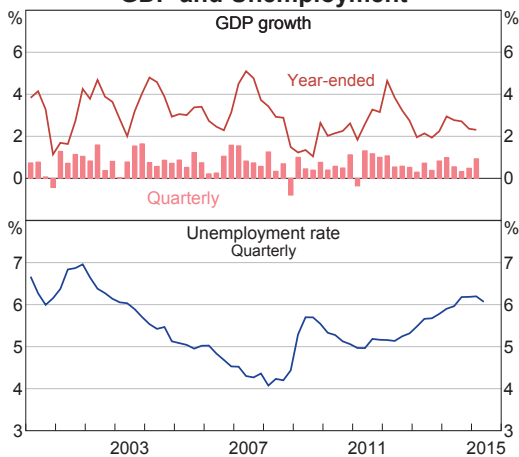


### 3. Domestic Economic Conditions

Growth of the Australian economy picked up in the March quarter, although it has remained below average over the past year and early indications are that the strength in the March quarter was not repeated in the June quarter (Graph 3.1). The key forces shaping the economy have remained much as they have been for some time. Business investment continued to decline over the year to the March quarter, particularly in the mining sector; non-mining business investment remains subdued. Resource exports made a substantial contribution to growth, as new capacity continued to come on line (Graph 3.2; Table 3.1). The depreciation of the exchange rate has supported exports of services, such as tourism, while service imports have declined. Very low interest rates are working to lift growth in other parts of the economy. Dwelling investment has grown strongly over the past year, housing prices

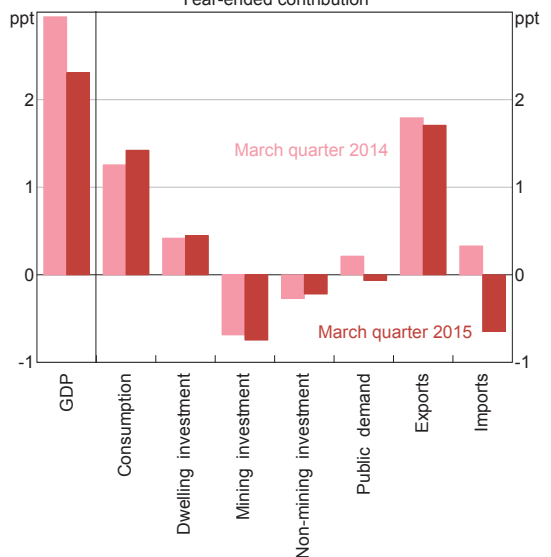
**Graph 3.1**  
GDP and Unemployment



Source: ABS

**Graph 3.2**  
GDP Growth

Year-ended contribution



Sources: ABS; RBA

are growing strongly in some parts of the country, and consumption growth has picked up from its lows in 2013. Income growth has been weaker than the growth of real activity, however, as the terms of trade have declined further. Public demand has not grown.

Labour market conditions have generally improved over the course of this year. The protracted period of low wage growth may be encouraging firms to increase employment by more than otherwise and the decline in population growth can help to explain the relatively stable unemployment rate during a period of below-average growth in output. Despite the improvement, there remains evidence of spare capacity in the labour market.

**Table 3.1: Demand and Output Growth**  
Per cent

	March quarter 2015	December quarter 2014	Year to March quarter 2015
GDP	0.9	0.5	2.3
Consumption	0.5	0.8	2.6
Dwelling investment	4.7	3.9	9.2
Mining investment <sup>(a)</sup>	-3.7	-4.2	-11.5
Non-mining investment <sup>(a)</sup>	-3.5	1.1	-2.3
Public demand	0.1	0.0	-0.3
Exports	5.0	1.6	8.1
Imports	3.1	-1.6	3.3
Nominal GDP	0.4	0.6	1.2
Real gross domestic income	0.2	0.1	-0.2

(a) RBA estimates  
Sources: ABS; RBA

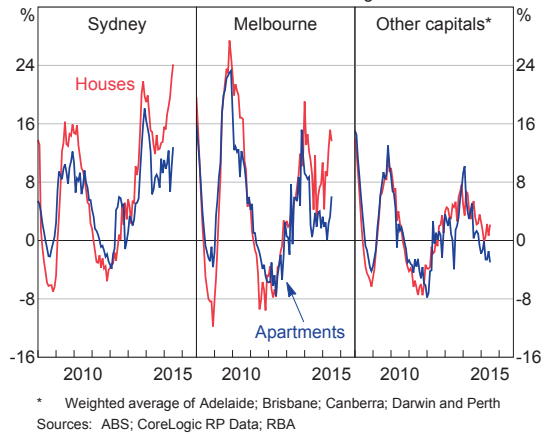
## Household Sector

Conditions in the new and established housing markets have remained strong overall, consistent with low interest rates. However, conditions have varied widely across market segments. Consumption growth looks to have picked up over the past couple of years, but remains below its average pace.

There is considerable variation in growth rates of housing prices across the country. Large price increases have been recorded for detached houses in Sydney and Melbourne, where market conditions remain strong (Graph 3.3). Growth of apartment prices in these cities has been noticeably slower, reflecting the large increases in higher-density housing supply over recent years, especially in Melbourne. Conditions in established housing markets outside of Sydney and Melbourne have been subdued, and prices have declined in a number of market segments.

In the rental market, there has been an increase in supply relative to demand over recent years. Loan approvals data suggest that the level of investor demand for housing remains very strong, and more so in the regions where housing price growth has been strongest. Meanwhile, the nationwide rental vacancy rate has continued to drift higher

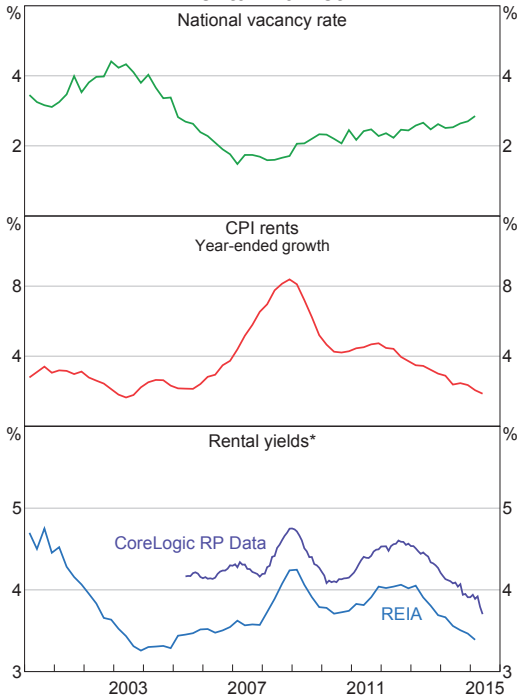
**Graph 3.3**  
**Capital City Housing Price Growth**  
Six-month-ended annualised growth



and, accordingly, rental price inflation has eased (Graph 3.4). This trend appears to be common across all capital cities, including in Perth where investor demand is relatively weak. Combined with strong national housing price growth, this has led to further declines in rental yields.

Reflecting low interest rates and associated strength in housing prices, dwelling investment rose by 9 per cent over the year to March and forward-looking indicators point to further strength in construction in the near term. Building approvals remain at high

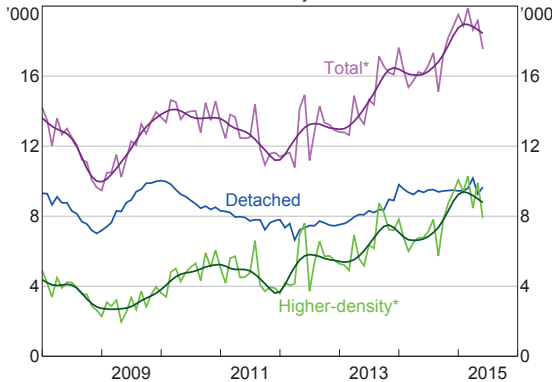
**Graph 3.4**  
**Rental Market**



\* REIA series uses an unmatched sample of rents and prices; CoreLogic RP Data series uses a matched sample and has been seasonally adjusted by the RBA  
Sources: ABS; CoreLogic RP Data; RBA; REIA

levels, as do loan approvals for new dwellings, notwithstanding some recent declines (Graph 3.5). First-home owner grants have continued to trend higher.

**Graph 3.5**  
**Private Residential Building Approvals**  
Monthly

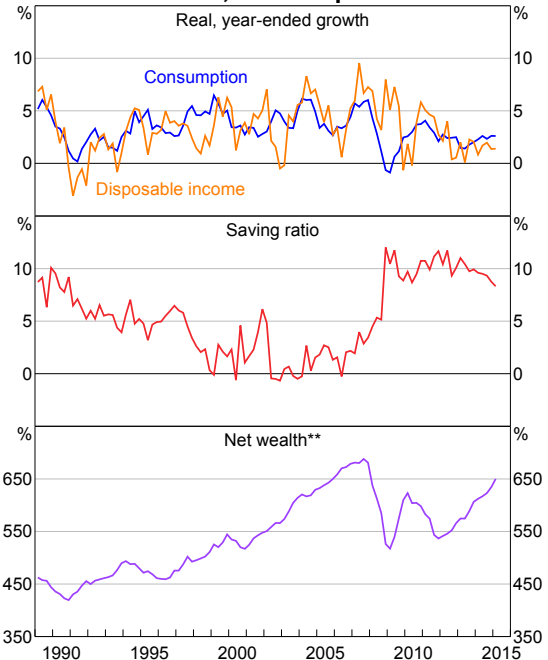


\* Smoothed lines are ABS trend measures  
Source: ABS

While new higher-density dwellings have accounted for much of the growth in dwelling investment over the past year, renovation activity has also picked up recently. Construction of new detached houses has grown more slowly over the past year, consistent with liaison reports that it is difficult to obtain suitable land ready for development in some parts of the country.

Consumption growth has picked up since its recent trough in 2013 (Graph 3.6). Consumption growth in per capita terms now appears to have been a bit stronger than it had earlier appeared given there have been downward revisions to population growth. Low interest rates and strong increases in wealth are supporting a rate of consumption growth that is higher than that of household disposable income. As a result, there has been a decline in the household saving ratio over the past couple of

**Graph 3.6**  
**Household Income, Consumption and Wealth\***



\* Household sector includes unincorporated enterprises; disposable income is after tax and interest payments; income level smoothed with a two-quarter moving average between March quarter 2000 and March quarter 2002; saving ratio is net of depreciation

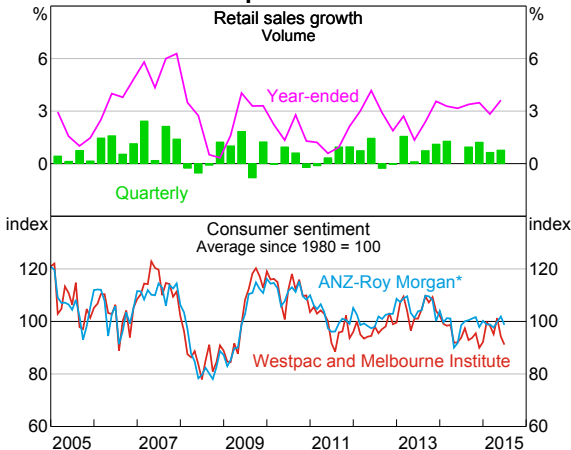
\*\* Per cent of annual household disposable income, before the deduction of interest payments

Sources: ABS; RBA

years. Nonetheless, it remains higher than it was over most of the 1990s and early 2000s. Consumption growth has been higher in New South Wales, which has had less direct exposure to the contraction in mining investment and the easing in population growth, as well as the strongest housing market. Household debt has increased moderately as a share of household income over the past few years (see 'Box B: Measuring Household Debt' for more information).

More recently, retail sales volumes increased by 0.8 per cent in the June quarter (Graph 3.7). Motor vehicle sales to households remain at high levels. Overall measures of consumer sentiment are a little below their long-run averages, although sentiment regarding households' own finances is more positive. Consumers' unemployment expectations remain elevated.

**Graph 3.7**  
**Consumption Indicators**

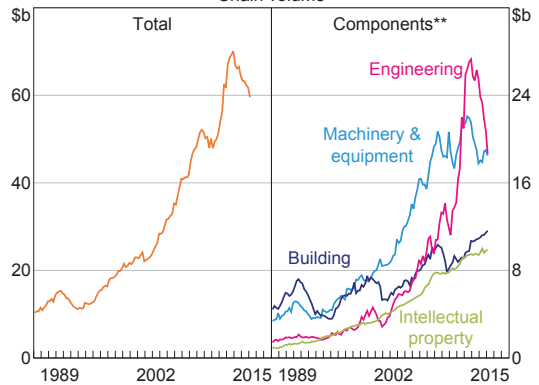


\* Rescaled to have the same average as the W-MI index since 1996  
Sources: ABS; ANZ-Roy Morgan; RBA; Westpac and Melbourne Institute

## Business Sector

Private business investment fell in the March quarter and was 6 per cent lower over the year (Graph 3.8). Much of the decline was attributed to weaker investment in engineering construction.

**Graph 3.8**  
**Private Business Investment\***  
Chain volume



\* Adjusted for second-hand asset transfers between the private and other sectors; reference year is 2012/13

\*\* Excluding cultivated biological resources

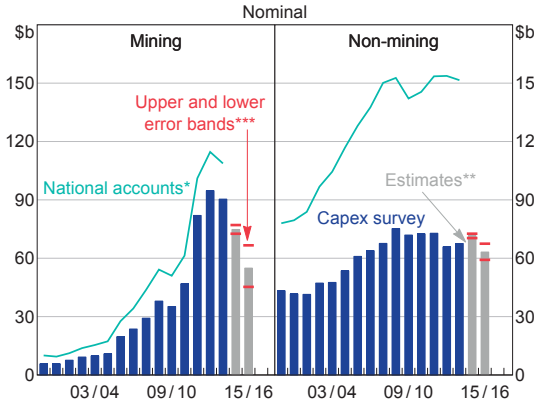
Sources: ABS; RBA

Mining investment has fallen substantially over the past three years, as large iron ore, coal and liquefied natural gas (LNG) projects have been completed, and few new projects have commenced. The ABS capital expenditure (Capex) survey implies that this trend will continue, and estimates for nominal mining investment derived from this survey were revised lower in the most recent release, particularly for 2015/16 (Graph 3.9). Bank liaison also continues to point to substantial declines in capital expenditure in the resource sector. In addition, mining sector profitability remains under pressure; mining sector profits fell by 22 per cent over the year to the March quarter, reflecting the decline in bulk commodity prices.

Non-mining business investment has been little changed for the past four years and surveys of investment intentions, as well as relatively low levels of non-residential building approvals, suggest that it will remain subdued over the coming year.<sup>1</sup> Indeed, the latest Capex survey implies non-mining investment will fall in 2015/16, consistent with weak underlying conditions in the commercial property

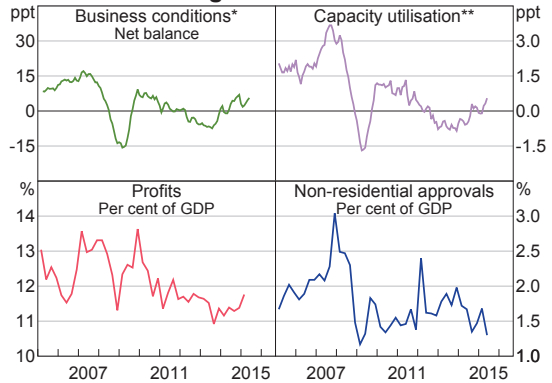
<sup>1</sup> There is some uncertainty in the way activity is attributed to the mining and non-mining sectors, suggesting some caution when interpreting the Bank's estimate of the split between mining and non-mining business investment over recent quarters.

**Graph 3.9**  
**Measures of Private Business Investment**



\* Adjusted for second-hand asset transfers between the private and other sectors; excluding cultivated biological resources  
 \*\* Estimates are firms' expected capital expenditure, adjusted for the past average difference between expected and realised spending  
 \*\*\* Error bands are based on the root mean square error of each adjusted estimate compared with the final outcome for investment in each year  
 Sources: ABS; RBA

**Graph 3.10**  
**Non-mining Business Indicators**



\* Gross value added weighted; deviation from average since 1989; three-month moving average  
 \*\* Investment share weighted; deviation from average since 1989; three-month moving average  
 Sources: ABS; NAB; RBA

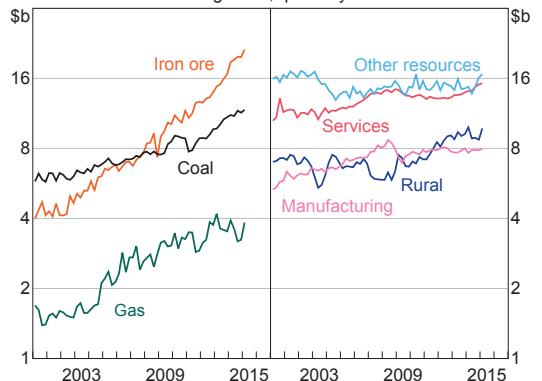
market. However, the Capex survey does not cover a large share of non-mining business investment that is included in the national accounts, such as in agriculture, education and health care. Nor does it capture investment in intangible items (which tends to grow at a steady pace). Also, a number of factors are supportive of non-mining investment. Non-mining company profits have increased by 6 per cent over the past year, employment growth has picked up and survey measures of business sentiment and capacity utilisation are around or above average levels (Graph 3.10).

The exchange rate depreciation is also providing more support to demand and investment in export-oriented industries, such as education and tourism and, in time, to domestic demand more broadly.

**External Sector**

Export volumes rose by 8 per cent over the year to the March quarter, driven by strong growth in resource exports, particularly iron ore and coal (Graph 3.11). In the March quarter, resource exports contributed 0.8 percentage points to GDP growth, although some of this reflected the temporary effect of favourable weather conditions. Exports of bulk commodities are expected to continue to grow over the next couple of years. However, the pace of growth is expected to moderate, and a sustained

**Graph 3.11**  
**Export Volumes\***  
Log scale, quarterly



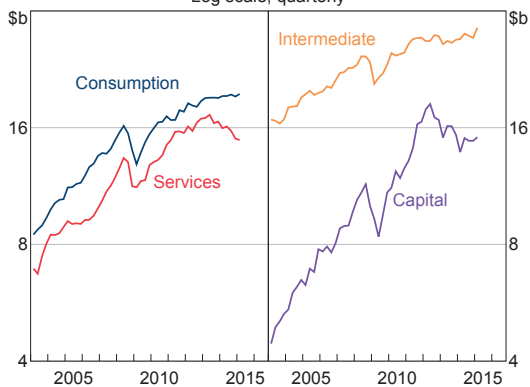
\* Reference year is 2012/13  
 Sources: ABS; RBA

period of low commodity prices could prompt some curtailment of supply by higher-cost producers, particularly of coal. In contrast, LNG exports are expected to increase substantially over the next couple of years, as a number of projects currently under construction begin production.

Service exports have grown over the past couple of years, driven by strength in tourism, education and business service exports. The depreciation of the exchange rate has supported this trend; since early 2013 the Australian dollar has depreciated by around 20 per cent on a trade-weighted basis and service exports have risen by 12 per cent. In contrast, manufactured exports have been subdued for some time and have not responded to the exchange rate depreciation by as much as historical relationships would suggest.

Import volumes increased in the March quarter, largely reflecting an increase in intermediate imports (Graph 3.12). Notwithstanding the increase, imports have been subdued in recent years. Capital imports have fallen as construction of many of the import-intensive, large-scale mining projects have approached completion and service imports have declined noticeably, as the depreciation of the exchange rate has discouraged expenditure on overseas travel and business service imports. Overall,

**Graph 3.12**  
**Import Volumes\***  
Log scale, quarterly



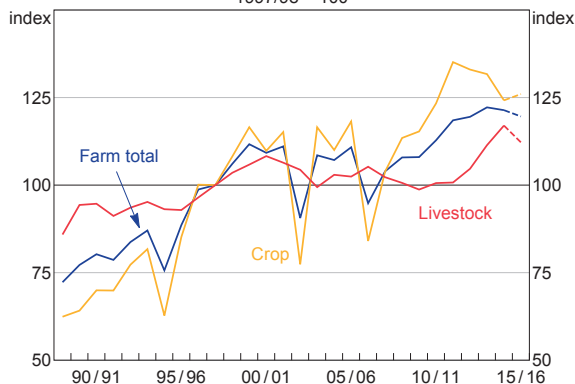
\* Reference year is 2012/13  
Source: ABS

net exports of services have contributed almost as much to GDP growth as iron ore exports over the past year.

## Farm Sector

The Australian Bureau of Agricultural and Resource Economics and Sciences (ABARES) expects farm production volumes to have fallen slightly in 2014/15 (Graph 3.13). This reflects a reduction in winter crop yields owing to dry conditions, partly offset by an expected increase in livestock production. Farm production volumes are forecast by ABARES to fall further in 2015/16; herd rebuilding is expected to lead to a decline in livestock production, and reduced rainfall and above-average temperatures associated with El Niño are expected to depress yields of winter crops.

**Graph 3.13**  
**Farm Production Volumes\***  
1997/98 = 100



\* Dashed lines represent 2015/16 forecasts; 2014/15 data are estimates  
Source: ABARES

## Government Sector

Recent federal and state government budgets suggest there will be ongoing fiscal consolidation over coming years (see 'Box C: Fiscal Policy and Economic Activity'). Further falls in commodity prices and lower-than-expected growth of labour income have led to downward revisions to revenue growth (offset in some states by higher-than-expected growth in stamp duty revenue). As a

result the consolidated deficit is expected to be a bit wider than originally forecast. In 2015/16, the consolidated deficit is expected to narrow to around 2½ per cent of GDP, and progressively lower deficits are expected for subsequent years. The fiscal consolidation is expected to continue to weigh on growth of domestic demand. The consolidated budget is expected to return to a balanced position by around 2019/20, although there remains a degree of uncertainty around which new policy initiatives will be legislated.

## Labour Market

Labour market conditions have generally improved over the course of this year. The unemployment rate has been relatively stable since the second half of last year, as have measures of underemployment, and the employment-to-population ratio has increased (Graph 3.14). The participation rate has been higher of late than the low points reached in recent years.

**Graph 3.14  
Labour Market**



Source: ABS

The general improvement in labour market conditions has occurred despite below-average growth in GDP over the past year. This may be partly explained by a decline in the rate of population growth, which means that less GDP growth was required to generate enough jobs to absorb the growth in the labour supply (see 'Box D: Implications of Lower Population Growth for the Australian

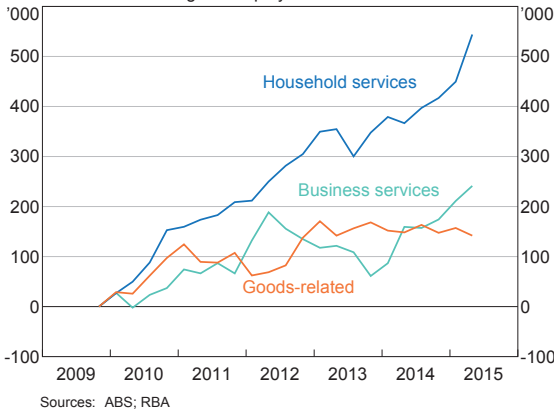
Economy').<sup>2</sup> The increase in labour demand, as implied by the rise in the employment-to-population ratio, may also have been supported by the protracted period of very low wage growth encouraging firms to retain or take on new employees. Unit labour costs have been little changed for nearly four years, which, along with the depreciation of the nominal exchange rate, has contributed to some improvement in the international cost competitiveness of Australian labour. Business liaison suggests that, while firms remain focussed on containing costs, rates of staff retrenchment may have eased.

While conditions have generally improved, there is still evidence of spare capacity in the labour market. The unemployment rate and the rate of unemployment benefit recipients both remain elevated, and the participation rate is still below its peak in 2010. Also, although average hours worked have been steady for most of the past year, they are below the levels seen a few years ago, and the incidence of employees working fewer hours than they desire is elevated.

Since late last year, employment growth has been driven by the service sector and has been strongest in New South Wales and Victoria (Graph 3.15). This pattern is consistent with a rebalancing of demand away from resource investment towards consumption and dwelling investment. Household service employment has continued to make a large contribution to employment growth, with recent strength in health care & social assistance. Arts & recreation and accommodation & food services also made sizeable contributions to employment growth over the year, consistent with liaison reports of recent strength in the tourism industry following the exchange rate depreciation. Business service employment has increased notably over the past

<sup>2</sup> While the labour force series do not yet reflect recently released data showing lower rates of population growth – and the number of people in each labour force category and their growth rates are overstated – measures expressed relative to the size of the labour force or population (such as the unemployment rate) are likely to be largely unaffected by revisions that will flow from the new population data.

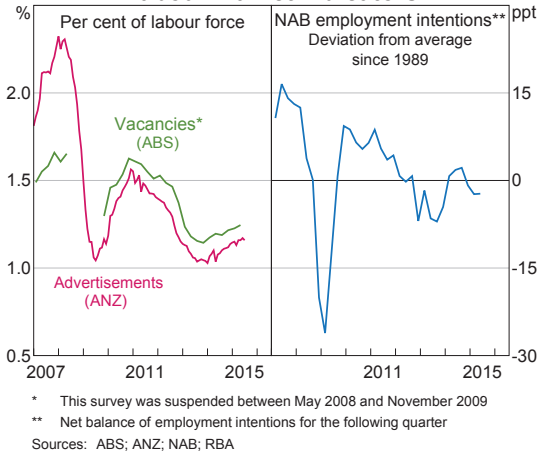
**Graph 3.15**  
**Employment Growth by Industry**  
 Change in employment since 2009



couple of quarters, in part driven by professions that are likely to be engaged in work related to residential building. In contrast, employment in sectors related to the production of goods has been little changed for several years. Mining and manufacturing employment have trended down for some time, although LNG-related employment looks to have lifted more recently. Construction employment has been relatively stable in recent quarters; declines in resource-related construction employment are likely to have been offset by growth in employment related to residential construction.

Leading indicators of labour demand have been mixed over recent months, although they are generally higher than a year ago. The ANZ measure of job advertisements and the ABS survey of job vacancies have trended higher (Graph 3.16). In line

**Graph 3.16**  
**Labour Market Indicators**



with trends in employment, growth in vacancies has been strongest in New South Wales and Victoria, and has been driven by the service industries. However, the NAB survey of businesses' hiring intentions has declined this year to be a bit below its long-run average. Also, reports from liaison suggest that hiring intentions have improved a little in recent months, but remain below average. The implications of these leading indicators for future labour market outcomes are somewhat complicated by the ongoing structural change in the economy. For example, some workers previously employed in resource-related jobs may not have the skills required for, or be located near, the advertised vacancies. While liaison suggests that many resource-related construction workers should be able to find work in other industries, the level of wages on offer is likely to be significantly lower. ❖