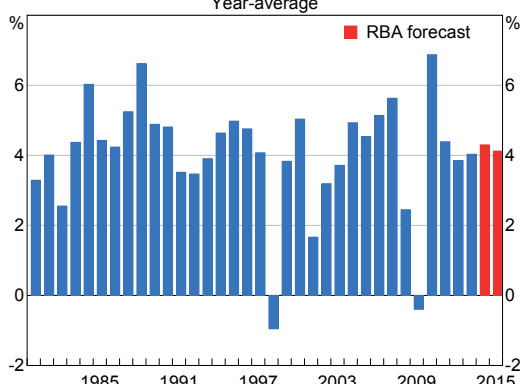


6. Economic Outlook

The International Economy

Overall growth of Australia's major trading partners (MTP) is expected to be around its long-run average in 2014 and 2015 (Graph 6.1). This forecast is little changed since the February *Statement* and is similar to those of most other forecasters.

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



* Aggregated using total export shares

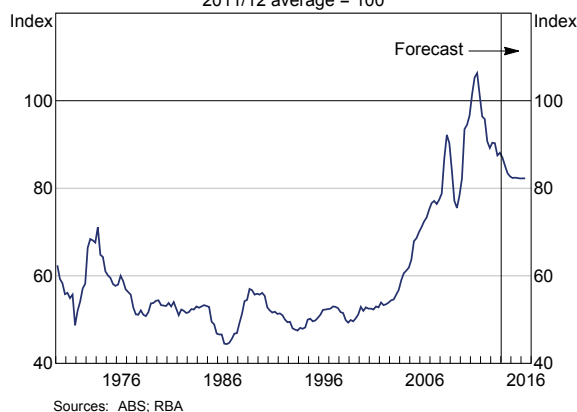
Sources: ABS; CEIC Data; RBA; Thomson Reuters

Chinese growth in 2014 is expected to be in line with the Chinese Government's target of around 7½ per cent. Recent data indicate that growth slowed in early 2014, but monetary conditions appear relatively accommodative, and there are signs that the government will endeavour to provide some support to economic activity in the coming quarters – predominantly through investment – to achieve growth close to its target. In Japan, growth in 2014 and 2015 is expected to be a little weaker than the relatively strong growth seen over the past

year. Activity is expected to contract in the June quarter following rapid growth in the lead-up to the consumption tax increase on 1 April, but in late 2014 and 2015 growth is likely to be close to the average of the past decade. In the rest of east Asia, the economic outlook is little changed, with growth expected to remain around its decade average. The US economy is expected to grow at a moderate pace, supported by stimulatory monetary policy and improvements in the labour market and household balance sheets. In the euro area, the gradual recovery in economic activity is expected to continue.

The outlook for the terms of trade is a little lower than at the time of the February *Statement*, mainly reflecting weaker-than-expected bulk commodity prices in recent months. The terms of trade are expected to be lower than in recent years reflecting increases in the supply of bulk commodities, although in mid 2016 the terms of trade are still expected to be around 50 per cent higher than their long-run average up to the mid 2000s (Graph 6.2). From 2015, a number of liquefied natural gas (LNG) projects are expected to move into the production phase. This is estimated to double the value of LNG exports to around 10 per cent of Australia's total exports by mid 2016. As a result, the price of LNG exports will begin to have a larger effect on Australia's terms of trade. In the Asia-Pacific market, LNG contracts are negotiated privately, so there is little public information to guide expectations about LNG prices, although they tend to be linked to the price of oil.

Graph 6.2
Terms of Trade
2011/12 average = 100



Domestic Activity

In preparing the domestic forecasts, as usual a number of technical assumptions have been employed. The exchange rate is assumed to remain at its current level over the forecast period (TWI at 71 and A\$ at US\$0.93), which is around 4 per cent higher than was assumed in the February *Statement*, and close to the levels assumed six months ago in the November *Statement*. The forecasts are based on the price of Brent oil remaining at US\$105 per barrel, a touch higher than the assumption in February. The cash rate is assumed to be unchanged over the forecast period at 2.5 per cent, which implies that borrowing rates remain at very low levels. The working-age population is assumed to grow by 1.8 per cent each year, drawing on forecasts by the Department of Immigration and Border Protection.

The starting point for the forecasts of the Australian economy is below-trend growth over 2013, but with slightly firmer growth in the final quarter of the year. Growth in 2013 was restrained by several headwinds, including a decline in both mining and non-mining investment, subdued growth in consumer spending, and the high level of the exchange rate. Over the past six months, however, growth looks to have strengthened a little, underpinned by very strong growth in resource exports, with production capacity continuing to expand as more projects reach

completion. Activity related to the household sector has also picked up slightly, buoyed by the low level of interest rates and the associated strengthening in housing prices. A number of survey measures of current business conditions are around average levels after increasing over late 2013.

Nonetheless, the Australian economy continues to face several key challenges. The decline in mining investment has some way to run, and is expected to gather speed as large mining projects reach completion. At the same time, survey evidence suggests that growth in non-mining investment will remain subdued in the near term. In addition, while the exchange rate depreciated over the second half of 2013 and into early 2014, easing pressure on several trade-exposed sectors, it has since partly retraced this decline and remains relatively high. Furthermore, fiscal restraint at both the federal and state levels of government is expected to weigh on growth in public demand over coming years.

Over 2014/15, GDP growth is expected to be a bit below trend at close to 2¾ per cent. It is then expected to pick up to an above-trend pace over 2015/16 (Table 6.1). Average growth over the forecast period is little changed from the February *Statement*, although in comparison with the earlier forecasts, growth is expected to be a touch stronger in early 2014 and a bit weaker later in the forecast period. These minor revisions reflect the net effect of the rise in the exchange rate over recent months – which is expected, at the margin, to restrain exports and boost imports over the next two years – and a slightly stronger outlook for consumption and dwelling investment over the coming year. Growth is likely to dip a little in coming quarters, as the growth in resource exports eases back from the very strong pace of late.

The outlook for below-trend growth over 2014/15 balances the opposing forces of the substantial fall in mining investment and planned fiscal restraint against the stimulus to growth from expansionary monetary policy. Low interest rates are expected to continue to support the established housing market,

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

	Year-ended					
	Dec 2013	June 2014	Dec 2014	June 2015	Dec 2015	June 2016
GDP growth	2.8	3	2¾	2¼–3¼	2¾–3¾	2¾–4¼
Non-farm GDP growth	2.6	3	3	2½–3½	2¾–3¾	2¾–4¼
CPI inflation ^(b)	2.7	3	2¾	2½–3½	2¼–3¼	2–3
Underlying inflation ^(b)	2½	2¾	2½	2¼–3¼	2–3	2–3
	Year-average					
	2013	2013/14	2014	2014/15	2015	2015/16
GDP growth	2.4	2¾	3	2¼–3¼	2¼–3¼	2½–4

(a) Technical assumptions include A\$ at US\$0.93, TWI at 71 and Brent crude oil price at US\$105 per barrel

(b) Based on current legislation for the price of carbon

Sources: ABS; RBA

the construction of new dwellings and household consumption. This pick-up in domestic demand is expected, in time, to flow through to stronger non-mining business investment and employment, and therefore higher GDP growth. Towards the end of the forecast period, a significant increase in LNG exports, as large plants currently being constructed commence production, will boost exports and GDP.

Household consumption is expected to be a bit stronger over 2014 compared with the February *Statement*, in light of the recent strengthening in consumer spending. The forecasts continue to embody consumption growth gradually rising to a bit above the trend pace of GDP growth by the end of the forecast period. This profile reflects some improvement in employment and wage growth, and rising wealth, and would see a further modest decline in the household saving ratio.

A pronounced increase in dwelling investment is underway, and recent information suggests that the upswing this year is likely to be a little larger than was forecast three months ago. Building approvals have been stronger than expected in recent months, remaining around their recent high levels. Other forward-looking indicators, such as loan approvals and first home owner grants for new construction, have continued to increase strongly. The increase in

dwelling investment is being driven by a number of supportive factors: interest rates are very low, housing prices are rising, rental yields are still around the average of the past decade, and government incentives for first home buyers have been refocused on the purchase of new, rather than existing, dwellings. Stronger conditions in the established housing market, including a rise in housing turnover, are also expected to support renovation activity, which to date has been quite subdued.

With governments at both the federal and state levels planning to undertake fiscal consolidation over the next few years, the outlook for growth in public demand remains very weak. Consistent with the most recent budget projections, the contribution to GDP growth from public demand over the forecast period is expected to be around half of its long-term average.

Business investment overall is expected to continue contracting as a result of declining mining investment. The peak of the mining investment boom appears to have passed, and sharp falls in mining investment are expected as large projects are completed and few new large mining projects are expected to commence in the near term. Indeed, surveys of firms' investment intentions point to a sharp decline in investment in the mining sector.

The substantial increase in the size of the capital stock in the resource sector means that there is likely to be more ongoing investment to maintain these assets than has been the case historically, but this expenditure on maintenance is small relative to the investment that has been undertaken to build the capital stock.

Non-mining investment is expected to pick up gradually after a period of subdued growth. The Capex survey of investment intentions suggests a small increase in non-mining investment in 2014/15. The level of non-residential building approvals over recent quarters is consistent with the Capex survey, which points to growth in non-mining investment in buildings and structures. The non-mining sector is expected to be supported by the low level of interest rates, increasing activity in the housing sector and a gradual increase in the growth of consumption. Businesses have seemingly been waiting for a sustained improvement in demand before undertaking further investment. Such an improvement is in prospect and some business surveys have reported an increase in conditions, to around average levels.

The outlook for growth in export volumes has been revised a little lower since the February *Statement*. This reflects small downward revisions to manufactured goods and services exports in line with the recent appreciation of the exchange rate, and downward revisions to rural exports owing to drier conditions in Queensland and northern New South Wales. Resource exports are expected to grow strongly, with additional LNG production coming on line from next year.

Labour market conditions have shown some signs of improvement in recent months. This is consistent with the pick-up in a range of indicators of economic activity since late last year, as conditions in the labour market typically lag activity by a few quarters. A number of forward-looking indicators of labour demand have strengthened of late, and the participation rate looks to have stabilised after having declined since late 2010, while growth

in employment has picked up in recent months. Similarly, recent liaison and business surveys suggest that the marked slowing in wage growth may have largely run its course.

Reflecting the signs of improvement in recent months, the forecasts now encompass less of an increase in the unemployment rate over the next year. However, the recovery in the labour market over the forecast period is expected to be fairly drawn out. GDP growth is not expected to rise above trend before mid 2015. Accordingly, the unemployment rate is not forecast to begin declining consistently until after this, and even then the decline in the unemployment rate towards the end of the forecast period is expected to be relatively modest. With a fair degree of spare capacity in the labour market over the forecast period, along with a continued focus by firms on containing costs, wage growth is expected to remain contained. Growth in wages (measured by the wage price index) is forecast to be around 2¾ per cent over 2014, thereafter picking up gradually to around 3 per cent – below its long-term average of 3½ per cent.

Inflation

The starting point for the inflation forecast is lower than was anticipated three months ago, given the outcome for headline and underlying inflation in the March quarter. Headline inflation was 0.5 per cent in the quarter in seasonally adjusted terms and 2.9 per cent over the year, with the year-ended pace boosted by a little under ¼ percentage point from the increase in the tobacco excise late last year. Underlying inflation was ½ per cent in the quarter, compared with ¾–1 per cent in the December quarter. The recent quarterly profile of inflation appears to overstate any change in inflationary pressures and in this regard it is likely that the past two quarters of inflation data have reflected an element of statistical noise. The pace of underlying inflation over the past two quarters has averaged a little under ¾ per cent, which is somewhat higher than was the case a year or two ago.

The forecast profile for quarterly underlying inflation from the June quarter onwards is little changed and continues to be affected by two opposing influences. The exchange rate is noticeably lower than a year ago. Accordingly, higher import prices are still expected to exert an upward influence on inflation for several years, albeit by a bit less than had been anticipated a few months ago. While the prices of tradable items (excluding volatile items and tobacco) declined slightly in the March quarter, their increase over the past year is broadly consistent with movements in the exchange rate and import prices. This increase is in contrast to the period of deflation in tradables prices seen over the preceding three years. Overall, the depreciation of the exchange rate seen since early last year is expected to add around $\frac{1}{4}$ to $\frac{1}{2}$ percentage point to underlying inflation in both 2014/15 and 2015/16.

Working in the other direction, domestic inflationary pressures are expected to remain subdued. As growth in output is expected to be below trend for a while yet, there is likely to be a degree of spare capacity in labour and product markets for several years. Over 2013, inflation in the prices of non-tradable items (which are affected more by domestic conditions and less by the exchange rate) had been surprisingly persistent, given slow growth in labour costs and little if any evidence of an expansion in firms' margins. However, the March quarter of 2014 saw a marked slowing in the pace of non-tradables inflation, bringing the year-ended pace to around 3 per cent, well below the decade average of nearly 4 per cent. Non-tradables inflation may well remain around 3 per cent over the next few years.

Aside from the influence of the exchange rate and labour costs, the inflation forecasts also reflect the effect of government legislation on some prices. The profile for headline inflation has been revised higher following the passage of legislation for further staged increases in the tobacco excise. These are expected to add around $\frac{1}{4}$ percentage point to year-ended headline inflation for the next three years. Meanwhile, the forecasts assume a price for carbon

based on current legislation. This assumption, unchanged since the August *Statement* last year and based on last year's Budget, is for a floating carbon price to be introduced on 1 July 2015. This would be expected to result in the carbon price falling, to be similar to that of European permits, which is estimated to subtract a bit less than $\frac{1}{2}$ percentage point from headline inflation, and around half that much from underlying inflation.

Uncertainties

On the international front, for most economies the uncertainty surrounding the forecasts appears broadly balanced. In China, growth slowed in the first quarter, as it did in each of the past two years. In both of those years, growth picked back up later in the year, in part because of government actions but potentially also reflecting a stronger seasonal pattern. It remains to be seen whether growth will again strengthen through this year. Recently, Chinese officials have emphasised the importance of stable growth for continued job creation, and have signalled that investment would remain key to growth in 2014. If more substantial measures are taken to foster momentum in investment in the near term, it is possible that growth will be stronger than forecast. However, if the authorities were instead to redouble efforts to place financing on a more sustainable footing and deepen market reforms, activity could be weaker in the near term with the potential for stronger growth in future years.

In Japan, economic growth has picked up since the introduction of stimulatory monetary and fiscal policies in late 2012. The expected contraction in output in the June quarter following the increase in the consumption tax in April is a source of uncertainty. The government's stimulus package may mean that any downturn is short-lived, but this is not clear yet. Also, if economic conditions soften by more than expected or inflationary pressures ease, the Bank of Japan may embark on a new round of monetary easing, which could lower the yen further.

In the United States, much of the weakness recorded in March quarter GDP appears to have reflected a temporary response to unusually cold weather earlier in the year. It remains possible that growth in 2014 could be stronger than expected if business sentiment improves markedly, which, combined with firms' strong financial positions, could result in a sharper pick-up in investment. In the euro area, while the economy is recovering gradually, inflation has declined steadily since late 2011, falling to less than 1 per cent. If growth in demand proves insufficient, there is a risk that inflation stays below the European Central Bank's (ECB's) target for a prolonged period of time, and inflation expectations could drift lower. This would increase real interest rates and both private and public debt burdens. However, actions by the ECB, or an improvement in sentiment, could enable the current momentum in growth to build.

The key uncertainties for the domestic forecasts continue to relate to the decline in mining investment and the anticipated pick-up in non-mining activity. It is clear that mining investment will decline from its very high level over coming years; however, there is considerable uncertainty about the timing and magnitude of the decrease. There is increasing evidence that some parts of the non-mining economy, such as consumption and dwelling investment, are responding to expansionary monetary policy and other forces supporting growth. However, for some other parts, in particular non-mining business investment, the timing and magnitude of the projected increase in activity remains uncertain. There is little accurate survey or other information about investment plans beyond the coming year to guide this forecast. A pick-up in aggregate demand could see a stronger recovery in non-mining investment than expected, more like the substantial pick-up experienced in some past cycles. Alternatively, firms may remain reluctant to undertake significant new investment as business surveys indicate that they currently have some spare capacity.

With fairly large changes in sectoral growth rates anticipated, there is significant uncertainty as to

whether the timing of stronger activity in some parts of the economy will coincide with weaker activity in other parts, and so whether aggregate growth will indeed increase gradually over the forecast period as predicted. Even if the transition of growth does proceed smoothly, the significant change in the composition of activity and growth could result in either excess demand for, or supply of, particular labour skills or types of capital. The composition of activity could have implications for employment, government revenue and expenditure, and for capital flows and so the exchange rate.

Further slowing in Chinese demand for steel would provide a downside risk to iron ore and coking coal prices, and hence the terms of trade. It could also lead to the closure of some higher-cost Australian coal producers and the cancellation of a number of coal investment projects. If the exchange rate was to depreciate with the decline in the terms of trade, there would be some offsetting boost to service and manufactured exports from a lower exchange rate, but any substantial weakening in Chinese steel production could be expected to reduce GDP growth over the forecast period.

How households respond to moderate income growth and higher wealth will have important implications for the growth of consumption. For the past few years, the household saving ratio has been higher than it had been for the previous two decades or so, but the saving ratio has declined a little over the past two years. Further changes in households' sentiment, and so their willingness to spend, could lead to either stronger or weaker consumption.

One area of potential shortages of capacity, which could have implications for both economic growth and inflation, is in dwelling construction. It is possible that capacity constraints could arise if the current number of building approvals, which is well above the levels of recent years, were to increase much further. While liaison indicates that there is little pressure on capacity at present, and the winding down of mining-related construction projects will increase labour availability, there remains some risk

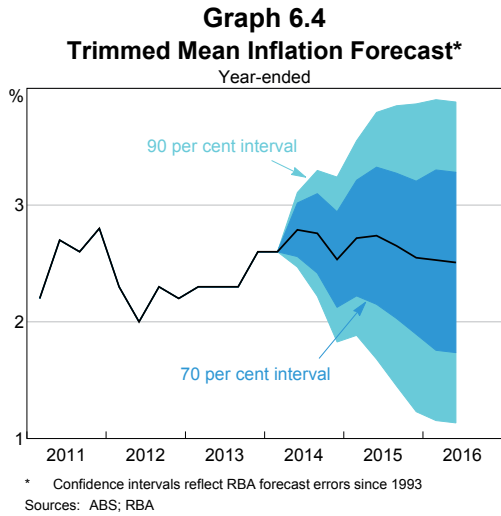
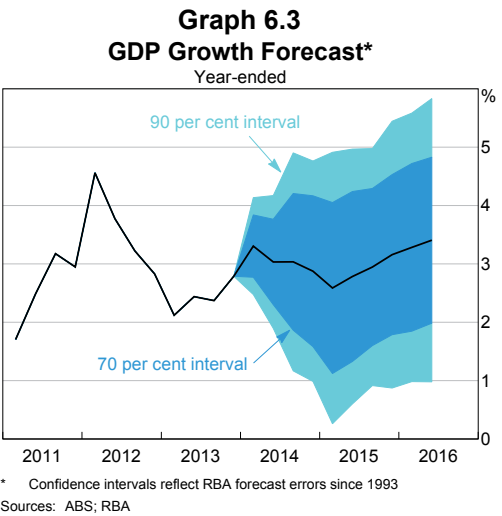
that a stronger recovery leads to capacity constraints and attendant wage and price pressures in the construction sector.

The forecasts have been prepared based on the most recent updates on the fiscal consolidation planned by state and federal governments. The federal and state budgets for 2014/15 will provide further detail on the likely profile for growth in public demand and the broader effects of fiscal actions over the next few years.

The path of the exchange rate presents a significant uncertainty for the forecasts of both economic activity and inflation. With resource prices, and so the terms of trade, expected to decline further, historical relationships suggest that the exchange rate could move lower over time. The increase in income payments to domestic and foreign owners accruing from strong growth in resource exports, as well as the conduct of monetary policy in major countries and associated capital flows, could also affect the exchange rate.

The pass-through of an exchange rate depreciation to consumer prices typically occurs over the course of several years because of the length of existing contracts, exchange rate hedging practices and businesses in the distribution chain temporarily absorbing currency fluctuations in their margins. The complexity of this process means that the size and speed of pass-through is highly uncertain. Pass-through in coming quarters could be faster than the historical average because retailers have increasingly sourced imported products directly rather than through domestic wholesalers. Working in the other direction, the soft state of demand might limit the extent to which firms are able to pass through higher imported costs.

These identified, and other unknown, risks mean that there is significant uncertainty about the path for GDP and inflation. One way of demonstrating the uncertainty surrounding the GDP and inflation forecasts is to present confidence intervals based on historical forecast errors (Graph 6.3 and Graph 6.4).¹ ❖



1 This is based on 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.

