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**Australian economic growth slips lower**

The Australian economy recorded its 23rd consecutive year of growth in 2013 – a very impressive achievement. Nonetheless, the pace of economic growth has slowed as the mining investment boom plateaued and conditions in the non-mining sector remain soft.

Australian economic growth fell to a two-year low of 2.3%/year in the September quarter of 2013. This outcome was disappointing for a country where ‘trend’ growth is considered to be around 3% to 3.25%. The sub-par result reflected modest growth in consumer spending, weak investment and declines in inventories. However, this was partially offset by a rise in net exports.

The Reserve Bank of Australia (RBA) cut the cash rate twice in 2013 to a record 53-year low of 2.5%. Cumulative monetary policy easing totalled 0.5% (0.25% in both May and August) as labour market and housing credit data remained soggy. The RBA justified the cuts on the benign inflation outlook, stating that the outlook for inflation (well within the 2% to 3% target) had afforded it scope to “adjust policy as needed.”

Soft wages, money supply and credit growth, together with the elevated Australian dollar all helped keep a lid on inflation, with underlying inflation at 2.3%/year in the September quarter.

Household borrowing costs have decreased to levels last seen during the GFC. The average bank variable mortgage rate is now just below 6% and the three-year fixed mortgage rate is around 5.3%. This helped boost the residential property market, with capital city house prices up by around 8% over the year to November. Auction clearance rates in Sydney and Melbourne are at their highest level in five years, reflecting pent-up demand. Dwelling approvals, a leading indicator of residential construction, has risen by 20% in the year to October, driven by apartment approvals. This in part also reflects supply-side constraints, with an estimated shortage of around 270,000 houses across Australia.

The Australian dollar had a ‘wild ride’ in 2013. It fell by 15% between April and August, but recovered back to an “uncomfortably high” level of around $US0.97 in late October, due to better Chinese and domestic economic data, the decisive Federal election outcome, iron ore price strength and the postponement of the US Federal Reserve’s (the Fed) withdrawal of its monetary stimulus (QE3 program).

As at December 9, the Australian dollar had retraced to around $US0.91 in anticipation of the reduction in QE3 from the Fed in the next few months. This should strengthen the US dollar, as the US economic recovery gains momentum. RBA Governor Glenn Stevens also resorted to ‘jawboning’ the Australian dollar lower, suggesting that the RBA may even intervene to force the currency down if necessary. A lower Australian dollar is an important factor in easing financial conditions for Australian businesses, acting as a ‘shock absorber’ as the economy rebalances to non-mining led growth.

The Federal election victory by the Liberal-National Party Coalition in early September triggered some improvement in confidence indicators later in the year. Business and consumer confidence are well up from their lows of two years ago and still appear to be improving. This has been accompanied by better-than-expected retail sales growth. However, Australian households remain cautious due to deteriorating employment conditions, as reflected in the very high household savings rate of 11.1% for the September quarter.

Employment growth remains soft, with the unemployment rate creeping up to 5.8% in August – near the GFC peak of 5.9%.

Before the Federal election, the Treasury revised up the budget deficit estimate for 2013/14 to 1.6% of GDP, from 1.2% in 2012/13. A further deterioration in the budget position is expected to be detailed prior to year-end.

Unlike the US, Australia avoided a prolonged debt-ceiling tussle The Treasurer, with the support of the Greens in the Senate, agreed to abolish the Australian government’s debt ceiling just a week before commonwealth debt was expected to exceed the current A$300 billion borrowing limit in early December. Going forward, the Government will provide more information on the level of debt and, importantly, what that debt is used for.

## The Australian economy: 2014 outlook

Heading into the New Year we have greater conviction that Australia’s pace of economic growth can accelerate in 2014. Therefore, we expect to see further signs of rebalancing in the economy, but only in a gradual fashion.

Capital spending by mining businesses on plant and equipment should hold up for the time being, given the high level of work yet to be done on committed projects (especially for LNG) and the continued strong commodity demand in China.

While we agree that growth is likely to remain sub-par at around 2.5%/year or slightly better, there could be upside risks to the RBA’s forecasts given the moderate pick-up in consumer spending, alongside the recovery in housing and improving global backdrop.

Business confidence is showing encouraging signs of a recovery, but conditions need to improve to ensure an upturn in non-mining business investment and hiring intentions. Unemployment is expected to peak at around 6.25% next year, according to RBA projections.

The Abbott Government’s focus on infrastructure investment should be a positive for non-mining activity, especially since improved transport links are critical for improving labour productivity, given weakening Australian income growth. Despite this, fiscal policy will likely be moderately contractionary in terms of the overall growth contribution next year.

We expect inflation to edge higher in 2014, towards the upper limit of the RBA’s target range of 2% to 3%. However, the subdued labour market outlook will contain inflation, offsetting price pressures arising from likely currency depreciation and rising housing prices. Housing inflation has continued to rise in 2013, raising concerns over an overheating housing market – increasing the hurdle for further RBA rate cuts.

Our base case scenario is that with global growth closer to trend next year, the Fed finally ‘tapering’ its monetary stimulus (placing downward pressure on the Australian dollar) and domestic monetary policy already stimulatory, the RBA will keep interest rates on hold at 2.5% until late 2014. Once the tightening cycle commences, rate increases are likely to be very gradual, given the protracted drag from declining mining capital expenditure and the benign inflation outlook.

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