5. Economic Outlook

Domestic economic conditions have been a bit softer than were expected at the time of the November *Statement*. As a result, the forecast for GDP growth has been revised lower. Consistent with this, the forecast for inflation has also been revised slightly lower. In summary, GDP growth is expected to be a little above trend over the forecast period and underlying inflation is expected to pick up to 2 per cent by late 2019 and to be a little higher in the following year.

As discussed in the chapter on 'The International Environment', GDP growth in Australia's major trading partners is projected to moderate from the strong growth seen in 2017 and early 2018. Growth is expected to slow by a bit more than was expected at the time of the November *Statement*, largely because growth in some of Australia's major trading partners slowed by a little more than expected in the second half of 2018. Ongoing trade tensions between the United States and some of its key trading partners, which had already lowered the outlook for global growth in the August and November *Statements*, remain a downside risk.

Although growth in the major advanced economies is expected to moderate, it is expected to remain sufficient to maintain upward pressure on inflation. Tight labour markets and a pick-up in wages growth are supporting consumption and adding to inflationary pressures. However, the decline in oil prices since the previous *Statement* will continue to reduce inflation in the near term. Should oil prices remain at current levels for a sustained period, this could be expected to support GDP growth in our trading partners because most of these economies are net oil importers.

Domestic GDP growth has been revised lower

GDP growth over the year to the September quarter was weaker than previously anticipated. This partly reflected weaker-than-expected consumption growth in the quarter and slower growth in household income. Consumption growth was also revised lower over recent years. There were also downward revisions to the recent history of some other components of GDP. As a result, the starting point for the year-ended growth forecasts is ¾ percentage point lower than previously expected (Table 5.1). Recent partial indicators point to firmer GDP growth in the December quarter resulting in year-ended growth of a bit below 3 per cent, which is a little above estimates of potential output growth.

Year-ended growth is expected to be around 3 per cent over 2019 and 2¾ per cent over 2020 (Graph 5.1). Accommodative monetary policy and tighter labour market conditions are expected to provide ongoing support to growth in household income and consumption. However, consumption growth is now expected to be 2¾ per cent over the forecast period, rather than 3 per cent as had been expected for some time. This reassessment of the outlook for consumption is informed by the downward revision in the national accounts and, to some extent, the recent declines in housing market activity. The outlook for household consumption growth continues to be one of the key sources of uncertainty for the domestic growth forecasts, particularly given uncertainties around the outlook for income

Table 5.1: Output Growth and Inflation Forecasts[(a)]

Per cent

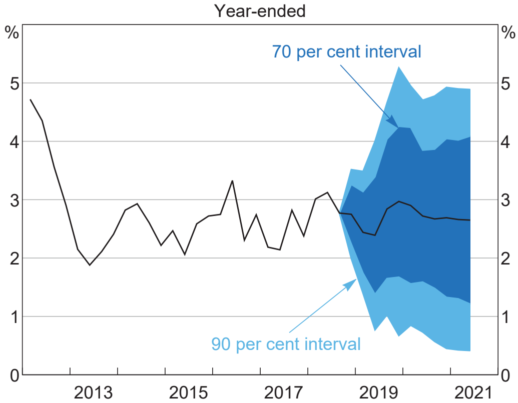
	Year-ended					
	Dec 2018	June 2019	Dec 2019	June 2020	Dec 2020	June 2021
GDP growth	2¾	2½	3	2¾	2¾	2¾
(previous)	(3½)	(3¼)	(3¼)	(3¼)	(3)	(n/a)
Unemployment rate[(b)]	5.0	5	5	5	4¾	4¾
(previous)	(5)	(5)	(5)	(4¾)	(4¾)	(n/a)
CPI inflation	1.8	1¼	1¾	2	2¼	2¼
(previous)	(2)	(2)	(2¼)	(2¼)	(2¼)	(n/a)
Trimmed mean inflation	1.8	1¾	2	2	2¼	2¼
(previous)	(1¾)	(2)	(2¼)	(2¼)	(2¼)	(n/a)
	Year-average					
	2018	2018/19	2019	2019/20	2020	2020/21
GDP growth	3	2½	2¾	2¾	2¾	2¾
(previous)	(3½)	(3¼)	(3¼)	(3¼)	(3¼)	(n/a)

(a) Technical assumptions include TWI at 62, A$ at US$0.72 and Brent crude oil price at US$63 per barrel; shaded regions are historical data; figures in parentheses show the corresponding forecasts in the November 2018 *Statement*

(b) Average rate in the quarter

Sources: ABS; RBA

Graph 5.1
GDP Growth Forecast*
Year-ended



* Confidence intervals reflect RBA forecast errors since 1993

Sources: ABS; RBA

growth and how developments in housing markets will affect household decision-making (see below).

The domestic forecasts are conditioned on the technical assumption that the cash rate evolves in line with market pricing. The exchange rate is assumed to be constant around 2 per cent below where it was at the time of the November *Statement*. The oil price is assumed to remain 13 per cent lower than at the time of the November *Statement*. The population aged 15 years and over is assumed to grow by 1.6 per cent per annum over 2019 and 2020 and by 1.5 per cent over 2021.

Consumption growth has been revised lower

Consumption growth was weak in the September quarter and was revised lower in most quarters over recent years, mainly because of lower spending on services such as finance & insurance. Consumption growth is expected to recover somewhat in the December quarter and year-ended growth is expected to increase gradually to be around 2¾ per cent, rather than 3 per cent, which had been the medium-term forecast for some time. This reassessment of the outlook for consumption growth is informed by the downward revision to the history of consumption, which has lowered annual consumption growth by 0.2 percentage points for the past three years. Sizeable revisions (in both directions) in recent national accounts have made it challenging to gauge underlying momentum in consumption growth. Recent declines in housing prices and housing market activity are also expected to weigh on consumption.

Recent measured growth in household disposable income, which is a significant determinant of consumption, has been weaker than expected due to subdued growth in non-labour income and strong growth in tax payments. Over coming years, household disposable income growth is expected to be supported by employment growth and a gradual pick-up in wages growth. Income tax cuts already announced will also support disposable income. The forecast contribution to household disposable income growth from unincorporated businesses has been revised lower in the near term due to a lower starting point for farm income than previously expected, as well as lower income for unincorporated businesses involved in the residential building sector, as dwelling investment declines. With household disposable income forecast to grow at about the same rate as consumption over the forecast period, the household saving ratio is expected to stabilise.

Dwelling investment will decline over the forecast period …

Dwelling investment is likely to be around its peak for this cycle, and is projected to decline over coming years. The pipeline of work to be done on higher-density housing remains very large, which should continue to support activity in the near term. This is consistent with reports from construction firms and developers in the Bank's liaison program. However, higher-density building approvals have been trending lower for around a year, and are expected to decline further over coming quarters. This implies a much lower level of activity once the current pipeline of work is completed. Information from the liaison program also points to a significant fall in pre-sales for new apartments over the past year. In addition to the difficulty of obtaining pre-sales, liaison with developers suggests that financial conditions have tightened further over the past six to twelve months. As a result, some developers are obtaining financing from alternative sources, though at a higher interest cost. Sales of new detached dwellings have also slowed. Detached housing investment is forecast to decline in the near term, broadly consistent with the decline in building approvals over the past year.

… but business investment is expected to support growth …

Non-mining investment growth slowed to around 3½ per cent over the year to the September quarter, mainly reflecting a moderation in non-residential building investment consistent with the slower pace of approvals since late 2017. Partial indicators and liaison indicate there is a solid pipeline of private infrastructure investment (particularly transport and electricity projects) and buildings (particularly offices and short-term accommodation), suggesting non-residential construction will pick up over coming quarters. Investment in machinery & equipment and computer software is also expected to support non-mining investment over the forecast period.

Mining investment fell sharply in the September quarter, associated with a further decline in spending on liquefied natural gas (LNG) projects. Information from the ABS' Capital Expenditure Survey and liaison suggest that there is little further expenditure needed to finalise the remaining LNG projects under construction, and these projects are now ramping up production and exports. Accordingly, mining investment is expected to be close to its trough, and should gradually pick up over 2019 and 2020 as resource firms increase expenditure to sustain production.

… along with public demand

Public demand is expected to provide an ongoing impetus to growth. Public investment will be supported by the large pipeline of infrastructure projects. Growth in public consumption is being supported by the rollout of the National Disability Insurance Scheme, which is due to be completed by mid 2020.

The federal government budget is expected to return to surplus over the coming years. More broadly, public demand is likely to be supported by additional revenues as employment continues to grow and mining profits remain high, although this may be offset to some extent by lower stamp duty revenues associated with easing housing market conditions, especially in New South Wales and Victoria. State and federal budgets indicate that public investment will remain at a high level for at least the next couple of years, though growth is expected to moderate over the forecast period.

The outlook for imports and exports is broadly unchanged

Imports are expected to continue growing over the forecast period, after declining in the September quarter, consistent with ongoing growth in public and private investment (which are relatively import-intensive types of spending).

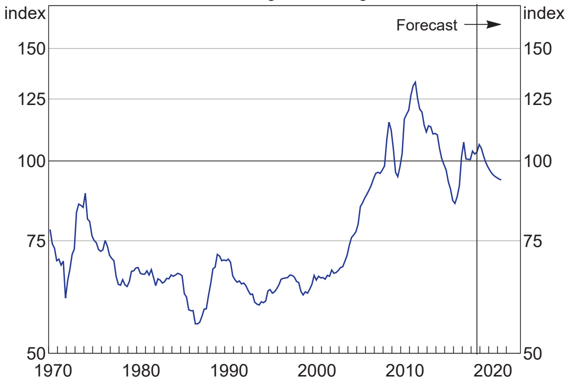
The outlook for export growth is a little lower in 2019, mainly because rural exports are likely to be weaker than previously expected. This follows updated information from the Australian Bureau of Agricultural and Resource Economics and Sciences about the impact of drought conditions on rural production and exports, particularly cereal crops. This weakness is expected to be offset to some extent by manufacturing and service exports, given the depreciation of the exchange rate over the past year or so and rising enrolments of overseas students. Resource exports are expected to have declined a little in the December quarter, based on partial trade data. LNG production is likely to ramp up a little more slowly in the next few quarters than was previously expected, but the outlook over the rest of the forecast period is little changed. By the end of 2019 all LNG projects are expected to have reached their targeted production levels; resource exports will then be at historically high levels but contributing little to GDP growth.

The terms of trade are still expected to moderate

The terms of trade are still expected to moderate over the forecast period (Graph 5.2) as Chinese demand for bulk commodities gradually declines and other low-cost supply enters the market. However, relative to the November *Statement*, the terms of trade have been revised a little lower from mid 2019 onward, predominantly reflecting the effect on LNG export prices of the recent decline in oil prices but are expected to remain above their early 2016 trough.

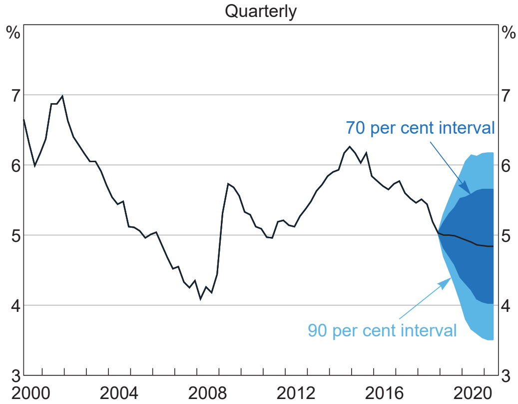
The forecast for the iron ore spot price has been revised higher, largely reflecting the closure of multiple Brazilian mines after a dam collapse; the potential for additional regulatory responses to the incident makes the outlook for prices more uncertain. The prices of other bulk commodity export prices have evolved largely as expected over recent months. Although the forecasts for thermal coal prices are broadly unchanged compared with the previous *Statement*, there

Graph 5.2
Terms of Trade
2016/17 average = 100, log scale



Sources: ABS; RBA

Graph 5.3
Unemployment Rate Forecast*
Quarterly



* Confidence intervals reflect RBA forecast errors since 1993
Sources: ABS; RBA

remains some upside risk given the continued strength in demand (particularly from Asia) and the lack of investment in new supply.

The unemployment rate is expected to move a little lower …

Labour market outcomes in the December quarter were better than expected at the time of the November *Statement*. Near-term leading indicators of labour demand suggest employment growth will remain above growth in the working-age population over the next six months. Further out, employment growth has been revised down marginally, consistent with the downward revision to GDP growth. The participation rate is expected to increase further, encouraged by strong labour market conditions. From a lower starting point, the unemployment rate is still expected to decline to around 4¾ per cent by late 2020 (Graph 5.3).

… leading to a gradual pick-up in wages growth

There has been little change to the wages growth profile since November. The gradual pick-up in wages growth is expected to continue, consistent with information from the Bank's liaison program and the expectation of a decline in labour market spare capacity. Wages growth in new enterprise bargaining agreements has increased a little and the share of workers that face wage freezes is expected to decline further. Average earnings from the national accounts, which is a broader measure of labour costs, is expected to grow at a slightly faster pace than the Wage Price Index (WPI) over the next few years. This forecast implicitly assumes that whatever compositional or other changes had been holding average earnings growth below WPI growth in recent years will gradually dissipate. How far this pick-up in wages growth translates into inflationary pressures will depend on whether there is an accompanying increase in productivity growth.

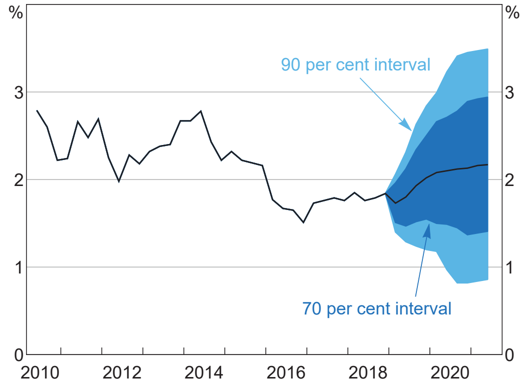
The inflation outlook has been revised lower

The December quarter inflation outcomes were marginally lower than forecast in the November *Statement*. For headline inflation this was largely because fuel prices were lower than expected. From this lower starting point, there has been a small downward revision to the underlying inflation forecast; year-ended trimmed mean inflation is now expected to increase to 2 per cent by the end of 2019 (previously in mid 2019) and to 2¼ per cent by the end of 2020 (Graph 5.4). This revision is consistent with the lower GDP growth profile and incorporates some of the previously flagged downside risk to administered and utilities price inflation in the near term. The depreciation of the exchange rate since the November *Statement* provides some offsetting effect.

In the near term, the forecast for headline inflation has been revised lower relative to the forecast for underlying inflation because of the large decline in fuel prices. The 11 per cent fall in fuel prices in the March quarter to date is expected to subtract 0.3 percentage points from headline inflation in the quarter. As a result, year-ended headline inflation is now forecast to fall to 1¼ per cent in early 2019. Further out, headline inflation is expected to grow around the same pace as underlying inflation. The tobacco excise increases, which have boosted headline inflation by around 0.4 per cent per annum over the past few years, are legislated until the end of 2020.

In terms of the components of inflation, policy developments suggest that inflation in utilities and administered prices may remain below average in 2019. It is unclear how households might respond to the shift in relative prices of these non-discretionary items. Leading indicators suggest that rent growth is likely to remain low in some capital cities for some time; overall, rent growth will depend on the outlook for construction activity

Graph 5.4
Trimmed Mean Inflation Forecast*
Year-ended



* Confidence intervals reflect RBA forecast errors since 1993
Sources: ABS; RBA

and population growth. Retail prices will also be influenced by any sustained movements in the exchange rate, changes in household spending decisions and the persistence of competitive forces putting downward pressure on retail prices.

There are a number of global and domestic uncertainties for the forecasts

Over the past three months, the downside risks to the global outlook have increased. Ongoing trade tensions continue to create uncertainty. In China, this has added to the considerable uncertainty that has existed for some time around how the authorities will balance the need to support growth at the same time as managing financial risks. Another factor affecting the balance of risks around the global growth outlook is that financial conditions appear to have tightened somewhat.

There are also a number of domestic uncertainties for the growth and inflation outlook. As has been the case for some time, uncertainty about the outlook for consumption growth is a key risk. Uncertainty about the outlook for household disposable income continues to be a factor, but the potential for lower household net wealth to affect consumption decisions has increased with recent developments in housing markets. Declining housing market activity also poses risks for other parts of the economy.

Labour market conditions over the past year suggest that economic activity has been stronger than the GDP data have signalled. Relatedly, there continues to be uncertainty about how quickly the unemployment rate will decline and how quickly that will feed into wage pressures and so inflation. In the near term, the outlook for inflation also depends on the extent to which utilities and administered price changes continue to put downward pressure on inflation.

Trade tensions remain a material risk to the global growth outlook and other political risks have increased

The outcome of the ongoing negotiations between the United States and China remains uncertain, but an escalation of trade tensions continues to be a significant risk. The United States is also considering adjustments to its trade policy on automotive imports, which could lead to much higher import tariffs or strict quotas. This would have a significant effect on economies with large automotive exports to the United States, such as Germany and Japan, and economies that are connected to automotive supply chains. The effects of these tensions are already apparent in data on trade and are likely to have contributed to the decline in investment intentions in some economies. The longer the uncertainty lasts, the larger these effects, and the adverse consequences for global growth, are likely to be.

There are a number of other political uncertainties that could materially harm the global growth outlook, particularly if they are not resolved quickly. The uncertainty about how the United Kingdom will exit the European Union and the future relationship between the two is likely to depress UK investment and consumption and spill over to weaker investment in the euro area. Political uncertainty in the euro area itself has also increased because of widespread social unrest in France and the resulting policy changes, and elevated concerns about economic and fiscal policies in Italy.

It is uncertain how policies in China will balance supporting growth and addressing financial risk

The Chinese authorities continue to face a number of policy trade-offs, and uncertainties about how they will be resolved pose risks to the outlook for the Chinese economy, demand for bulk commodities and Australia's terms of trade. Recent fiscal and monetary policy measures have focused on specific areas of weakness in the economy – namely, public infrastructure spending and small and private sector firms – so as to avoid adding to already high debt levels. If economic activity responds less vigorously to these measures than anticipated, Chinese growth could be weaker than forecast. However, in this event the government could introduce more aggressive stimulus measures. Uncertainty about the relative responses of growth and debt to the current policy mix complicates the challenge that authorities face in controlling economy-wide leverage. For example, even if the current relatively targeted approach to stimulus implies a further moderation in broad credit growth, slowing growth in nominal incomes will make it harder for the existing debt principal to be inflated away.

Trade frictions with the United States have eased in recent months, but there is a risk that they could increase again and become entrenched, or be resolved in a way that distorts bilateral (and third-country) trade flows. This would result in medium-term negative effects on China's manufacturing export sector. While the impact could be mitigated by allowing the renminbi to depreciate, authorities might resist such an outcome to avoid fuelling expectations of further currency depreciation, which could encourage capital outflows. The evolution of policies towards China's property markets, infrastructure spending and environmental controls will also be significant for the growth trajectory and, in particular, the outlook for Chinese steel demand.

A significant tightening of global financial conditions could have real effects

Conditions in financial markets have tightened somewhat in the major advanced economies after a lengthy period during which conditions were very accommodative. However, the cost of finance and particularly compensation for financial risk remain low relative to history, so there is a risk of further tightening. This could occur in response to a range of triggers, including: trade tensions escalating; growth in China decelerating more sharply than expected; a disorderly Brexit; or concerns about sovereign and banking sector risk in Italy re-emerging. The effect would be larger for economies with pre-existing vulnerabilities, such as elevated sovereign, corporate or household debt, or less resilient financial institutions and markets. In some circumstances, these effects could spill over to other economies. The capacity of economies to offset these effects through domestic policy or adjustment in exchange rates differs.

The prices of financial securities in Australia tend to move closely with those in major financial centres, so a tightening in global financial conditions could transmit quite quickly to Australia. However, the Australian dollar also tends to depreciate during periods of heightened volatility, acting as a shock absorber for the Australian economy, particularly given that foreign borrowing by Australian institutions and residents is well hedged against currency movements.

Domestically, the outlook for consumption remains a key source of uncertainty

As discussed above, the recent volatility in the consumption data and a series of revisions in recent quarters has made it harder than usual to gauge the underlying momentum in consumption growth. As has been the case for some time, the ongoing uncertainty about the outlook for household income also has a direct bearing on forecasts for consumption. Recent developments in housing markets have highlighted the additional risks that come from uncertainty about how households might change their consumption decisions in response. Household consumption accounts for just over half of GDP, so if consumption growth were to be materially higher or lower than currently forecast, there would be implications for the forecasts for overall GDP growth, employment growth and inflation.

As noted above, real disposable income growth is expected to pick up, supported by a tightening in labour market conditions and income tax cuts. Some uncertainties that affect the outlook for inflation, such as the level of retail competition and administered prices, also affect households' purchasing power, and so their real disposable income. If household income growth does not increase as expected, or households take some time to feel confident that wages growth will pick up in a sustained way, then consumption growth could be lower than currently forecast. Consumption has thus far been resilient to measured weak income growth, which has been absorbed through a lower rate of saving. This is less likely in an environment where net household wealth is declining.

The decline in housing turnover over the past year has weighed on demand for items such as household appliances and furnishings that are more likely to be purchased when moving into a new home. More generally, the decline in household wealth associated with falling housing prices has likely put some downward pressure on consumption growth. However, these recent falls have followed several years of very strong growth in prices. If households take a longer-term perspective of their wealth, they may look through the recent declines; even if they do react, it is unclear how quickly this might occur.

The high level of household debt also remains a key consideration for household consumption. In general, more indebted households are likely to be more sensitive to changes in their expected income growth and household wealth; consumption growth may be weaker for a time if households become concerned about their debt levels and choose to pay down debt more quickly. It is also possible that households that are highly indebted or credit-constrained will be more sensitive to falling housing prices than to rising prices.

Weaker housing construction and prices could have pervasive economic effects

There are a number of channels other than consumption through which housing market conditions can affect economic activity. These channels have been incorporated into the central forecasts, but the effects are uncertain, particularly when there is uncertainty about the outlook for housing prices.

The decline in housing prices will have a direct effect on dwelling investment but the timing and magnitude of the effect is uncertain. The pipeline of work to be done is large and is expected to support dwelling investment for some time, even though residential building approvals have already declined considerably. The extent of the support from the pipeline could be more protracted than currently expected. But there is a risk that dwelling investment declines sooner and by more than currently forecast. This would have flow-on effects to the outlook for employment and household income. Very weak conditions in the earlier stages of residential development identified in business liaison point to further downside risk to dwelling investment in 2020 and beyond.

There are also a number of indirect channels through which a decline in housing prices could affect the economy. Lower housing prices could limit how much small businesses can borrow when using housing as collateral. The decline in housing market turnover associated with the decline in housing prices has implications for business and household services, such as real estate and legal services. Changes in housing prices and turnover can also affect public demand through their effect on state government stamp duty revenue.

Labour market conditions could tighten faster than expected

Labour market conditions over the past year could imply that economic activity has been stronger than the GDP data have signalled. Furthermore, some of the leading indicators suggest that the unemployment rate may fall faster than forecast over the first half of 2019. If this is realised, there may be less of a downside risk to income and consumption growth than outlined above. In addition, strong labour demand could be met to a greater extent than usual by existing workers or those who are currently outside the labour force (which would also imply a stronger participation rate than currently projected).

Regardless, as spare capacity in the labour market declines, wages growth is expected to increase gradually. To date, the data that have become available and reports from liaison have been consistent with this outlook. However, it remains uncertain how fast this spare capacity will be absorbed, and this is compounded by uncertainty about how fast this will translate into wage pressures. Recent international evidence indicates that this process could take longer than previous experience suggests, but that wage pressures do eventually build in very tight labour markets.

A number of other factors could lead to lower inflation than forecast

Headline inflation is expected to decline in the near term due to the recent sharp fall in oil prices. If the decline in oil prices is sustained, this will lower business input costs, which could flow through to lower underlying inflation over time. Reserve Bank estimates suggest that a sustained 15 per cent fall in oil prices will subtract about ½ percentage point from headline inflation immediately through direct effects and could cumulatively subtract around ¼ percentage points from underlying inflation through indirect effects over two to three years. At a component level, government initiatives to reduce cost-of-living pressures could result in downward pressure on administered price inflation for some time. There is also a risk that wholesale electricity prices could decline significantly over the next few years as a large volume of new renewable energy generation comes online.

Longer-term measures of inflation expectations remain consistent with the Bank's medium-term inflation target. Although the effect of lower oil prices on inflation should be temporary, some measures of inflation expectations are quite sensitive to oil prices. More broadly, an extended period of inflation below the target range could lead to lower inflation expectations, potentially affecting wage and price setting. At the same time, lower fuel prices and lower inflation for utilities and administered items will boost households' real purchasing power, which could contribute to price pressures elsewhere.