

Overview

Over the past year, growth of Australia's major trading partners (MTPs) has been around its historical average. In China, GDP growth eased marginally over the year to the September quarter, with weakness in the property sector weighing on growth of industrial production, which has slowed a little. Nevertheless, overall growth remains consistent with the authorities' target of 7.5 per cent for this year. In Japan, activity looks to have increased modestly following the sharp decline in output after the consumption tax increase in April. In the rest of east Asia, over the past two quarters output looks to have grown at around its average pace of recent years, while the US economy has grown at an above-trend pace over the same period. Meanwhile, the recovery in the euro area remains fragile, with activity growing only very modestly in recent months. Inflation has been low in all major regions of the world and global financial conditions remain very accommodative.

With global economic conditions not changing much over recent months, the outlook is still for Australia's MTP growth to be a little above its long-run average in 2014 and 2015. Growth in China is expected to trend gradually lower, one reason being that policymakers may be willing to accept some easing in growth in order to place financing on a sounder footing. GDP growth in Japan, the rest of east Asia and the euro area is expected to be around their averages of the past decade, which are quite a bit slower than their longer-term averages. Growth in the US economy is expected to continue at an above-trend pace.

Commodity prices overall have fallen further since the previous *Statement*, with notable declines in the prices of iron ore and oil, although prices of base metals have risen. Much of the decline in iron ore prices this year owes to the increase in global supply following significant expansion in capacity, including in Australia. Some easing in the growth of Chinese steel production has also played a role. Coal prices are lower than they were earlier this year. Oil prices have declined significantly over recent months largely as a result of rising global supply, which will provide support for global growth. As a result of weaker-than-expected prices for bulk commodities, the forecast for Australia's terms of trade have been revised a little lower.

Volatility in financial markets has risen over recent months after a period of being unusually low. While there has been no obvious trigger for the increase in volatility, the divergent paths of policy in the major economies have probably contributed. Global bond yields have declined, along with market expectations for policy rates. Global equity prices have moved within a sizeable range but in net terms have been little changed and are around multi-year highs in the United States and Japan. Australian bond and equity markets have generally moved in line with global developments. The US dollar has appreciated against most currencies, particularly the yen, but remains at a low level by historical standards.

As expected, the US Federal Reserve ended its asset purchase program at its October meeting. Market pricing implies that the first increase in the US federal funds rate is expected around October 2015, later

than indicated by commentary by Federal Open Market Committee members. In contrast to this, the Bank of Japan recently announced a significant expansion in its program of quantitative easing. Meanwhile, the European Central Bank is aiming to expand its balance sheet back towards the level seen in 2012, through term lending to the banking system at low rates and by purchasing covered bonds and asset-backed securities.

Australian financial conditions remain very accommodative. Lending rates have continued to edge lower for both households and businesses. The exchange rate has depreciated by about 5 per cent in trade-weighted terms since the previous *Statement*. However, the Australian dollar remains high by historical standards and, in trade-weighted terms, is above the level seen earlier in the year despite the sizeable declines in key commodity prices over the course of this year.

In 2013/14, Australian GDP growth was a bit below trend in year-average terms. Growth of mining activity remained strong, with a rise in resource exports more than offsetting large falls in mining investment. Growth of non-mining economic activity was aided by very low interest rates, with a noticeable increase in dwelling investment and a modest increase in consumption growth. However, non-mining business investment remained subdued. Public demand made a positive contribution to growth.

Over recent months, the composition of growth appears to have been little changed and its pace looks to have been a bit below trend.

Resource exports have continued to grow strongly, as new capacity has come on line. Australian production of iron ore is likely to expand further, despite the substantial decline in prices over this year, and the production of liquefied natural gas from new facilities will begin to ramp up gradually over coming quarters. Coal production is expected to be sustained at a high level even though a few smaller, higher-cost mines have closed in response to lower coal prices. As projects for bulk

commodities continue to reach completion, and with only a few new projects under consideration, mining investment is expected to decline more sharply over coming quarters than the decline seen to date.

Surveys of business confidence and conditions, as well as capacity utilisation, have all increased since last year to be around average levels. Non-mining business investment, however, remains subdued, and liaison continues to suggest that firms are reluctant to undertake significant new investment projects until they see a more substantial improvement in demand. Even so, the Australian Bureau of Statistics' capital expenditure survey suggests that modest growth of non-mining business investment is in prospect for this financial year. In line with this, there is a substantial pipeline of non-residential building work yet to be done, although the prospect for non-residential building over the medium term is less positive than it was earlier as approvals for these projects have declined over the course of this year.

Strong growth in dwelling investment is likely to continue, as evidenced by the high level of building approvals and strength in other forward-looking indicators. Conditions in the established housing market also remain strong. Housing price growth has slowed from the rapid pace of late last year, but is still quite high in Sydney and Melbourne. While growth of housing credit for owner-occupiers is only a little above that of income, investor credit continues to grow at a noticeably faster rate.

Household consumption appears to be growing moderately, reflecting the opposing forces of slow growth in incomes on the one hand and very low interest rates and strong increases in wealth on the other. Consumption is expected to continue growing a little faster than income, which implies a further gradual decline in the saving ratio.

Conditions in the labour market remain subdued. On revised estimates, the unemployment rate has risen a little over the past six months. Employment has grown by about 1 per cent over the year to date,

which is somewhat slower than population growth. Forward-looking indicators have increased to levels consistent with moderate employment growth in coming months. Meanwhile, wage growth remains low, which is in line with a degree of spare capacity in the labour market.

CPI inflation declined in the September quarter, following several quarters where it had been rising. Much, though not all, of the decline in inflation in the September quarter reflected the effect of the removal of the carbon price on utility prices. Underlying inflation also declined in the September quarter to $\frac{1}{2}$ per cent from $\frac{3}{4}$ per cent, to be $2\frac{1}{2}$ per cent in year-ended terms. The prices of tradable items (excluding volatile items and tobacco) were lower in the September quarter, though they still remain higher than a year earlier. While tradables inflation tends to be quite volatile from quarter to quarter, the decline in prices in the September quarter was unexpected, given that prices of tradable items had been picking up in response to the depreciation of the exchange rate since early 2013. Non-tradables inflation (excluding utility prices) was little changed in the quarter and remains relatively low in year-ended terms, consistent with weak domestic cost and margin pressures. The low growth of wage costs is particularly apparent in the low inflation of market services, for which labour is a substantial input. In contrast, inflation of new dwelling costs increased in line with the strength of activity in the housing market.

The outlook for domestic growth has not changed from that presented in the August *Statement*. GDP growth is still expected to be below trend until mid 2015, before picking up gradually to be a bit above trend by the end of 2016. The key forces shaping the economy and the outlook are much as they were previously. The low level of interest rates and strong population growth are expected to continue to underpin rising housing activity and housing prices. These, in turn, are expected to support consumption through their effect on household incomes and household wealth. In time, a pick-up in household

demand should support higher business investment in the non-mining sector. Exports, especially of resources, are expected to continue to contribute to growth, while declining mining investment and, to a lesser extent, fiscal consolidation at both the state and federal levels are likely to weigh on growth over the forecast period.

A gradual strengthening of economic growth should, in time, lead to stronger growth of employment. However, in the near term, with growth in economic activity forecast to remain below trend, the unemployment rate is likely to stay elevated.

Inflation is projected to remain consistent with the target over the forecast period. The depreciation of the exchange rate since early 2013 is expected to exert some further upward pressure on inflation over the next couple of years, but spare capacity in labour and product markets will continue to weigh on domestic inflationary pressures for some time.

Overall, the risks to the global economic outlook appear to be broadly balanced. A key risk is the condition of the Chinese property market, which has been a source of uncertainty for some time. The Chinese authorities had earlier been trying to engineer a slowing in the growth of property prices. Now that the market has turned down, some restrictions on purchasing have been removed in most cities and the authorities have acted to provide some support to purchasers and developers. It is too early to know how effective these efforts will be, or what implications the slowing in the Chinese property market may have for Chinese commodity demand, economic activity or financial stability.

The path of the exchange rate is another significant source of uncertainty for the forecasts. Notwithstanding the depreciation over recent months, the Australian dollar remains above most estimates of its fundamental value. A lower exchange rate would help to achieve more balanced growth in the economy. It would also put some temporary upward pressure on inflation. However, the recent announcements in Japan on monetary

policy and pension fund asset allocation increase the probability of consequent capital flows seeking more attractive yields on various assets in Australia (along with other destinations). Such flows could hold the Australian dollar at a higher level than real economic fundamentals would imply.

Domestically, an important source of uncertainty continues to be the speed and timing of the anticipated recovery in non-mining business investment. While the recent data suggest that a substantial pick-up in non-mining investment is still some way off, the fundamental factors supporting investment remain in place, including low interest rates, strong population growth, gradually rising capacity utilisation and a period of weak investment over the past few years. If the appetite for businesses to take on risk improves, growth in non-mining business investment could eventually be stronger than forecast.

While consumption appears to have been growing moderately, those states where the housing market has been especially strong have also seen stronger growth in consumption and economic activity more generally over the past year. This suggests that consumption growth may pick up faster than expected if property markets in other parts of the country strengthen. However, it is also possible that the increase in wealth from rising housing prices is having less of an effect on consumption than has been the case previously. This would suggest that consumption growth might pick up by less, and the saving ratio fall by less, than forecast.

The cash rate has been unchanged at its current low level for over a year and interest rates paid by borrowers have declined slightly over this period. The very low levels of interest rates are having the sorts of effects normally expected on the economy, contributing to a pick-up in the growth of non-mining activity via strong growth in dwelling investment and providing support to growth in household expenditure more generally. Also, the conditions are in place for stronger growth in non-mining business investment. Despite the recent depreciation of the exchange rate, the Australian dollar remains above most estimates of its fundamental value, particularly given the further declines in key commodity prices over the course of this year. As a result, the exchange rate is offering less assistance than would normally be expected in achieving balanced growth in the economy.

The very accommodative monetary policy settings will continue to provide support to demand and help growth to strengthen, in time. Meanwhile, inflation is expected to be consistent with the 2–3 per cent target over the next two years. Given that assessment, the Board's judgement at its recent meetings has been that monetary policy is appropriately configured to foster sustainable growth in demand and inflation outcomes consistent with the target. On present indications, the most prudent course is likely to be a period of stability in interest rates. ✎