Overview

The Australian economy is growing a little above trend, although GDP growth slowed unexpectedly in the September quarter. In contrast, the labour market continues to improve, with the unemployment rate having fallen to 5 per cent. Underlying inflation remains low but is above its trough. The Bank's growth forecasts have been revised down in light of recent data, particularly for consumption. GDP growth is expected to be around 3 per cent over this year and 2¾ per cent over 2020.

With growth expected to be a little above trend and the unemployment rate continuing to decline, underlying inflation is expected to increase gradually, reaching 2¼ per cent by the end of 2020. Lower petrol prices are expected to result in headline inflation falling to about 1¼ per cent in early 2019 before rebounding to be similar to underlying inflation. Forecasts for underlying inflation have been revised slightly lower, reflecting somewhat lower growth and expected near-term weakness in administered and utilities price inflation.

The global economy continues to grow at a solid rate, although global growth moderated in the second half of 2018. Downside risks to the global outlook have increased. Trade tensions are beginning to affect the level and pattern of trade. Growth in most of Australia's major trading partners is nonetheless likely to remain around trend for the next year or so.

GDP growth in China slowed as expected over 2018, following the earlier tightening in financial conditions. However, a range of indicators suggest a more pronounced slowing in momentum. Some of the slowing stems from efforts to rein in shadow financing as well as the effects of recent tariff increases on bilateral trade with the United States. The Chinese authorities have responded with further targeted policy easing, while remaining mindful of the need to limit financial risks and reduce leverage.

Elsewhere in Asia, softer external demand has weighed on growth, including from China. Trade tensions are affecting some economies in the region, particularly those that are part of global supply chains that involve China. But other economies could be expected to benefit if manufacturing firms shift their production out of China to avoid US tariffs and higher Chinese labour costs. Domestic demand in east Asia has generally been resilient.

Growth in the major advanced economies diverged over 2018. In the United States, growth remains strong, partly because fiscal stimulus continues to support consumption spending. Growth in Japan is expected to recover from the effects of natural disasters that occurred in the September quarter. By contrast, growth in the euro area moderated in the second half of 2018. All three major advanced economies have benefited from tight labour markets supporting household spending.

With unemployment rates at multi-decade lows across many major advanced economies, wages growth continues to drift up. Core inflation is around target in the United States and several other advanced economies, but it remains low in the euro area and Japan. The recent decline in oil prices is reducing headline inflation globally.

For most of Australia's trading partners, though, it is also boosting real incomes and spending because these economies are net oil importers.

Financial market conditions in major markets have tightened somewhat over recent months, and volatility in some markets has increased. However, risk premiums generally remain low by historical standards and long-term bond yields have declined as market participants have scaled back their expectations of monetary policy tightening. Lower inflation expectations, driven by the recent decline in oil prices, have also contributed to the decline in nominal yields. The cost of funding for businesses and households therefore remains relatively low. Financial conditions in some emerging markets have eased recently because US bond yields have declined, the US dollar has depreciated and domestic policies have been adjusted in some cases.

Money market rates in Australia remain higher than a year ago. This has increased banks' funding costs a little relative to the average of 2017. In response, banks have increased their standard variable housing interest rates by around 15 basis points. However, banks continue to compete vigorously for lower-risk borrowers, so average interest rates actually paid are little changed and remain low. Competition to lend to larger businesses also remains strong, and growth in credit to these borrowers has picked up in recent months. In contrast, lending conditions for small business are more constrained.

On a trade-weighted basis, the Australian dollar has depreciated a little in recent months, but it remains within the narrow range it has been in for some time. The differential between Australian and major economies' market interest rates has narrowed a little since the end of 2018. This has tended to offset the pressure for the exchange rate to appreciate, stemming from higher commodity prices.

Australia's terms of trade have held up at recent levels, though they are still expected to decline over the next few years. Large movements in the prices of key commodity exports have had opposing effects on the terms of trade of late. Australia has shifted from being a net importer to a net exporter of oil-related products, because liquefied natural gas (LNG) exports have increased significantly over the past couple of years. The sharp decline in oil prices since October, if sustained, will therefore tend to reduce the terms of trade. Following a number of mine closures in Brazil, iron ore prices have increased sharply in recent weeks; the outlook for prices is uncertain, and depends partly on production being restored and whether other sources of supply come on line.

Domestically, GDP growth was weaker than expected in the September quarter. Growth was also revised down for some earlier quarters. Consumption growth was particularly weak, and was revised down for most quarters over recent years. Household income growth was also weaker than expected in the quarter, despite the ongoing solid growth in labour income as the labour market improves.

In light of recent data and revisions to past outcomes, the Bank's forecasts for consumption growth have been lowered. The outlook for consumption growth hinges on household income growth picking up, and by enough to offset households responding to falling housing prices by reining in their spending. Such a pick-up in income growth seems probable given the improving labour market, but is not assured. In the context of high household debt, currently weak income growth and falling housing prices, the resilience of consumption growth is a key uncertainty for the overall outlook.

Dwelling investment has held up at a high level recently. The large pipeline of work to be done

has helped sustain this rate of activity and will continue to do so in the near term. But building approvals have fallen and developers report that it is difficult to finance apartment projects and attract sufficient pre-sales to proceed. Dwelling investment could therefore tail off sooner and faster than earlier projected.

The current correction in the housing market is a significant area of uncertainty. Housing prices nationally had increased by almost 50 per cent over the five years to September 2017, and they have fallen by around 8 per cent since then. The decline has been occurring in a benign context of low interest rates, strong population growth and positive labour market conditions, especially in New South Wales and Victoria, where the recent capital-city price falls have been largest. Increased housing supply has contributed to the falls in prices, particularly in Sydney. Rental vacancy rates have increased in Sydney and rental growth has slowed there.

The implications of the housing market correction for the broader economy depend on how households respond, including how they take previous price increases into account in their spending decisions. Households' demand for credit has eased, particularly for investors. Credit supply has also tightened for some borrowers. Meanwhile, growth in credit to owner-occupiers has slowed in recent months but has been around 5½ per cent in annualised terms.

The outlook for business investment remains positive. The remaining LNG projects are close to completion. Once that occurs, mining investment is expected to trend up, bringing to an end an extended period in which it had been a drag on overall economic growth. In non-mining sectors, the pipeline of work in non-residential building and private infrastructure projects remains above averages of recent years, and solid growth in corporate profits is also likely to support investment spending. Recent survey measures of business conditions in the non-mining sector have turned down. If sustained, this would imply a weaker outcome for both investment and employment growth.

Resource exports were affected by supply disruptions in the September and December quarters. As these disruptions are gradually resolved and additional capacity comes on line, resource exports are expected to increase over the next year or so. Drought conditions in key agricultural regions have reduced rural production and exports. Low soil moisture and continued dry weather forecast for some regions imply that a near-term recovery in rural output is unlikely.

Conditions in the labour market have continued to improve. The unemployment rate averaged 5 per cent in the December quarter, and employment recorded another strong increase. Conditions are especially positive in New South Wales and Victoria, where unemployment rates are now in the 4–4½ per cent range. Forward-looking indicators continue to point to above-average employment growth in coming months. If this occurs, it should support a further gradual decline in the unemployment rate.

Consistent with the gradually tightening labour market, wages growth has increased a little in recent quarters. In particular, fewer workers are subject to wage freezes than in recent years. Increases in minimum wage rates have also contributed to the increase. If the labour market continues to improve as expected, wages growth should continue to pick up gradually.

CPI inflation in the December quarter was a little lower than expected three months ago, mostly reflecting the fall in petrol prices in November and December. The recent data did not suggest a major shift in underlying inflationary pressures, which remain low. In addition to the effects of

ongoing slow growth in labour costs and rents, decisions around administered prices have helped keep inflation low; this dynamic could continue for a while yet. Deflationary pressures on retail prices eased a little in the December quarter. This partly reflected some pass-through of the modest depreciation in the Australian dollar to retail prices of imported goods.

Lower petrol prices will reduce CPI inflation significantly in the March quarter, but, beyond that, both CPI and underlying inflation are expected to increase gradually as the labour market tightens. Decisions around utilities and other administered prices pose a downside risk to the inflation outlook, but would boost real household incomes.

The Reserve Bank Board has maintained the cash rate at 1½ per cent since August 2016. This expansionary setting of monetary policy has helped support growth and create the conditions for lower unemployment and a gradual increase in inflation. The steady setting of monetary policy has supported stability and confidence in the Australian economy.

At its recent meetings, the Board has paid close attention to developments in the housing market and the implications that lower prices might have for construction activity and households' spending decisions. The Board has also considered how the prospects for consumption growth would be affected if household income growth does not pick up.

The labour market has been strengthening over the past year, but less progress has been seen on the inflation front. The Board continues to judge that further progress in reducing unemployment and bringing inflation into the target range can reasonably be expected. If that scenario should come to pass, higher interest rates would become appropriate at some point. Other scenarios, in which the labour market and consumption growth are weaker than currently expected, are also possible. If there were then to be a sustained increase in unemployment and a lack of progress in returning inflation to target, it might instead be appropriate to lower the cash rate.

In light of the recent data and the inherent uncertainties around the forecasts, the probabilities of these two sets of scenarios have shifted to be more evenly balanced than previously. The Board therefore does not see a strong case to adjust the cash rate in the near term. It will maintain its medium-term focus, aimed at achieving its objectives of full employment, inflation averaging 2–3 per cent and financial stability.