

Economic Issues

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The Performance of Services Index (PSI)

How is it travelling?

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- The AIG – CBA PSI survey has now been running for two years.
 - Our analysis of the track record to date is encouraging.
 - The PSI has a useful correlation with activity, the labour market and inflation.
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Summary

The Australian Industry Group (AIG) and the Commonwealth Bank have been running a survey of activity in the services sector for a couple of years now. The Performance of Services Index (PSI) gives a monthly reading on activity in the services sector. Its international counterparts include the US Non-Manufacturing ISM. The US survey commenced in 1998 and is now viewed as an important economic indicator by financial markets.

The PSI is important because the services sector is a *growing* part of the economy. And it is now the *dominant* part of the economy. The services sector also plays a key role in determining overall inflation trends. Service sector prices reflect more closely the state of domestic price pressures. Goods prices tend to be driven more by developments in global markets.

With two years worth of readings now in the spreadsheet, we've had a close look at what sort of information content we are getting out of the PSI. The early results are encouraging. The survey does seem to have a useful correlation with activity, the labour market and inflation.

The correlations appear stronger for the activity measures than the price measures. The services component of GDP growth, for example, tends to track the overall PSI readings quite well. The employment component of the overall PSI does a good job in picking job trends and a better job in picking shifts in services jobs. The retail subset of the PSI sales readings picks the direction of retail spending swings (but not necessarily the magnitude of those swings). Similarly, changes in the PSI sales component tend to pick the direction of changes in company profits. The gap between the PSI delivery and orders components – a proxy for capacity-type pressures – contains some information about firms capex and inventory holdings.

The PSI's "prices paid" component is strongly in "expansion" territory at the moment. The correlation between prices paid and the CPI's measure of services prices is reasonably loose. But a better "fit" is obtained when we use measures of pricing power derived from the PSI. The PSI price measure is, of course, measuring prices paid by survey respondents. As such, it should be a better proxy for upstream price indicators. And that seems to be the case. The prices paid measure is a good guide to trends in the Producer Price Index. And it has some information content about wage trends as well.

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The PSI: what is it?

Services now dominate the economy.

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The PSI gives a monthly reading on activity in the services sector.

The PSI survey is drawn from a database of 950 organisations. It covers firms in wholesale, transport & storage, communication services, finance & insurance, property and business services, health & community services, cultural & recreational services, and personal & other services.

Participants are surveyed each month on how their sales, orders, employment, stocks, and deliveries have changed relative to the previous month. Data on changes in prices paid is also collected.

The PSI is similar to the US Non-Manufacturing ISM-

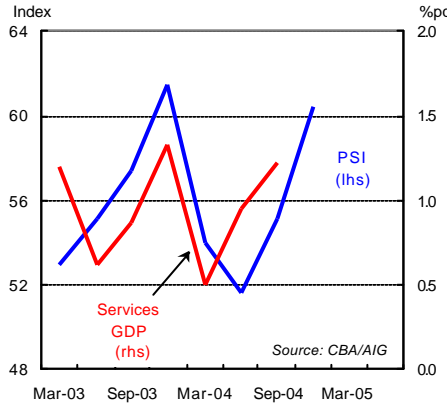
The PSI results are presented as diffusion indexes. These indexes have leading indicator properties and show the direction of change. A reading >50 means expansion. The further above (below) 50 the stronger the expansion (contraction). The PSI is released on the 3rd business day of each month.

The PSI: the track record.

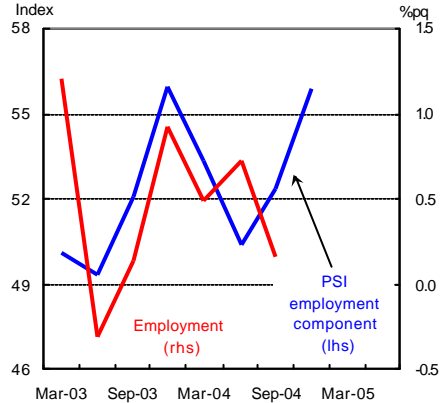
With two years worth of readings now in the spreadsheet, we've had a close look at what sort of information content we are getting out of the survey. The early results are encouraging. The survey does seem to have a useful correlation with activity, the labour market and inflation.

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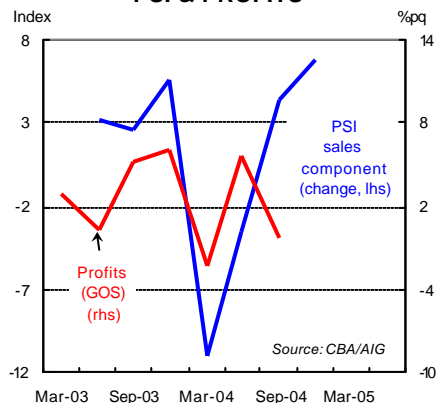
PSI & GROWTH



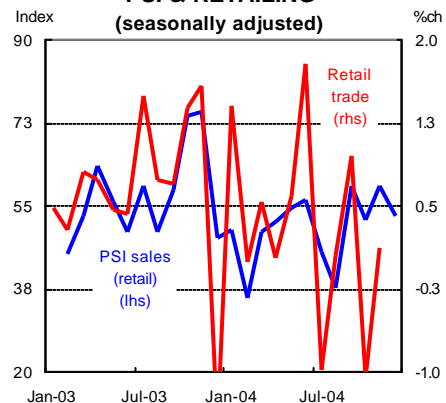
PSI & EMPLOYMENT



PSI & PROFITS



PSI & RETAILING (seasonally adjusted)

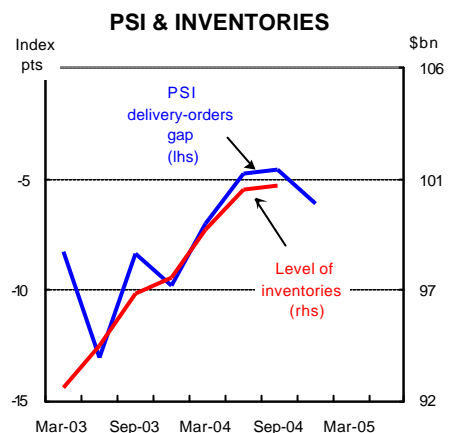
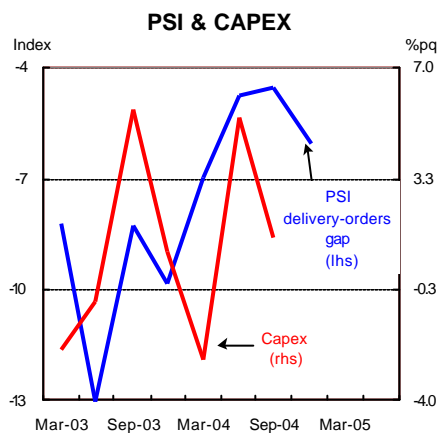




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The correlations appear stronger for the activity measures than the price measures. In particular:

- the services component of GDP growth tends to track the overall PSI readings quite well;
- the employment component of the overall PSI does a good job in picking job trends and a better job in picking shifts in services jobs;
- the retail subset of the PSI sales readings picks the *direction* of retail spending swings (but not necessarily the *magnitude* of those swings);
- similarly, changes in the PSI sales component tend to pick the direction of changes in company profits;
- the gap between the PSI delivery and orders components – a proxy for capacity-type pressures – contains some information about firms capex and inventory holdings.



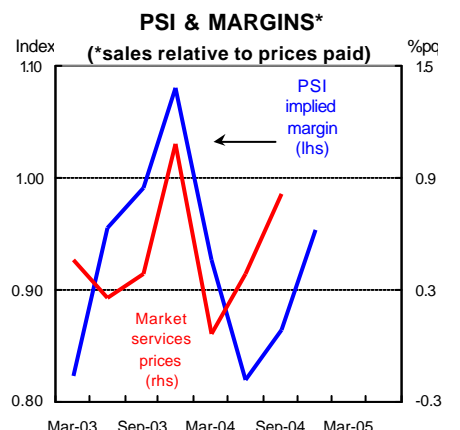
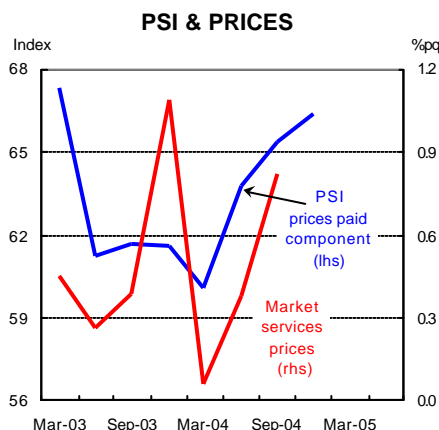
The QIV messages.

The PSI readings for the quarter just ended imply that we will see another solid rise in service sector output. That December quarter output lift appears to have flowed through to company bottom lines again. It has also required a sizeable lift in labour hiring and capex. Sales look to have run a little ahead of production in the final months of 2004, so inventory holdings may fall a little.

Price readings derived from the PSI survey are consistent with the idea that inflation risks for 2005 are tilted to the high side.

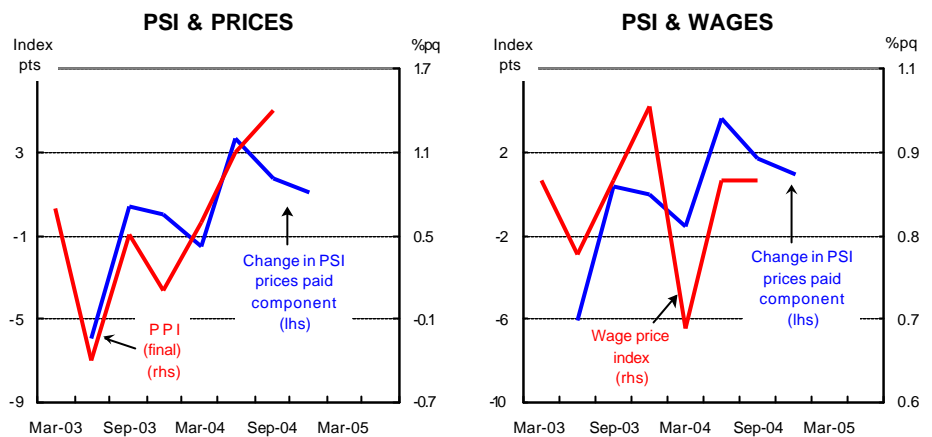
The PSI's prices paid component is strongly in expansion territory at the moment. The correlation between prices paid and the CPI's measure of services prices is reasonably loose. But a better "fit" is obtained when measures of pricing power derived from the PSI are used. Swings in a margins proxy – based on sales trends relative to price trends – is correlated with services prices. Petrol prices seem to have a significant influence on the PSI's prices paid component.

PSI price readings are consistent with the idea that inflation risks for 2005 are tilted to the high side.





The prices paid measure is a good guide to trends in the Producer Price Index and wage trends.



The PSI price measure is, of course, measuring prices paid by survey respondents. As such, it should be a better proxy for upstream price indicators. And that seems to be the case. The prices paid measure is a good guide to trends in the Producer Price Index. And it has some information content about wage trends as well.

The PSI: work in progress.

We think that the usefulness of the PSI will continue to grow.

It is still early days. Only a limited run of data is available. Nevertheless, the PSI does provide us with useful and timely readings on developments in the economy in general and the services sector in particular. We think its usefulness will continue to grow.

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