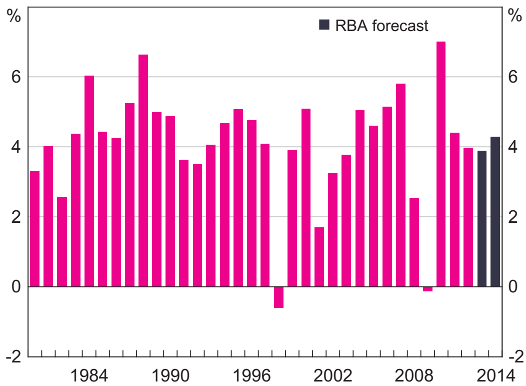
6. Economic Outlook

The International Economy

The Bank's forecast for growth in Australia's major trading partners is little changed from the August *Statement* for both 2013 and 2014. In 2013, trading partner growth is expected to remain slightly below its decade average of around 4 per cent before picking up to about 4¼ per cent in 2014 (Graph 6.1). This forecast is similar to those published by other forecasters.

Graph 6.1
Australia's Trading Partner Growth*
Year-average



* Aggregated using Australia's export shares
Sources: ABS; CEIC Data; RBA; Thomson Reuters

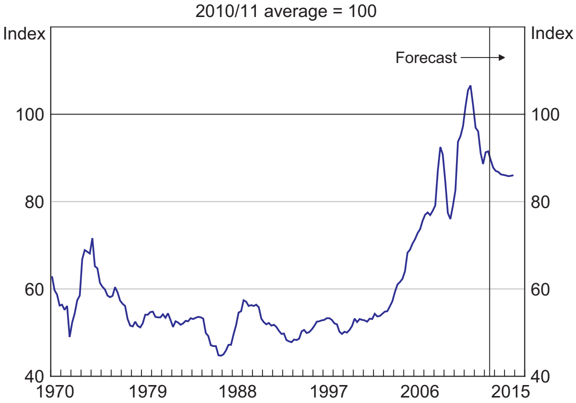
For most countries, revisions to expected growth for 2013 since the previous *Statement* reflect published data for the second and third quarters, with relatively small changes to the outlook for the remainder of 2013 and for 2014. The Chinese economy is expected to grow a little faster in 2013 than previously anticipated, though still close to the government's target of 7½ per cent. This follows stronger-than-expected September quarter data and an upward revision to GDP in the June quarter. Domestic demand is expected to remain strong. In Japan, average growth over the forecast period is anticipated to be similar to the pace seen over the past year or so, although the increase in the consumption tax and the newly announced temporary fiscal stimulus are likely to see growth stronger in the near term than further out. In the rest of east Asia, growth for 2014 has been revised down a little, more so for the middle-income countries. Notably in Indonesia, the combination of high inflation and the tightening of monetary policy is expected to weigh on activity. The outlook for India is also a bit softer, given the recent weakness in activity and tighter monetary and fiscal policies.

In the United States, the economy is expected to gather momentum gradually through 2014, given very stimulatory monetary policy and progress already made in repairing private sector balance sheets. The recent partial shutdown of the US federal government and the protracted negotiation of an increase in the debt ceiling are likely to have had only a minor negative effect on the recovery. Economic conditions have improved a little in the euro area in recent months and, while activity remains weak, the economy is expected to record positive growth in 2014.

Over the second half of 2013, the terms of trade are forecast to retrace the gains seen over the first half of the year and then decline gradually thereafter as the global supply of bulk commodities increases (Graph 6.2). The overall profile is slightly higher than it was in the August *Statement*, in part reflecting higher-than-expected prices received for iron ore of late.

Graph 6.2
Terms of Trade

2010/11 average = 100



Sources: ABS; RBA

Domestic Activity

In preparing the domestic forecasts, a number of technical assumptions have been employed, as usual. The exchange rate is assumed to remain at its current level over the forecast period (A$ at US$0.95 and the TWI at 72, which is around 5 per cent higher than was assumed in the August *Statement* but still 7 per cent lower than assumed in the May *Statement*). The forecasts are based on the price for Brent oil remaining at US$104 per barrel, the same as the assumption in August. The cash rate is assumed to be unchanged over the forecast period at 2.50 per cent. The low level of the cash rate has resulted in variable borrowing rates below their 2009 lows. The working-age population is assumed to grow by 1.8 per cent each year, drawing on forecasts by the Department of Immigration and Citizenship and in line with the August *Statement*.

The starting point for the forecasts of the Australian economy is below-trend growth over the year to the June quarter 2013, with several factors weighing on growth – the fall in mining investment, moderate consumer spending growth and ongoing fiscal restraint. The available indicators suggest that growth remained below trend in the September quarter. Retail sales and the Bank's liaison point to moderate growth of household spending. Measures of current business conditions from surveys have been below average for some time. Consistent with this, non-mining investment intentions remain subdued, while the decline in mining investment has much further to run as large mining projects continue to reach completion.

On a more positive note, indicators of business and consumer confidence have risen to above-average levels in recent months. It is too early to know whether this pick-up will be sustained and whether it will transmit to economic activity. In one area where confidence has been building for longer, namely the housing market, indicators of dwelling investment continue to point to further growth. Resource exports growth has remained strong as investment projects reach completion, thereby adding to productive capacity.

GDP growth is now expected to remain below trend at close to 2½ per cent through to the end of 2014, before picking up to above trend by the end of the forecast period (Table 6.1). This outlook is a little weaker over 2014 than at the time of the August *Statement*, as the latest liaison information points to a more pronounced fall in mining investment over 2014, with some large projects delayed or looking less likely to proceed. The appreciation since the August *Statement* means that the still high level of the exchange rate is also expected to constrain activity in the traded sector by more than was expected three months ago. For consumption, the positive effects from various indicators of household sentiment are judged to be mostly offset by weaker prospects for growth of household income, owing to the labour market remaining soft through 2014.

Overall, the outlook for below-trend growth over the coming year reflects the substantial fall in mining investment, planned fiscal restraint and the still high level of the Australian dollar. On the other hand, low interest rates are stimulating dwelling construction as well as prices and turnover in the established housing market. It is likely that these trends will be associated with stronger growth in household consumption over time. Subsequently, this pick-up in demand, and the improvement in consumer and business sentiment, is expected to flow through to stronger non-mining business investment, which would contribute to higher GDP growth over 2015.

Table 6.1: Output Growth and Inflation Forecasts[(a)]
Per cent

	Year-ended					
	June 2013	Dec 2013	June 2014	Dec 2014	Jun 2015	Dec 2015
GDP growth	2.6	2¼	2½	2–3	2¼–3¼	2¾–4¼
Non-farm GDP growth	2.7	2¼	2½	2–3	2¼–3¼	2¾–4¼
CPI inflation[(b)]	2.4	2½	2¾	2–3	2–3	1½ –2½
Underlying inflation[(b)]	2½	2¼	2½	2–3	2–3	1¾ –2¾
	Year-average					
	2012/13	2013	2013/14	2014	2014/15	2015
GDP growth	2.6	2½	2½	2–3	2–3	2½ –3½

(a) Technical assumptions include A$ at US$0.95, TWI at 72 and Brent crude oil price at US$104 per barrel
(b) Based on current legislation for the price of carbon
Sources: ABS; RBA

The outlook for household consumption is in fact a little stronger than at the time of the August *Statement*, reflecting the balance of forces pushing in two directions. An impetus to consumption has come from the strengthening conditions in the established housing market, with increased turnover and prices, as well as higher equity prices and the apparent improvement in consumer confidence. Working in the other direction is slower income growth, given softer wage outcomes and expectations for slightly slower employment growth (reflecting the downward revision to aggregate GDP growth). Overall, while growth of consumption spending is expected to be below trend over the remainder of 2013, it could rise to a bit above trend by the end of the forecast period. With consumption spending expected to grow faster than incomes, consistent with rising wealth, the forecasts embody a modest decline in the household saving ratio towards the lower end of the range seen over recent years.

The recovery in dwelling investment is expected to continue, and to accelerate somewhat, over the forecast period. The environment for this form of investment remains favourable, with low interest rates, rental yields that are around the highest they have been for a decade and support for first home buyers that favours construction of new dwellings. Stronger conditions in the established housing market will also promote investment, including renovation activity (which tends to rise with higher housing turnover). Building approvals and other forward-looking indicators, such as loan approvals and first home owner grants for new construction, are consistent with a recovery in dwelling investment.

With governments at both the federal and state levels planning to undertake fiscal consolidation over the next few years, growth of public demand is expected to be very low relative to its historical average. Consistent with budget projections, the contribution to GDP growth from public demand over the forecast period is expected to be around one-third of its historical rate. This outlook has not changed since the previous *Statement*; at the federal level more detail will be available in the Mid-Year Economic and Fiscal Outlook.

The outlook for mining investment has been revised lower, particularly in 2014/15, primarily due to a reappraisal of the prospects for investment in the coal sector. A range of information points to some delay in the expansion of coal mining, and the viability of some of this expansion being more tentative than previously considered. Investment in iron ore and liquefied natural gas (LNG) extraction has also been revised down a little. While the expectations component of the ABS capital expenditure (Capex) survey remains strong for the mining sector, this is inconsistent with the lack of new commitments to mining projects and a lack of current expenditure on development and planning work that would precede new projects. Given this, it is expected that mining investment will continue to decline, but to do so more rapidly from around the middle of next year. The share of mining investment in GDP is anticipated to decline by around 3 percentage points over two and a half years. The impact on GDP will be smaller in magnitude than the decline in mining investment because a large share of this investment spending is estimated to be on imported capital goods.

Overall, non-mining investment is expected to remain subdued in the near term. Surveys of firms' intentions suggest that there will be little growth in non-mining business investment over the next year or so. Also, office vacancy rates have increased and measures of capacity utilisation have been a little below average. Non-residential construction is, however, expected to be supported by the large stock of work planned or currently underway, most notably in the healthcare sector. Further out in the forecast period, non-mining investment is expected to pick up given the low level of investment and hence low growth of the non-mining capital stock over recent years, the low level of interest rates, increasing consumption growth and strong population growth. The recent pick-up in measures of business confidence and the depreciation of the exchange rate since earlier in the year support this outlook.

Prospects for export volumes remain good and exports are expected to make a significant contribution to GDP growth in the coming years. Given the significant investment that has occurred to date and is still underway, bulk commodity exports are expected to increase strongly over the next few years. Growth of resource exports is expected to pick up even more noticeably from 2016 as new LNG production facilities come on line.

With output growing below trend, the labour market has softened over 2013. The level of employment is little changed since earlier in the year, although total hours worked have continued to grow with an increase in average hours worked. The unemployment rate remains on a gradual upward trend and the participation rate has declined. The near-term outlook for employment remains soft. Forward-looking indicators of employment growth generally appear to have stabilised after falling through most of the year, although they remain at low levels. Further out, the more subdued outlook for mining investment and so for aggregate activity has seen the profile for employment revised down slightly. The winding down of mining investment from very high levels is likely to weigh on employment growth, with industries that provide inputs to mining investment projects – such as construction and business services – particularly affected. Unemployment is anticipated to continue to increase gradually for the next year or so as the economy grows at a below-trend pace. Later in 2015, the improvement in non-resource activity is expected to see employment growth pick up and unemployment begin to decline.

Consistent with spare capacity in the labour market, wage growth has eased across states and industries over the course of the past year. On some measures, wage growth has been around its slowest pace in a decade. Wage growth is expected to remain contained over the forecast period, owing to the labour market remaining soft for the next one to two years and pressures on firms to contain costs. Various leading indicators of wage growth, including surveys of firms' wage expectations and information from the Bank's liaison, also indicate that wage pressures are likely to remain limited. Overall, wage growth is expected to remain below 3 per cent over most of the forecast period.

Inflation

The forecasts for inflation are little changed, notwithstanding some influence from a slightly higher-than-expected outcome for the September quarter, the slightly weaker labour market and higher exchange rate.

The quarterly rate of inflation picked up in the September quarter, by a bit more than expected, boosted by a rise in fuel prices. Year-ended inflation declined as the direct effect of the earlier introduction of the carbon price dropped out of the calculation.

The various measures suggest that underlying inflation was around ½–¾ per cent in the quarter and the year-ended pace of underlying inflation was a touch lower than a quarter ago, at a little above 2¼ per cent.

While the exchange rate has appreciated since the previous *Statement*, it remains lower than earlier in the year. Accordingly, higher import prices are expected to add to inflation over the course of the next few years, but by a bit less than was expected three months ago. Higher import prices are expected to begin to exert an upward influence on tradables prices in the next few quarters, with increasing prices for tradables items likely to become the norm, in contrast to the deflation in these items experienced in recent years. Altogether, the forecasts anticipate that the rise in import prices will contribute up to ¼ percentage point to the annual rate of inflation over the forecast period.

Working in the other direction, the subdued outlook for the labour market in the near term is likely to exert downward pressure on wages and so inflation. Unit labour costs have been unchanged over the past year and growth of these costs is expected to remain contained over the forecast horizon. Accordingly, domestically generated inflationary pressures are likely to remain modest.

Inflation will also be affected by the price of carbon. As in the previous *Statement*, the forecasts incorporate a path for the carbon price that is based on current legislation, which stipulates a move from a fixed to floating carbon price on 1 July 2015. This would be likely to see the carbon price fall to be similar to the price of European permits. In line with projections in the Australian Government's budget, the forecasts assume a floating price of around $12 in 2015/16, down from the fixed price of around $25 in 2014/15. This change is expected to subtract under ½ per cent from CPI inflation in 2015 and around half that much from underlying inflation.

The government has stated that it intends to repeal the carbon price on 1 July 2014. Based on modelling by Treasury, the introduction of the carbon price was expected to add 0.7 per cent to the CPI and it seems reasonable to assume that its removal would result in a reduction in the CPI of a similar magnitude. Under this outcome, the forecast for CPI inflation would be lower by around 0.7 percentage points over the year to June 2015 at 1¼–2¼ per cent (with inflation in the subsequent period being higher than the current forecasts because the price of carbon would not be declining in that period). Underlying inflation would again respond by less than this, with the forecasts a little more than ¼ percentage point lower over the year to June 2015 at 1½–2½ per cent. The government has also stated its intention to increase tobacco excise in a sequence of steps over the next four years. These increases, which are not incorporated in the forecasts, would be expected to add a little less than ¼ percentage point to the forecasts for headline inflation over each of the next four years, but not affect underlying inflation.

Risks

Just as the forecast for trading partner growth is little changed from the August *Statement*, many of the risks surrounding those forecasts are as they were three months ago. For most economies, the risks appear broadly balanced. The notable exception remains the euro area, where risks to growth appear to be to the downside given the still weak state of the economy and ongoing need for resolution of banking and fiscal problems. However, the risks in the euro area economy may be becoming slightly more balanced with the improvement in conditions apparent over the past six months or so.

In China, after the authorities had signalled concern about the rapid expansion of financing earlier in the year, there was a noticeable decline in the extent of new borrowing. In August and September, however, growth of bank and non-bank lending rebounded. It remains to be seen how sustained this rebound will be. A renewed effort to address the build-up of debt could slow the pace of borrowing and so some forms of economic activity. On the other hand, failure to contain the build-up of risks in the financial system may strengthen activity in the near term but presents risks to the economy further out. Policymakers also face challenges calibrating and implementing structural reforms: a program of significant reforms could raise the potential growth of the economy, but a failure to reform could constrain future growth. A key meeting of the Chinese Communist Party in November is expected to provide more detail on the plans for reform.

Following the two and a half week partial shutdown of the US Government, there has been only a temporary resolution of the fiscal problems, with further agreement needed by early next year to continue funding government operations and increase the debt ceiling. While the most recent events appear to have had little impact on the ongoing recovery in economic activity, the potential for another shutdown or protracted debt ceiling negotiations could contribute to ongoing uncertainty for firms and households, and hamper the recovery. Moreover, uncertainty about the timing of withdrawal of the extraordinary monetary stimulus in the United States has increased. This has resulted in some substantial moves in financial market prices and sentiment. When expansionary monetary policy settings are eventually pared back in the United States, financial conditions could tighten disproportionately in developing economies, with the possibility for negative effects on economic activity. How policymakers in these economies prepare for, and respond to, these possibilities will have a bearing on growth outcomes.

In Japan, for the improvement in economic conditions to persist, there will need to be sustained increases in business investment. The increase in the consumption tax next April will be an important hurdle for the Japanese economy, although the announcement that the tax rise will be accompanied by a temporary fiscal stimulus improves the prospects for growth at that time. There continues to be little information about the proposed structural reforms, which are critical to raising the potential growth rate of the Japanese economy.

For the Australian economy, there remains substantial uncertainty about the transition as mining investment declines and other sources of growth pick up. While the prospects for resource exports remain strong, there is considerable uncertainty around the forecasts for mining investment. This uncertainty manifested itself more recently with a reassessment of the prospects for coal investment. While there could be further cost overruns, there is little planning and development underway for new projects, which would suggest little upside risk to the profile for mining investment activity in the near term.

The forecasts encompass a recovery in non-mining business investment that is more muted than in past cyclical upturns. While this seems likely in the near term given current economic conditions and leading indicators, the low level of non-mining business investment in recent years, together with the freeing up of labour from mining investment projects and stimulatory financial conditions, could eventually see non-mining investment pick up at the faster rates seen in some past upturns. While a faster recovery would seem more likely if the recent improvement in business confidence is sustained, past experience indicates that it is very difficult to predict when such a strong cyclical upswing in business investment may occur.

If housing market conditions strengthen more substantially, the associated boost to wealth and sentiment could result in lower saving and stronger-than-expected consumption growth. If this were accompanied by a return to increasing household leverage, it could raise concerns from the perspective of financial stability, although to date growth of housing credit overall remains moderate. On the other hand, there is a risk that households become more cautious in the face of slower income growth, resulting in weaker consumption growth.

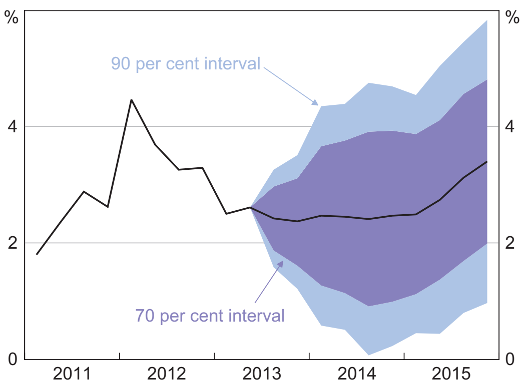
The weak outlook for growth of public demand is consistent with the fiscal consolidation underway and that which is planned. The forecasts imply that growth of public demand over the next few years will continue to be the weakest seen for at least 50 years. It is possible that with below-trend growth in the economy in the near term, governments will not restrain spending growth to the extent assumed.

A significant uncertainty for the forecasts is the path of the exchange rate. The forecasts are, as usual, predicated on a constant exchange rate. The exchange rate appreciated significantly during the past decade as higher commodity prices led to a boom in mining investment. The higher exchange rate shifted demand toward external sources, so relieving pressure on domestic capacity to accommodate the substantial increase in mining investment. The decline in mining investment, even if commodity prices remain high, will result in a reduction in the capital inflow that has been funding that investment and a reduction in domestic demand, and so could well result in a lower exchange rate. A further depreciation similar in magnitude to that seen earlier this year could be expected to see growth return to trend, or even above trend, sooner than forecast and assist with the required rebalancing of growth in the domestic economy. A depreciation of this size could also see inflation move into the top half of the target range for a time.

If the recent pick-up in confidence were to be even more durable than expected, employment and inflation might also be expected to pick up. Following a long period during which firms outside the mining sector have been reluctant to take on new risks and have been focused on containing costs, a shift in confidence might translate into more employment growth than has been assumed, thereby lifting labour costs and inflation somewhat. However, if the transition to non-mining led growth were to progress less smoothly than anticipated, then the labour market could weaken by more than is expected, resulting in lower inflation outcomes. The need for labour to shift to non-resource related jobs might also see a period during which there is an increased mismatch between the skills required for vacant jobs and those of available workers, pushing up unemployment for a time as well as limiting the economy's potential to grow without generating additional wage growth.

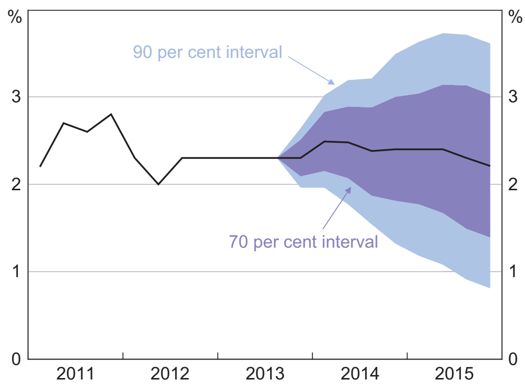
These identified, and other unknown, risks mean that the path for GDP and inflation may well differ from the forecasts presented. One way of demonstrating the uncertainty surrounding GDP and inflation forecasts is to present confidence intervals based on historical forecast errors (Graph 6.3 and Graph 6.4).[1]

Graph 6.3
GDP Growth Forecast*
Year-ended



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

Graph 6.4
Trimmed Mean Inflation Forecast*
Year-ended



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

1 This is based on Bank research; see Tulip P and S Wallace (2012), 'Estimates of Uncertainty around the RBA's Forecasts', RBA Research Discussion Paper No 2012-07 and RBA (2013), 'Box E: Forecast Confidence Intervals', *Statement on Monetary Policy*, February, p 68 for further details.