Media release

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Leading Index recovering slowly

The annualised growth rate of the Westpac–Melbourne Institute Leading Index, which indicates the likely pace of economic activity three to nine months into the future, was –3.9% in May well below its long term trend of 2.6%. The annualised growth rate of the Coincident Index was –0.1%, also below its long term trend of 3.0%.

Westpac's Chief Economist, Bill Evans, commented, "The revised data shows that the annualised growth rate in the Leading Index reached its lowpoint (–6.1%) in February and since then we have seen steady, albeit modest, improvement. The revised growth rate in April has printed at –4.1% so this May reading supports the reasonable expectation that we have passed the worst although the Index is still contracting on a six month annualised basis. The annualised growth rate has now been negative for 8 consecutive months but the lowpoint appears to have been reached after just 5 months. That compares with the last two recessions we have had in this country when the annualised growth rate remained negative for 20 months (1989/1991) and 16 months (1981/83). In those episodes it took 12 (1990/92) and 11 (1983/84) months before the growth rate reached its lowpoint.

“The more rapid recovery in the growth rate gives us some comfort that this economic downturn will be shorter than we saw in those previous cycles.

"Certainly recent economic data supports a stronger and earlier recovery than we had previously expected. The Westpac–MI Index of Consumer Sentiment has risen by 23.2% over the last two months to reach its highest level since December 2007. Business Confidence measures are also on the rise with the June NAB business survey showing the highest level of business confidence since December 2007. A housing recovery seems to be in full swing with the value of loans to Owner Occupiers up by 36% over the year and loans to investors up by 18% in the last 3 months. Last week we released the results of a July survey we conducted with the Melbourne Institute which showed that more than 50% of respondents expect house prices to rise over the next 12 months compared with only around 30% in the equivalent survey in May.

"These boosts to confidence and housing can undoubtedly be sourced back to policy – the Federal Government's aggressive fiscal stimulus packages and the rapid fall in interest rates as the banks slashed variable mortgage rates in the wake of the Reserve Bank's aggressive 425 basis point rate cut.

"Australia is also benefiting directly from the considerably stronger economic conditions in China. Over the 6 months to March exports fell globally by around 20% whereas Australia's exports actually rose by 1.7%. With our imports down by 14% Australia has enjoyed an unprecedented growth boost from the external sector. Net exports added almost 4 ppt's to growth over Q4 and Q1 effectively for now keeping Australia out of a technical recession and in turn providing households with a significant boost to Confidence.

"With net exports likely to provide yet another boost to growth in the June quarter and consumers set to maintain a decent pace of spending growth there is now a good chance that the economy will withstand the expected sharp contraction in business investment and housing construction and register modest but nevertheless positive growth. Positive growth in the June quarter will move us further away from the risk of technical recession while the improvements in Confidence are likely to imply somewhat more robust consumer spending; business investment and employment intentions than we expected earlier in the year. By year's end the housing recovery will certainly be supporting growth while the ongoing momentum in China and stabilisation in the global economy should support exports.

“These observations may be running a little ahead of the current signals from the Leading Index but at least it appears that the Leading Index's growth rate has passed its lows. The timing of any movement back to positive growth is very uncertain. However, we expect that the return will be well before the 16-20 consecutive months of negative growth we saw in the recessions.

“The level of the Leading Index fell by 0.5 points in May from 248.7 to 248.2. Two of the four monthly components fell in May – dwelling approvals (–12.5%) and US industrial production (–1.1%). The all ordinaries index and the money supply both rose by 1%. It seems unlikely that the external component of the Index (US industrial production) is capturing that China effect we referred to above. That is because the bulk of Australia's exports to China are supporting infrastructure investment rather than the export sector that could be expected to be captured by a US activity variable.

“The improvement in the growth rate of the Index from the –6.1% lowpoint in February to the –3.9% in May has been mainly due to the rise in the all ordinaries Index (+1.4ppts); improvement in overtime worked (+1.2ppts) and corporate profits (+0.6ppts). That has been partly offset by wholesale prices (–0.4ppts) and productivity (–0.3ppts).

"The level of the Coincident Index increased by 0.5 points with the low point in its growth rate (–2.1%) having also passed in February.

"Last week Westpac changed its view on the interest rate outlook. We no longer expect that the Reserve Bank will be cutting rates any further despite a very clear easing bias. The Bank is expected to be on hold for an extended period as it deals with the uncertainties of a very weak world economy and an Australian economy which has been benefiting from an aggressive stimulus package from the authorities; record low interest rates; and a resurgent China." Mr Evans said.

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