

6. Economic Outlook

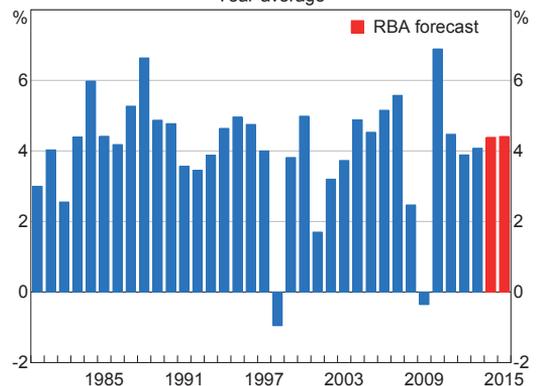
The International Economy

Overall growth of Australia’s major trading partners is expected to be a bit above its long-run average pace in 2014 and 2015 (Graph 6.1). This forecast is little changed from the August *Statement*. The 20 per cent decline in oil prices since the start of the year, if sustained, is likely to provide a measure of support for global growth in 2015 as real incomes in oil-importing countries increase and production costs decline, offset to some extent by the effect of lower incomes for oil-exporting countries.

Chinese GDP growth in 2014 is expected to be close to the authorities’ target of 7.5 per cent. The downturn in the property market is likely to weigh on activity in the next few quarters. More generally, GDP growth in 2015 and 2016 is expected to trend gradually lower reflecting supply-side factors (such as the declining working-age population) and the willingness of policymakers to accept some slowing in growth to place financing on a sounder footing after the rapid build-up of leverage in recent years.

In Japan, output appears to have picked up in the September quarter, although the consumption tax increase in April has weighed more on activity than had been anticipated. As a result, the forecast for 2014 has been revised down. The Bank of Japan recently responded to weaker-than-expected growth with additional monetary stimulus. The Japanese economy is expected to grow at around its average pace of the past decade in 2014 and 2015. In the rest of east Asia, growth in 2014 is expected to be below its decade average, before picking up in 2015 to around average. This forecast is unchanged since the August *Statement*.

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

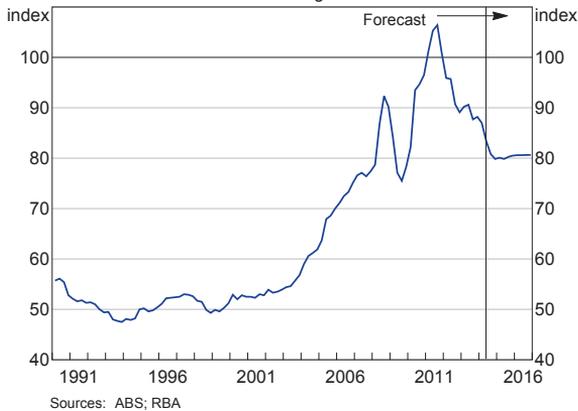


* Aggregated using total export shares
 Sources: ABS; CEIC Data; RBA; Thomson Reuters

The outlook for the US economy is also unchanged. It is expected to expand at a pace that is a little above trend, supported by stimulatory monetary policy and further improvement in the labour market. The recovery in the euro area is still expected to be modest.

The outlook for the terms of trade has been revised down by about 2½ per cent, in large part owing to weaker-than-expected commodity prices over recent months, particularly for iron ore. This has been marginally offset by the effect of falling oil prices on import prices. Overall, the terms of trade are expected to fall by around 4 per cent over the rest of 2014 and early 2015, reflecting gradual pass-through of recent declines in spot prices for bulk commodities and further increases in global capacity, before flattening out around mid 2015 (Graph 6.2).

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 68 and A\$ at US\$0.86). This is around 4½ per cent lower on a trade-weighted basis than the assumption underlying the forecasts in the *August Statement*. The forecasts are based on the price of Brent oil at US\$86 per barrel, which is almost 20 per cent lower than the assumption used in August. The cash rate is assumed to stay at 2.5 per cent over the forecast period, implying that borrowing rates also remain at very low levels. As in the previous *Statement*, the working-age population is assumed to grow by 1.8 per cent over 2015 and by 1.7 per cent over 2016, drawing on forecasts by the Department of Immigration and Border Protection.

The starting point for the forecasts is that, in 2013/14, the Australian economy grew at a year-average pace that was a bit below trend. Despite large falls in mining investment in the year, rising resource exports meant that growth of mining activity overall remained high. Growth of non-mining economic activity remained below its long-run average pace, but it had picked up owing to stronger growth in dwelling investment and public demand

and a modest pick-up in consumption growth. Non-mining business investment remained subdued.

The available indicators suggest that GDP growth remained moderate in the September quarter. Growth of resource exports and non-mining activity is likely to have been offset by a further decline in mining investment. Timely indicators are consistent with moderate growth of consumption and survey measures of business conditions and confidence are close to their long-run averages. Conditions in the housing market are consistent with strong growth in dwelling investment. While the work yet to be done in the non-residential building sector remains elevated and should support investment in the near term, forward-looking indicators, such as non-residential building approvals, have weakened over the course of this year, implying that there is less growth in prospect in this sector than previously expected.

Forecasts for GDP growth are unchanged from the previous *Statement* at an aggregate level. GDP growth is expected to be below trend over 2014/15, before picking up to an around-trend pace over 2015/16 and to a bit above trend by the end of 2016 (Table 6.1). There have been some minor changes to the components in response to incoming data and changes to the assumptions outlined above.

A key consideration in the development of these forecasts has been the extent to which the exchange rate depreciation since the *August Statement* has offset the faster-than-expected decline in the terms of trade. The latter tends to be contractionary for the economy because the lower prices received for exports weigh on national income and expenditure, although much of the decline in commodity prices this year reflects strong growth in the volume of bulk commodity exports from Australia. An exchange rate depreciation is expansionary because it increases export incomes in Australian dollar terms and increases import prices, which causes households and businesses to substitute towards domestically produced goods and services.

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

	Year-ended					
	June 2014	Dec 2014	June 2015	Dec 2015	June 2016	Dec 2016
GDP growth	3.1	2½	2–3	2½–3½	2¾–3¾	2¾–4¼
Non-farm GDP growth	3.3	2¾	2–3	2½–3½	2¾–3¾	2¾–4¼
CPI inflation ^(b)	3.0	1¾	1½–2½	2½–3½	2½–3½	2½–3½
Underlying inflation ^(b)	2¾	2¼	2–3	2¼–3¼	2¼–3¼	2¼–3¼
	Year-average ^(c)					
	2013/14	2014	2014/15	2015	2015/16	2016
GDP growth	2.5	2¼–3¼	2–3	2–3	2½–3½	2½–4

(a) Technical assumptions include A\$ at US\$0.86, TWI at 68 and Brent crude oil price at US\$86 per barrel

(b) Based on current legislation

(c) Based on 2013/14 release of the annual national accounts, rather than the June quarter 2014 release

Sources: ABS; RBA

The net effect of recent changes in the exchange rate and changes in the terms of trade is, by itself, likely to be a small boost to GDP in the near term. This reflects higher net exports, as well as the effect of lower oil prices on costs of production and real household incomes. However, the net effect of these changes has been roughly matched by a downward revision to growth in business investment based on data that suggest the growth of non-residential construction will be weaker than had previously been forecast.

Nonetheless, the key forces shaping the forecasts remain as they were. The low level of interest rates and strong population growth continue to support household demand, through both higher prices and activity in the housing market and, in turn, consumption. In time, growth of household demand and the impetus to domestic production provided by the exchange rate depreciation since early 2013 are expected to increase capacity utilisation further and spur non-mining business investment (although this will be offset to some extent by the higher cost of imported investment goods). Export growth is expected to continue to make a sizeable contribution to GDP growth, particularly towards the end of the forecast period when liquefied natural gas exports are expected to be growing strongly. In contrast, sharp declines in mining investment are still

expected to subtract around 1¼ percentage points from GDP growth in 2015. Also, fiscal consolidation at all levels of government will weigh on GDP growth over the forecast period.

Household consumption is expected to pick up gradually to a pace slightly above trend by 2016. Near-term indicators have evolved broadly as expected; retail sales growth strengthened in the September quarter while consumer sentiment has been around or a little below average in recent months. The forecasts envisage that consumption will grow by more than income, implying a further gradual decline in the saving ratio.

Dwelling investment is expected to increase at an above-average pace, and the profile has not changed significantly since the August *Statement*. Over the forecast horizon, dwelling investment is being supported by low interest rates, strong population growth and relatively low rates of construction over the past decade. Forward-looking indicators point to further strong growth in new construction in coming quarters. Alterations and additions activity has been weaker than expected over the past year, but is expected to pick up gradually.

Labour market forecasts are little changed. Conditions remain subdued and there is still a degree of spare capacity. The unemployment rate is

elevated, the participation rate is low and business surveys and liaison suggest that labour is readily available. A sustained decline in the unemployment rate is not expected for some time.

Consistent with subdued labour market conditions, wage growth remains low. Although wage growth is not expected to decline further, with many firms foreseeing a period of stable wage growth, pressure on public and private sector employers to contain costs means that wage growth is likely to remain low for a time and pick up only gradually towards the end of the forecast period. Meanwhile, productivity growth is expected to remain a little above its average pace of the past decade. Combined, these forces imply that unit labour costs will remain well contained.

Inflation

The inflation forecast has been revised up slightly since the previous *Statement*, reflecting the recent further depreciation of the exchange rate. Nevertheless, inflation is expected to remain consistent with the inflation target over the forecast period.

Inflation eased in the September quarter and was a little lower than expected, following a few quarters over which inflation was a little higher than expected. Indicators of underlying inflation slowed to around ½ per cent in quarterly terms while underlying inflation over the year was around the middle of the inflation target.

While tradables prices declined unexpectedly in the September quarter, they are likely to rise over the next few years, reflecting the ongoing pass-through of the exchange rate depreciation to final consumer prices. Altogether, the direct effects of the exchange rate depreciation since early 2013 are expected to add a little under ½ percentage point to underlying inflation each year over the forecast period.

In contrast, domestic inflationary pressures are generally expected to remain subdued. In particular, spare capacity in the labour market is expected to

contain labour costs, spare capacity in product markets is likely to constrain firms' ability to expand margins, and inflation expectations remain modest. As a result, inflation in many non-tradable items, whose prices are primarily determined by domestic factors, is expected to remain below its average since 2000. An exception to this is the new housing component of the CPI, which has continued to record higher inflation in recent quarters reflecting strong conditions in the housing sector, and this dynamic is likely to continue.

Lower crude oil prices are expected to reduce fuel costs in coming quarters. This is expected to reduce CPI inflation by 0.1 percentage point in the December quarter, and to have a negligible effect thereafter. The effects on underlying inflation are expected to be small. The recent increase in the fuel excise is expected to only partly offset the effect of lower crude oil prices.

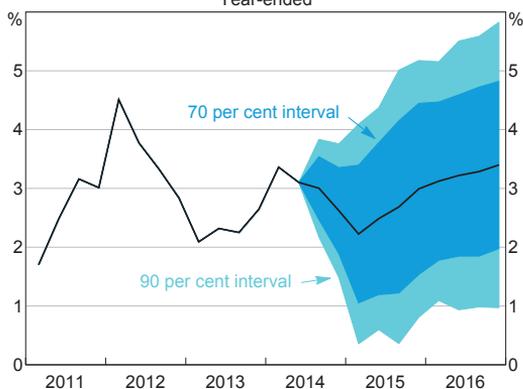
Government policy measures affected inflation in the September quarter and will continue to do so over the forecast period. Given that these effects are not indicative of an excess or shortfall of demand in the economy, they do not have a direct bearing on monetary policy. The repeal of the carbon price had a direct effect on utility prices in the September quarter and is expected to weigh on inflation more generally in the quarters ahead. The timing of the indirect effects is uncertain and difficult to observe amid the usual variation in consumer prices driven by other factors. Cost savings to businesses in the form of lower energy prices may take some time to be passed on to final consumer prices. Finally, the staged increase in tobacco excise in 2015 and 2016 is expected to contribute around ¼ percentage point each year to the rate of headline inflation, but to have little effect on underlying inflation.

Uncertainties

The forecasts are based on a range of assumptions about the evolution of some variables, such as the exchange rate, and judgements about how

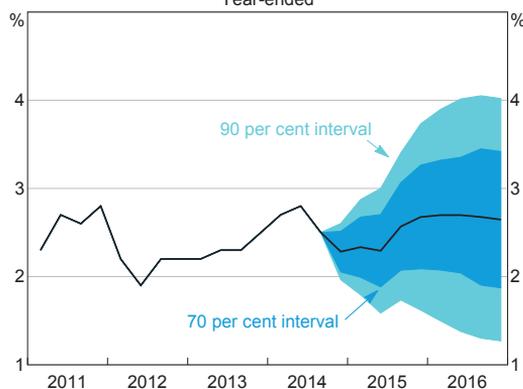
developments in one part of the economy will affect others. One way of demonstrating the uncertainty surrounding the central forecasts is to present confidence intervals based on historical forecast errors (Graph 6.3 and Graph 6.4). The 70 per cent confidence interval for GDP growth happens to encompass most market economist forecasts. It is also worth considering the consequences that different assumptions and judgements might have on the forecasts and to consider the possibility of events occurring that are not a part of the central forecast.

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

External uncertainties

There are numerous uncertainties about how events offshore will unfold, and exactly how policymakers and financial markets will respond. For example:

- if the flow of data suggests that there is less spare capacity in the US economy than currently envisaged, interest rates might rise faster than markets expect, with implications for financial markets and exchange rate movements
- the recovery in Japan or the euro area could be slower than currently envisaged if the policy stimulus in these regions does not have the desired effect
- official estimates suggest that the outbreak of the Ebola virus in West Africa is unlikely to have serious consequences for the global economy. To date, World Bank estimates suggest that the economic costs amount to less than 0.05 per cent of world GDP under its 'high Ebola' scenario, in which the virus is not brought under control in the region until 2015. Nevertheless, these estimates are uncertain and do not fully reflect any effects on confidence that the outbreak may have if it spreads more widely.

In terms of more specific external risks, conditions in the Chinese property market and changes in the exchange rate are key sources of uncertainty.

Chinese housing market

The Chinese authorities have taken some actions recently to support activity in the property market, but it remains to be seen if these measures will be sufficient to avoid a protracted slump. There are a few reasons to be concerned about downside risks to the property market in the current episode and the potential effects on residential investment and economic activity more generally. First, unlike previous episodes (including in 2008), the current downturn in the property cycle has been accompanied by a slowing in growth in total social financing, partly as a result of efforts to place financing and economy-wide leverage on a more sustainable footing. Second,

there appears to be a large overhang of property developer debt and unsold property relative to earlier episodes, and anecdotal reports point to weak demand conditions in smaller cities.

The housing market also poses risks to financial stability in China. Although the direct exposure of the banking sector to the real estate market is moderate, property developers also raise sizeable funds through trust companies, entrusted lending (bank-intermediated intercompany finance) and informal lending channels. As the banks ultimately fund much of this lending, they would potentially be exposed if a negative shock to the housing market led to financial losses among less regulated financial entities. While the authorities could respond with a more substantial easing of financial conditions, this might undermine broader regulatory efforts to reduce the scale of non-bank and off-balance sheet financing activities, which are aimed at limiting the accumulation of risks in the financial system.

If there was a very large and protracted decline in the Chinese property market, this would be likely to reduce demand for Australia's exports of bulk commodities and the prices received for them. Over the past year, prices for bulk commodities have fallen by about a third. While much of this fall has been the result of increasing supply of iron ore and coal, weaker growth of Chinese demand for steel is also likely to have put downward pressure on prices in recent months. If growth of Chinese steel production was to weaken a lot further, without accompanying cuts to iron ore and coking coal production globally, further commodity price falls may eventuate. This would have implications for the revenue of Australian miners. For higher-cost Australian miners, further price falls could precipitate the closure of unprofitable mines, especially in the coal industry, leading to lower exports than otherwise.

Exchange rate

The path of the exchange rate is an important source of uncertainty for the forecasts. The exchange rate has depreciated by a further 4½ per cent since the August *Statement*. However, given the substantial decline in commodity prices over the course of this year, the exchange rate remains above most estimates of its fundamental value.

The prospect of a rise in US interest rates next year, though widely anticipated, could lead to a further appreciation of the US dollar and hence a depreciation of the Australian dollar. Other things being equal, a further depreciation of the Australian dollar would tend to support demand for Australian producers, thereby adding somewhat to growth. It would also lead to upward pressure on inflation, for a time. Based on historical relationships, a 10 per cent depreciation of the Australian dollar (that is not associated with any further decline in commodity prices) would be expected to increase output by ½–1 per cent over a period of two years or so. Year-ended inflation would be higher by a little less than ½ percentage point over each of the following two years or so. However, if the exchange rate depreciation were to be accompanied by a larger-than-expected decline in commodity prices, the net effects would be smaller than the estimates above.

On the other hand, the recent announcements in Japan on monetary policy and pension fund asset allocation increase the probability of capital flows seeking attractive yields in Australia (and elsewhere). Such flows could hold the Australian dollar at a higher level than real economic fundamentals would imply.

There is also uncertainty about the extent to which changes in import prices are passed through to inflation. The forecasts assume that the degree of pass-through is consistent with historical relationships, although the speed of pass-through could be slower or faster than expected depending on the strength of trading conditions.

Domestic uncertainties

The key domestically sourced uncertainties surrounding the forecasts arise from uncertainty about: how low income growth and wealth effects from the housing market might translate into consumption; the timing and speed of the recovery in non-mining business investment; and the impact of structural changes, such as the transition from the investment to the production phase of the mining boom, on capacity utilisation in the economy.

Household sector

As outlined above, the consumption forecasts are little changed from the August *Statement*. The effects of weak growth in real household income are expected to be offset by a further gradual decline in the saving ratio.

Consumption is likely to be supported by above-average growth of housing prices. The operation of a wealth effect on consumption is consistent with the fact that consumption growth over the past year or so has been strongest in New South Wales and Victoria, where housing price increases have been greatest. This suggests that consumption may pick up further if the property markets in other parts of the country strengthen. However, another possibility is that, in aggregate, the increase in wealth from rising housing prices is having less of an effect on consumption than it did previously. In particular, in recent years fewer households appear to have been utilising the increase in the value of their houses to increase their leverage or trade up. This is one channel by which households had increased consumption in earlier episodes, notably the period of rising house prices in the early 2000s. The possibility that this effect is weaker increases the likelihood that the saving ratio could be higher than we expect based on historical experience. If that is the case, consumption growth might be a little weaker than is forecast.

Business investment

A sharp slowing in mining investment is widely expected as existing projects are completed and few new projects commence. However, there is uncertainty about the pace and timing of this slowing, as well as the level of expenditure that will be required to maintain the existing stock of capital in the mining sector.

Outside the mining sector, the recent data have been a bit weaker than expected, including non-residential building approvals and spending intentions for building and structures from the Capex survey. This has led to a slight reduction in the strength of the forecast recovery in non-mining investment. Further, the forecasts are predicated on a turnaround in non-residential approvals that is less pronounced than was the case in other upswings, reflecting subdued underlying conditions in the commercial property market.

There is considerable uncertainty about the timing and the speed of the recovery in non-mining investment. One possibility is that the recovery could be delayed further if businesses wait for a more substantial pick-up in demand. Alternatively, the timing of the pick-up in investment could be as forecast, but its magnitude much larger than forecast if firms become more willing to take on risk, particularly given the period of below-average growth of investment over recent years. It is hard to know if and when such a change in sentiment might occur, but it is more likely to do so when the fundamental determinants of investment are in place, as appears to be the case at present. The forecast for business investment balances the range of possible outcomes that encompass these scenarios.

Capacity utilisation

The forecasts for inflation assume that pressures from domestic costs and margins remain subdued given spare capacity in labour and product markets. However, if demand were to pick up by more than expected, or if there is less spare capacity than currently assumed, inflation could be higher. Various factors might weigh on the economy's productive capacity in the next few years. For example, the ageing of the workforce might constrain labour supply. Also, the need for labour to shift from the

mining to the non-mining sectors might lead to a mismatch between the skills and location of workers versus the needs of employers. In addition, subdued investment in non-mining sectors in recent years may weigh on the economy's productive capacity. While growth in labour productivity has been quite strong in recent years, it is not clear whether this growth will be sustained. If productivity growth is weaker than expected, this could lead to more domestic inflationary pressures than currently assumed. ✎