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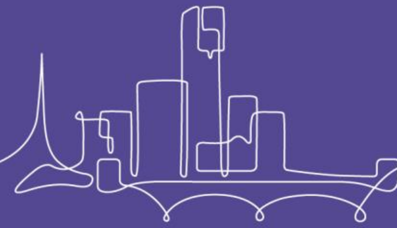
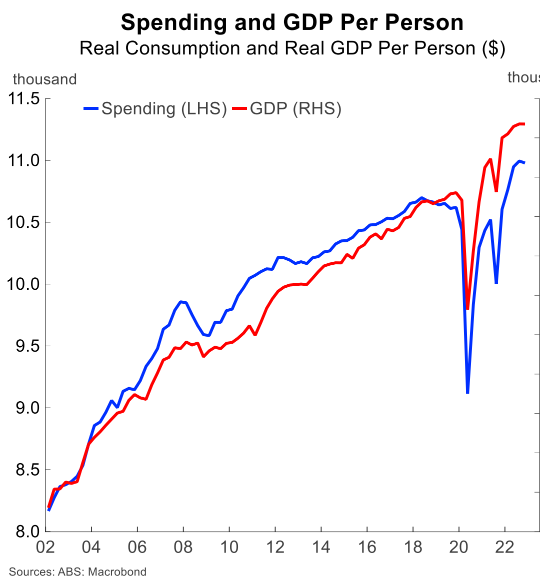


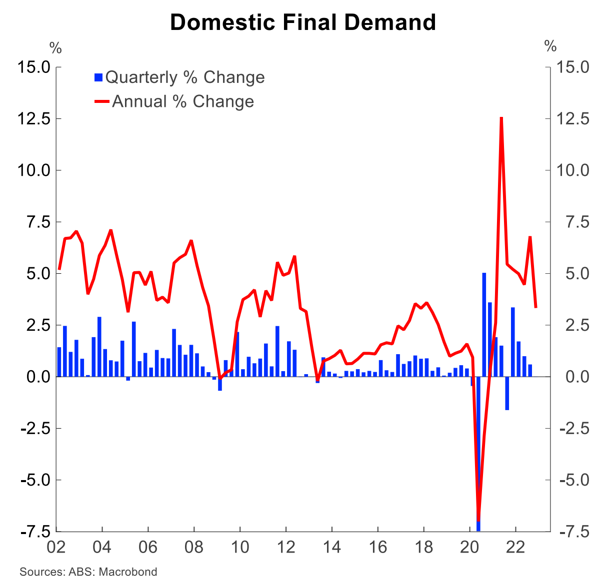
Wednesday, 1 March 2023

National Accounts

The RBA's Narrow Path Just Got Narrower

- **<u>The economy has reached its turning point.</u> The impact of higher interest rates, inflation, and rents showed in today's outcome, a dynamic we expect will continue through 2023.**
- **<u>Household disposable income</u> declined and recorded its weakest outcome since the September quarter 2012 (outside of COVID) as income growth has not kept up with higher costs of living. Households are reducing savings to fund their expenses.**
- **<u>Domestic demand</u> from households, governments, and businesses came to a halt over the quarter. Outside of COVID this was the weakest outcome since the June quarter 2014. Growth in the prices of goods and services consumed domestically eased to its slowest quarterly rate since the December quarter 2021.**
- **The return of <u>overseas arrivals</u> at a record pace is holding up aggregate economic activity. Economic activity (or GDP) per capita was flat over the quarter. However, in aggregate terms GDP increased by 0.5% over the quarter on the back of a higher population.**
- **<u>Household consumption</u> on a per person basis declined over the quarter. Without the increase in the population, aggregate consumption (which accounts for around 55% of the economy) would have also gone backwards.**
- **The <u>Residential construction</u> sector is under pressure. Shortages of materials, labour and the unwinding of HomeBuilder and other subsidies have more than offset the tailwind from the healthy pipeline of activity – forward indicators point to continued weakness.**
- **<u>The external sector continues to outperform</u>. Services and mining exports are growing strongly, while imports have slowed on the back of weaker domestic demand.**





Key Themes and Outlook

The latest set of national accounts revealed that the reopening boost to activity has now run its course and that the Australian economy is set for a more challenging outlook as the elevated cost-of-living, higher rents and higher interest rates apply the handbrakes.

Domestic demand was flat in the December quarter, reflecting an economy that has stalled under the weight of a severe bout of inflation and the associated rise in interest rates needed to bring prices back down. Indeed, without the tailwind from trade and migration the Australian economy would have contracted sharply in the December quarter as consumption slowed and investment went backwards.

As the economy's 'engine room', household spending is essential to maintaining growth. In the December quarter, household consumption growth eased to a sickly 0.3% as household budgets came under increasing pressure. However, this is not the full story. We experienced a record surge in overseas arrivals in 2022 and every additional person adds to consumption. When we exclude population growth and look at per capita consumption, household spending actually declined. Put another way, without the extra demand from overseas arrivals, aggregate consumption would have declined over the quarter.

Instead, incomes were diverted towards higher housing costs and the increased cost-of-living. In particular, higher interest payments on mortgage debt, which surged to a record $20bn in the quarter. Mortgage holders were not alone, as rents continued to rise rapidly in the December quarter and domestic prices recorded their largest annual increase in over 32 years.

However, the pull-back in spending alone was not enough for households to stump up the extra cash needed to cover higher expenses. The household savings ratio declined sharply to 4.5%, its lowest level September quarter 2008 (and equal to the September quarter of 2017) and below the long-run average of around 5-6%. This means households diverted a higher share of their income towards expenses and are making smaller contributions to their savings. However, there remains a large stock of savings accumulated throughout the pandemic.

Unfortunately, the pressure on households is unlikely to let up anytime soon. The Reserve Bank (RBA) has already increased the cash rate by 25-basis points in 2023 and has flagged at least two more hikes from here. Additionally, rate hikes from November and December are unlikely to have shown up in today's data as it takes time for increases in the cash rate to flow through to repayments and ultimately to spending which is what the RBA is watching. Rents are also expected to maintain their rapid growth over 2023 and the inflation fight is looking like it is going to be more and more prolonged.

However, it is not all doom and gloom. At present, the most prominent risk to the economic outlook is a higher than anticipated rise in interest rates, which are already proving a substantial drag on the economy. Encouragingly, there were some positive developments on the inflation outlook which may reduce this risk. Though, they are unlikely to sway the RBA for its current path for now.

While inflationary pressures accelerated in the December quarter, there was a promising weakening in goods price inflation, which appeared unwilling to budge in the December quarter inflation report. Additionally, the wage measures in the National Accounts suggest that although wage growth remains healthy, the risk of a wage price spiral is low. We have now passed a peak in labour market tightness, and this is already flowing through to wage outcomes.

Growth in the broader measures of economic activity – GDP – also eased. GDP expanded by 0.5% in the September quarter, down from 0.7% in the September quarter. Annual GDP growth slowed

to 2.7%. This was largely driven by a sizeable contribution to growth from foreign trade. A surge in tourism combined with a rebound in commodity exports produced a marked increase in exports, while softer domestic demand saw imports soften. It should be noted that GDP per capita was flat over the quarter – again without the surge in overseas arrivals, economic activity could have completely stalled.

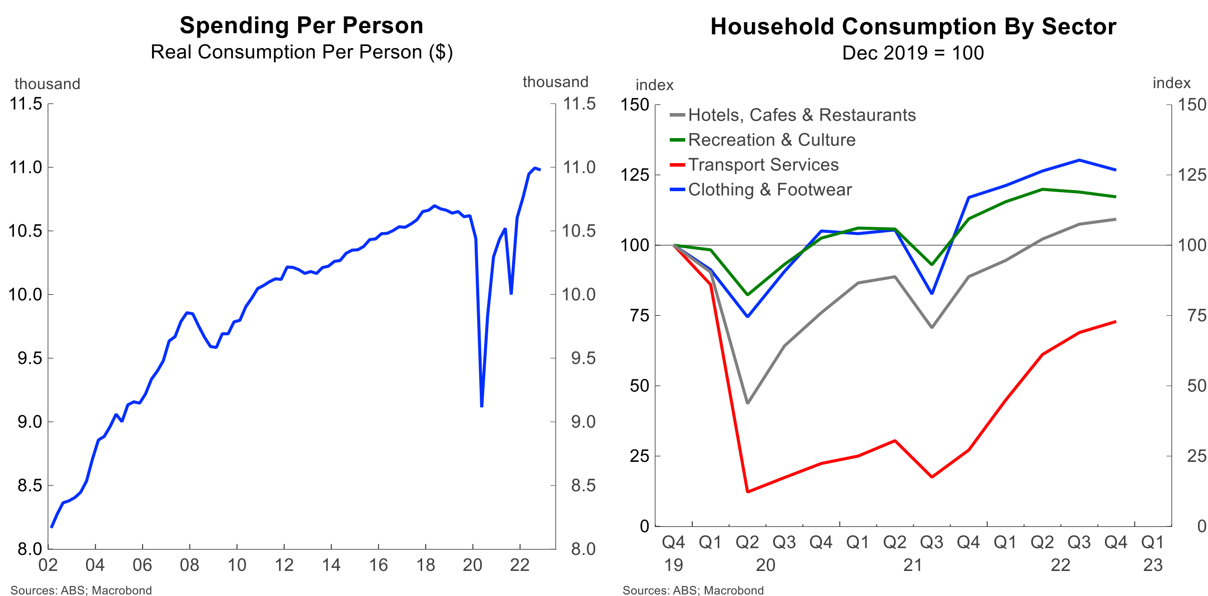
GDP Expenditure Measure

The headline GDP measure is an average of 3 measures – expenditure, income and production. The expenditure measure of GDP rose 0.5% in the December quarter to be 2.7% higher in annual terms.

Household consumption rose by 0.3% in the quarter, to be 5.4% higher through the year. This was the weakest quarterly rise since the delta lockdowns in September 2021. Growth in discretionary spending eased to 0.4% over the quarter, while essential spending grew at the slower rate of 0.3%.

While aggregate household consumption increased, on a per capita basis consumption declined by 0.1%. Outside of the COVID period, this was the first quarterly decline since the September quarter 2019. In addition, growth in consumption per capita was lower than initially estimated over the September quarter 2022, revised down to a 0.4% increase over the September quarter.

This outcome suggests that overseas arrivals are adding to aggregate consumption. In the absence of the strong pick up in net overseas arrivals, aggregate household spending would have gone backwards. The question for policy makers is how long this dynamic will persist – that is, for how long the increase in overseas arrivals will continue to offset the fall in spending per person.



Growth in household spending has been a key theme driving economic growth since Delta lockdowns lifted towards the end of 2021. The December quarter outcome showed that this reopening tailwind has largely played out and households are now more concerned with the higher cost of living, higher rents, and higher interest rates.

In particular, spending on discretionary items eased over the December quarter. Spending on recreation and culture declined by 1.4% on the back of a 0.8% fall in the previous quarter. Spending on household goods and appliances continued to slide alongside the downturn in the housing market, down 1.2% over the quarter to be 3.5% lower through the year. Clothing and footwear and the operation of vehicles also declined over the quarter, by 2.7% and 1.8%, respectively.

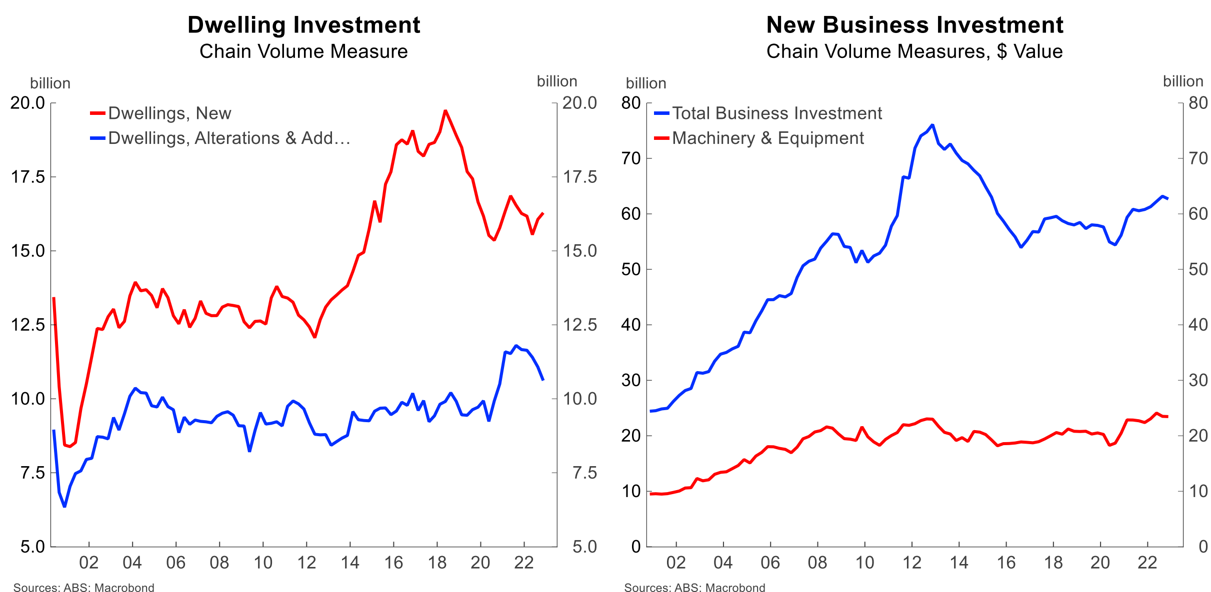
On the other hand, spending on cafes and restaurants increased by 1.6% over the quarter. This was down from 5.2% in the previous quarter. There was also strength in spending on transport services (includes flights and other forms of travel) which was 5.7% higher over the quarter, but down on the 12.8% increase recorded in the previous quarter.

Selected Expenditure Items on GDP, Chain Volume Measures

	Quarterly % Change
Household Consumption	0.3
Public Consumption	0.6
Dwelling Investment	-0.9
New Business Investment	-0.8
New Public Investment	-2.1
	Contribution to GDP, ppt
Inventories	-0.5
Net Exports	1.1

Food spending bounced back in the December quarter, up by 2.4%. This suggests that households have started to switch from eating out to eating at home more regularly – a trend we expect will continue. Other categories which contributed to consumption growth in the quarter included purchases of vehicles (2.9%), spending on health (1.1%) and spending on communication (0.8%).

A lot has been said about the recent increase in advertised rents. Today's release showed that total estimated rents had gone up by 1.2% over the quarter, and by a strong 4.2% in annual terms. This includes actual rents paid by households and also imputed rents paid by owner occupiers. Note that the CPI rents (which only includes rents actually paid) increased by 4.8% in annual terms to the end of January – showing continued strength.



New business investment declined by 0.8% in the quarter but remained 3.1% higher over the year. New business investment detracted 0.1 percentage points from growth in the quarter. The

quarterly outcome was driven by a sharp fall in non-dwelling construction due to the completion of major projects. Engineering construction (-0.8%) and new buildings (-3.8%) both declined. Spending on new machinery & equipment fell 0.2% in the quarter. This followed a sharp 2.5% decline in the previous quarter.

Cultivated biological resources (2.9%) and intellectual property products (1.0%) added to growth in the quarter. However, these categories are relatively small compared to non-dwelling construction and machinery & equipment.

Dwelling investment declined by 0.9% in the quarter, to be 3.7% lower over the year. The outcome was driven by a 4.2% decline in alterations & additions. The unwinding of HomeBuilder and other state-based incentives has reduced activity in the renovation sector.

New dwellings increased by 1.4% over the quarter and by 3.3% in the previous quarter. There remains a solid pipeline of work to be done which will support construction in the near term. This activity has been pushed out due to a range of disruptions and challenges, including weather and COVID-19 disruptions, materials shortages, and labour challenges amid a tight labour market. However, the sector is facing a weaker outlook in the future. Leading indicators, such as building approvals, suggest that work is likely to slow once the existing pipeline of unfinished dwellings is completed.

Ownership transfer costs fell for the fifth consecutive quarter, plunging by 6.2%. In annual terms, ownership transfer costs dropped by 20.6% – the largest annual plunge since the March quarter of 2019.

This category reflects costs associated with transfer of new and existing properties between owners, including real estate agent and legal fees. As a result, this category is typically closely aligned with turnover in the housing market. Turnover in the housing market has continued to be lacklustre, as interest rates increase, and dwelling prices decline.

Net exports drove the positive result, contributing 1.1 percentage points. The terms of trade, which is a ratio of export prices to import prices, rose 0.6% in the quarter, to be 7.2% higher over the year.

In volume terms (i.e. stripping out prices), exports rose 1.1% and imports declined 4.3%. The increase in exports was driven by services exports, with goods exports falling. Services exports rose 9.8%, reflecting the sustained recovery in education and personal travel as international students and tourists continued to return to Australia.

Imports of goods and services fell 4.3%. Imports of goods (-3.8%) drove the fall and was broad-based across consumption, capital and intermediate goods, aligned with weaker domestic demand. A fall in services imports (-6.5%) also contributed as Australian travellers favoured cheaper, short-haul destinations.

New public demand increased by 0.2% in the quarter, to be 3.2% higher over the year. This reflected a 0.6% rise in government consumption and a 1.9% fall in new public investment.

The **change in inventories** detracted 0.5 percentage points from growth. Private non-farm inventories experienced a rundown as retail inventories declined, reflecting the fall in consumption good imports.

Bringing the domestic components together, **domestic final demand** was flat over the quarter. Outside of the COVID period, this was the weakest outcome since the June quarter 2014. In annual terms, domestic final demand grew 3.3%, however, this was impacted by base effects. Growth has moderated in each of the last four quarters, in line with the wind down of the pandemic recovery

and growing cost-of-living pressures for households.

GDP Income Measure

The GDP income measure rose by 0.5% in the December quarter when excluding the impact of prices. This is down from the revised 0.6% increase recorded in the September quarter. In annual terms, the income measure of GDP was 2.6% higher than a year ago. This is down significantly from the 6.2% gain over the year to the September quarter, which was impacted by base effects.

In nominal terms, the GDP income measure rose 2.1%, up from the 1.2% gain in the September quarter. The gain in the quarter was driven by a 1.1 percentage point contribution from gross operating surplus and a 0.9 percentage point contribution from compensation of employees. In annual terms, the GDP income measure increased by 12.0%.

The detail below reflects nominal changes in the income measure of GDP.

Compensation of employees (i.e. wages, salaries and other benefits) increased by 2.1% in the quarter. This continues the strong quarterly growth we have seen over 2022. In fact, over the past four quarters, CoE grew by 2.1%, 3.2%, 2.6%, and 2.1%, respectively. In annual terms, CoE jumped by 10.4% – the fastest annual pace since the September quarter of 2007, over 15 years ago!

Wages and salaries make up the majority of CoE and grew by 2.1% in the quarter. The annual rate also jumped to the highest rate in over 15 years, at 10.2%.

CoE can be broken down in many ways and is driven by a combination of factors, including employment growth, changes in hours worked, and changes in earnings per hour. These measures can also be looked at individually across the non-farm sector, which removes some of the volatility that can accompany the farm sector. These are examined below.

Non-farm total CoE grew by 2.1% over the quarter and 10.4% over the year. Much of this growth was driven by gains in employment.

Non-farm employment is estimated to have grown by 1.1% over the quarter and 6.0% over the year. Employment has grown strongly as the economy has been recovering from the worst of the pandemic. The labour market has become incredibly tight and the unemployment rate fell to the lowest level in almost 50 years during 2022, at 3.4%. Increases in participation to record levels have contributed to strong growth in employment as employers looked to absorb spare capacity in the labour force where they could.

The opening of the international border has also added to growth, as the flow of migrants has increased to record levels. In fact, non-farm employment is estimated to have grown by over 700k people over the past 12 months. This is the 2nd strongest gain in a 12-month period on record, only eclipsed by the 12 months to the June quarter of 2021, when the economy was bouncing back from the first round of lockdowns.

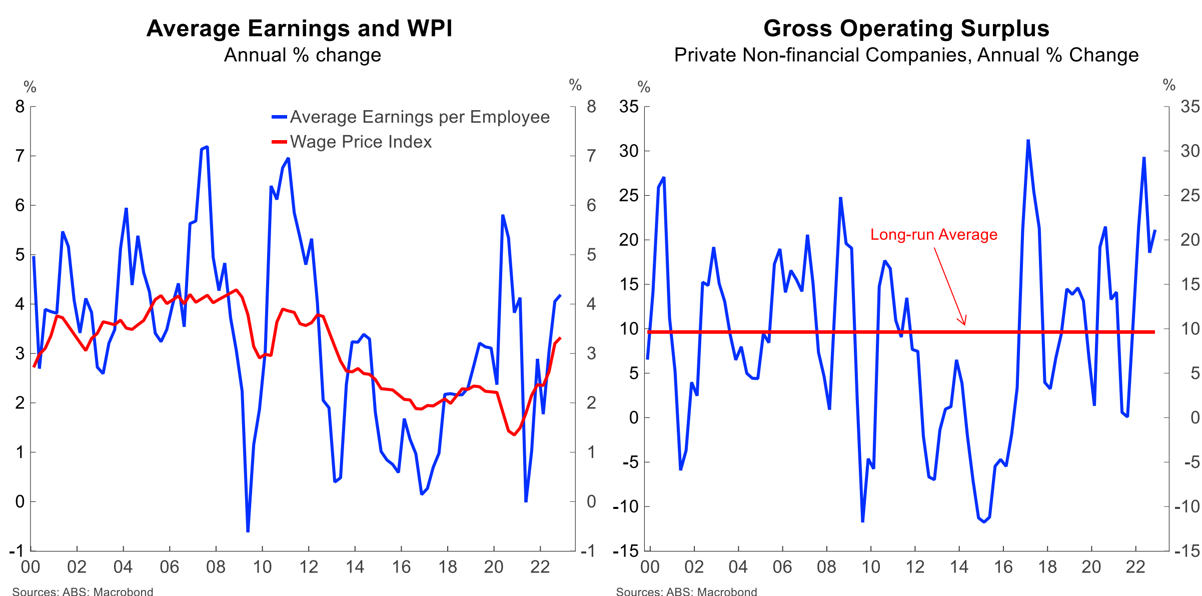
Average non-farm compensation per employee has also grown strongly, rising by 0.9% in the quarter and 4.2% over the year. The quarterly pace follows a 2.2% outcome in the September quarter. This reflects a combination of people shifting from part-time to full-time work, gaining additional hours of work, and compositional shifts in the labour force.

Non-farm compensation per hour worked was flat in the December quarter, to be 2.9% higher over the year. This follows growth of 2.2% in the September quarter. This is a broad measure of wages growth across the non-farm sector and accounts for changes in the composition of the labour force, and bonus and overtime payments. This contrasts with the Wage Price Index (WPI), which measures base wages in a fixed basket of jobs. The WPI rose by 0.8% over the December quarter and 3.3% over the year. The disconnect between the two measures may be explained by

changes in the composition of the labour force, as employment across the hospitality and tourism industry grows in line with the recovery of international tourism.

The outcome also suggests that wage pressures in the economy are not as hot as indicated by other measures of wages and implies that the risk of a price-wage spiral is low. The RBA will certainly be taking a close look at these (and other) measures of labour cost growth over coming quarters to gain a better understanding of wages growth across the economy.

The other key component of CoE, **employer's social contribution** (i.e. superannuation contributions) grew 2.0% in the quarter, to be 12.0% higher over the year – the highest annual pace on record! Superannuation contributions grow in line with employment income, so growth tends to be highly correlated with CoE growth. Additionally, annual growth has been impacted by increases in the Superannuation Guarantee (SG) rate, which rose from 10.0% to 10.5% at the beginning of the 2022-23 financial year.



The **gross operating surplus** (i.e. profits) jumped by 2.9% in the quarter and surged by 15.8% over the year. This followed a 1.8% decline in the September quarter. The gain was driven by a 3.7% increase in profits of private non-financial corporations. Drivers of the gain including growth in profits in the mining sectors, reflecting higher production and commodity prices, increases in retail trade, as price rose while cost pressures declined, and professional, scientific & technical services.

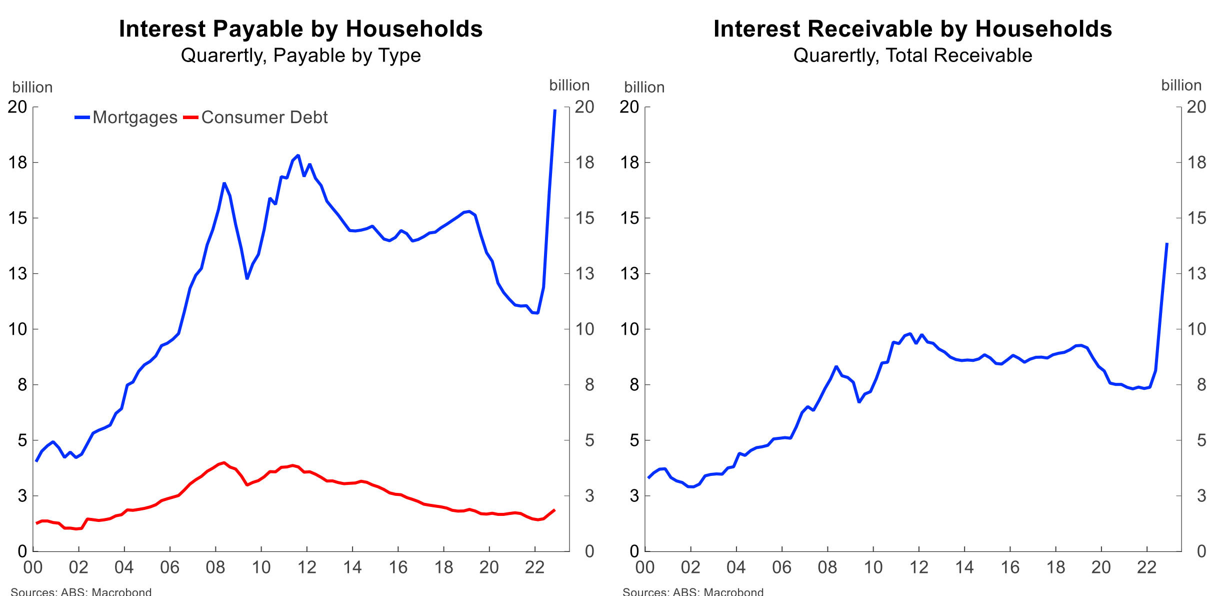
Taxes less subsidies rose 2.0% over the year. This followed a 3.7% gain in the September quarter. Taxes were 3.8% higher as excise taxes jumped 34.2%, reflecting the reversal of the halving of the fuel excise tax. Other taxes also rose in line with continued growth in economic activity, including GST and gambling taxes. Subsidies jumped 19.5% as the Fuel Tax Credits Scheme returned to more normal levels.

Gross **household disposable income** fell 0.7% over the quarter, to be 3.3% higher over the year. The quarterly outcome was the weakest since the September quarter 2012 (outside of COVID). Rising interest costs are weighing on households as the cash rate had been lifted sharply over 2022. The gross household disposable income measure reflects the impact of changes to both income receivable and income payable for households. Total gross income rose by 1.6%, largely driven by the 2.1% gain in CoE in the quarter. Other forms of non-labour income also rose. The main driver here was increases in interest rates on the pool of savings households have on their

balance sheets, which rose by 25.3% to $13.9 billion.

However, these impacts were more than offset increases in income payable. In fact, income payable rose by the most in over 20 years, up 8.9% in the quarter. This largely reflected a jump income tax payments. Income tax payments were 7.4% higher in the quarter and contributed 4.6 percentage points to the gain in income payable. Income tax payments rise as employment income increases. Additionally, a base effect has likely impacted the quarter as many of the refunds from the low- and middle-income tax offset (LIMTO) would have been paid in the September quarter.

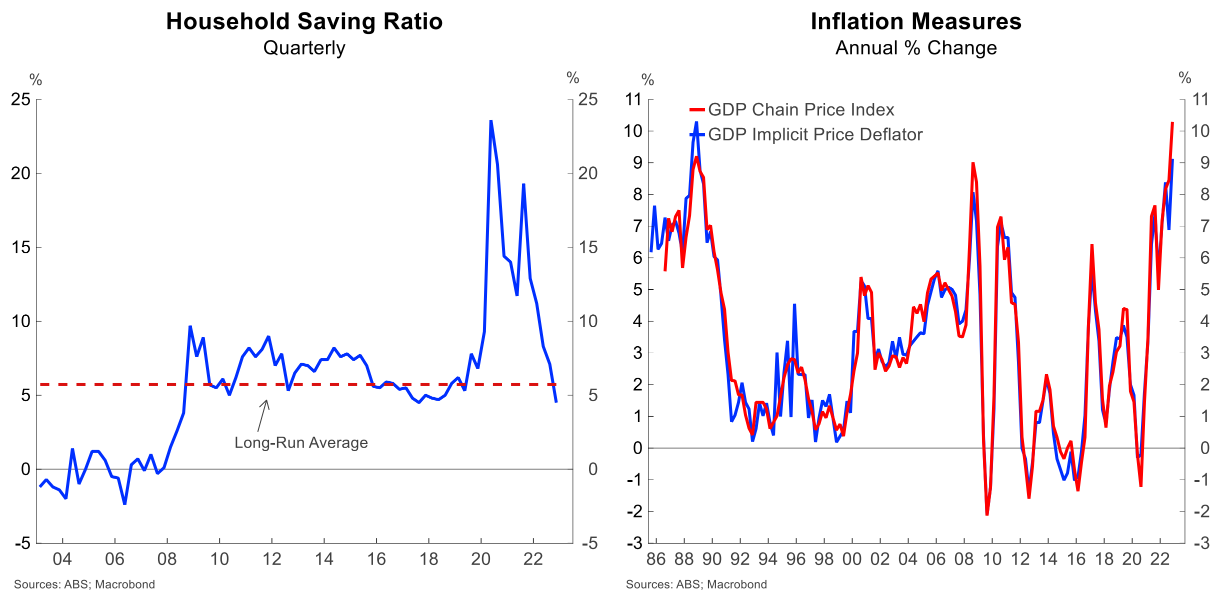
The other major hit to household incomes was a 23.0% surge in interest payments – to a record high of almost $20 billion in the quarter! The second highest was the September quarter of 2011, at $17.8 billion. This contributed 3.2 percentage points to the gain in income payable and follows a 36.1% leap in the September quarter. Higher interest payments reflect the pass through of higher interest costs as the RBA embarked on the most aggressive interest rate hiking cycle since inflation targeting.



The **household saving ratio** declined for a fifth consecutive quarter, easing from 7.1% to 4.5%. This is the lowest rate of household saving since the September quarter of 2008 (and equal to the September quarter of 2017). Importantly, the saving ratio has now fallen below the level that would be considered a trend rate of saving (around 5-6%). While households are still saving in absolute terms, the fall below this trend rate suggests that households are now beginning to dig into the pool of almost $300 billion of "excess" savings that were built up during the pandemic.

How households treat the excess pool of savings that have been built up during the pandemic is a key uncertainty surrounding the economic outlook. If households choose to dig into these excess savings to fund their consumption, spending may be stronger than otherwise. On the other hand, if households treat these savings as part of their wealth, they are likely to only draw on them slowly over time, rather than run them down in the short-term to fund consumption.

Of course, the ultimate outcome will be a combination of these choices, and higher income and higher wealth households are less likely to need to dig into this pool of savings to fund future consumption.



The **terms of trade** (the ratio of export prices to import prices) rose 0.6% over the quarter, to be 7.2% higher over the year. A record high terms of trade in 2022 supported national income over the year. While the terms of trade has pulled back from record levels, the increase in the December quarter supported profits in the mining sector in the quarter. The increase was driven by higher export prices (+1.8%), which more than offset higher import prices (1.3%).

Higher commodity prices contributed to the gain, as the RBA's index of commodity prices rose.

The national accounts also provide two broad measures of inflation which capture price increases across a wider array of goods and services in the economy, not just those specific to household consumption. As expected, these measures showed a strengthening of inflationary pressures in the quarter.

The GDP **implicit price deflator**, which measures price changes but also the effects of compositional changes in the GDP, increased by 1.6% in the quarter and 9.1% over the year. This was the strongest annual rise since the late 1980s. This reflects the strong domestic prices pressures and elevated terms of trade recorded throughout most of 2022. Additionally, the **domestic demand deflator**, which reflects changes in domestic prices, jumped 1.3% over the quarter. This was the lowest quarterly rise since the December quarter 2021 and represents a step down from the 2.0% recorded in the September quarter 2022. However, in annual terms the domestic demand deflator accelerated to 6.5% - the largest annual surge in over 32 years.

The GDP **chain price index,** which removes the impacts of compositional changes in GDP and is a more pure measure of prices changes only, rose 0.6% in the quarter, to be 10.3% higher in annual terms.

State Final Demand

Across the regions, growth varied considerably and overall, was softer than the September quarter of 2022.

Weakness was concentrated in NSW, Queensland, SA, Tasmania and the NT. Household consumption growth underperformed in these regions and even contracted in Queensland and South Australia. However, this was not the only source of softness. Investment was also particularly weak in these areas, especially for housing, with the exception of Queensland which continued to record strong growth in housing investment. Pulling in the other direction,

government spending remained strong in each of these regions, save for the NT, offsetting some of the weakness elsewhere.

At the other end of the ledger was the ACT, Victoria and WA which all expanded in the December quarter. The ACT was the standout, growing 0.3%, driven by a surge in public spending. Households in WA and Victoria did most of the heavy lifting for household consumption in the December quarter, but this was dragged down by a fall in fixed capital investment in both States.

In annual terms, growth was solid in all the major states, indicative of the strong economic recovery underway throughout most of 2022. However, it appears that momentum is starting to slip across the board as the headwinds facing the Australian economy continue to grow.

State & Territory Final Demand, December Quarter 2022

	NSW	VIC	QLD	SA	WA	TAS	NT	ACT
Quarterly % Change								
Final Consumption Expenditure								
General Government	0.5	1.5	1.2	1.6	-2.8	1.0	-0.9	1.6
Households	0.2	0.4	-0.1	-0.1	1.6	0.0	0.2	0.1
Gross Fixed Capital Formation								
Private	-1.8	-1.0	-3.4	-2.2	-0.6	-2.3	0.0	-3.5
Public	-0.1	-3.1	1.6	-3.3	2.0	0.3	-4.6	-2.6
State Final Demand	-0.1	0.2	-0.3	-0.2	0.1	0.0	-0.5	0.3
Annual % Change								
Final Consumption Expenditure								
General Government	2.0	-0.6	4.9	2.2	4.9	3.1	3.9	3.8
Households	5.8	8.1	3.1	4.4	3.7	1.2	0.6	7.2
Gross Fixed Capital Formation								
Private	-2.1	-0.5	-4.1	5.5	-0.2	-3.0	5.0	-8.2
Public	3.7	0.2	6.0	-14.3	7.7	2.2	14.0	8.7
State Final Demand	3.4	4.1	2.4	3.2	3.2	1.1	3.3	3.9

Industry Breakdown

The slowing in consumer spending over the December quarter and in particular, the change in household spending preferences, was a key theme shaping industry performance in the December quarter.

The continued rotation of household spending towards services and away from goods was especially evident. As a result, industries tied to consumer services including other services, admin & support services and arts & recreation, outperformed. In contrast, those industries tied heavily to goods consumption, including manufacturing, retail trade and wholesale trade, were worse off. However, apart from a select few exceptions in the services sector, the slowing in household consumption was evident across all consumer facing industries.

We have also seen a considerable downturn in housing investment. This is weighing on the performance of the construction industry, along with the impact of higher material and labour costs. While prolonged delays from adverse weather events contributed to the decline in output in the agricultural sector.

The electricity, gas, water & waste industry suffered the largest fall in activity in the December

quarter, experiencing its sharpest contraction on record. However, this was largely attributable to a sharp decline in electricity demand as we moved into the warmer months of the year. The pronounced 1.9% fall on Professional, Scientific and Technical Services was due to decreased demand for accounting and consulting services – another indicator that the broader economy is slowing.

In annual terms, growth appears more widespread as most industries benefitted from the strong post-pandemic recovery. Just over half of the industry categories are currently growing above their 10-year average, suggesting that while the recovery has been robust, extraordinary rates of growth have been reserved to those industries most closely tied to the reopening.

Industry Gross Value Added, Chain Volume Measures

Ranked by Quarterly % Change, December Quarter 2022

By Industry	Quarterly % Change	Annual % Change
Other Services	4.9	5.0
Mining	3.2	4.8
Information, Media & Telecommunications	2.6	9.2
Administrative & Supportive Services	2.4	6.6
Arts & Recreation services	2.4	10.1
Public Administration & Safety	1.7	0.8
Accommodation & Food Services	1.4	20.3
Rental, Hiring & Real Estate Services	1.1	0.3
Transport, Postal & Warehousing	0.6	13.0
Education & Training	0.4	1.4
Financial & Insurance services	-0.2	0.6
Construction	-0.3	1.8
Healthcare	-0.3	1.0
Retail Trade	-0.4	0.9
Wholesale Trade	-0.7	1.9
Manufacturing	-1.8	-2.9
Professional, Scientific & Technical Services	-1.8	4.4
Agriculture, Forestry & Fishing	-2.6	-9.1
Electricity, Gas, Water & Waste Services	-4.9	0.2

Source: ABS

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