption goods were weak, however, reflecting the caution among consumers and weak retailing story. Consumption-goods imports fell by 1.7% in the quarter. The non-monetary gold imports component also dropped (by 33.5%) but this remains a very volatile component.

The primary income deficit, which is the other big and larger component of the current account balance, improved modestly by \$0.9bn to \$13.2bn. The mining sector is making huge profits, but some of the dividends and profits from these companies flow to offshore investors and/or parent companies. That net outflow is contributing to keeping the net primary income deficit large.

### **- Terms of Trade**

There was a further increase in the terms of trade of 5.8% in Q1 and of 22.3% on a year ago. The rises in the terms of trade are providing a large net income injections to the Australian economy. This income injection and the upswing in private business investment are the key factors behind our expectation that the RBA will hike rates this year. We see the most likely timing of the first rate hike this year being August.

### **- Net Exports Contribution to GDP**

In chain-volume terms, exports dropped by 8.7% in the March quarter, the largest fall in 37 years. The largest drop witnessed in the volumes of coal, coke & briquettes production in 30½ years of 26.8% drove the decline. Meanwhile, imports in chain-volume terms, rose by 0.8% in the quarter.

It means net exports will detract 2.4 percentage points to GDP for the March quarter due for release tomorrow. This deduction is very large and well outside of the range of consensus expectations prior to this data's release. The median consensus expectation had been for a drag of 1.2 percentage points.

### **- Net Foreign Debt**

Australia's net foreign debt liability increased \$29.8bn to \$677.3bn in the March quarter.

**Government Spending:**

Government spending on consumption rose by 1.4% in the March quarter and on investment fell by 0.7%. It suggests that the government spending component of GDP will make a positive contribution to GDP growth in the March quarter of around 0.2 percentage points.

**Q1 GDP Implications:**

The bucket of partial economic indicators that have been released over this week and last week have suggested downside risk to the GDP outcome for tomorrow.

Today's data showing a much larger-than-expected drag from net exports has led analysts to revised downwards forecasts for Q1 GDP. We also have revised downwards our forecast. Ahead of today's data, we had been looking for a contraction in GDP of 0.6% (compared with a median consensus expectation of 0.4%).

Our final GDP forecast is that the economy contracted by 1.0% in the March quarter – that would be the largest contraction recorded in 20 years (assuming no revision to historical data).

The median consensus forecast after today's data is now for a contraction in GDP of 1.1%. The poll surveyed 22 institutions. The most pessimistic forecaster is expecting a contraction of 2% while the most optimistic forecaster is expecting a contraction of 0.1%.

**Cash Rate Implications:**

The Reserve Bank has said it will look through the impact of the floods, but we still think such a weak GDP result makes it difficult for the RBA to hike rates as soon as next week.

Further, the run of economic data since the last RBA board meeting has generally been on the disappointing side. This disappointing data includes today's data on house prices, building approvals and private sector credit (please refer to our separate release for more detail).

Our long-held view has been that the RBA will not raise rates until August. Today's data further supports our view.

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