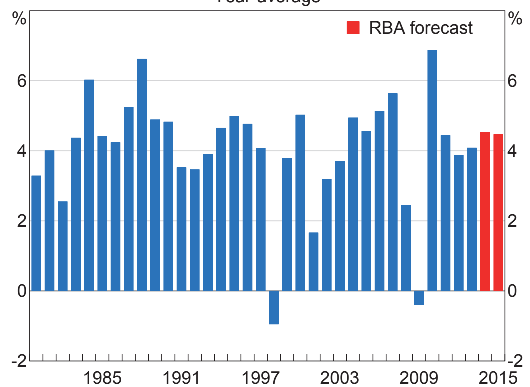
6. Economic Outlook

The International Economy

Overall, growth of Australia's major trading partners (MTPs) is expected to be a bit above its long-run average in 2014 and 2015 (Graph 6.1). Forecasts for most individual trading partners are not above their historical averages; rather, the forecast of above-average MTP growth reflects the changing pattern in the destinations of Australian exports. In particular, an increased share of Australia's exports is going to China, which is growing much faster than elsewhere.

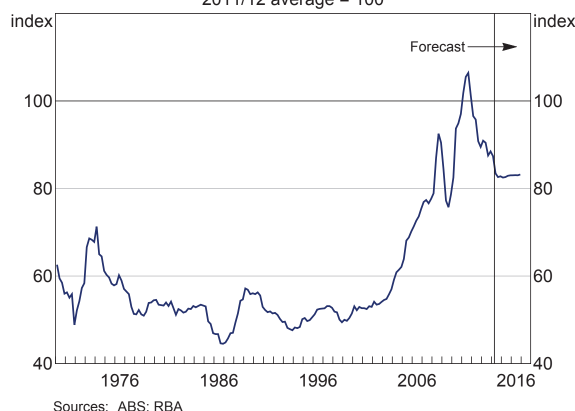
Chinese GDP growth in 2014 is expected to be close to the authorities' target of 7.5 per cent. Recent data suggest that growth has picked up following weaker-than-expected growth in the March quarter. This is consistent with relatively accommodative fiscal and monetary conditions, which have seen debt continue to grow as a share of GDP and which should continue to support activity in the second half of the year.

In Japan, for 2014 as a whole, growth is expected to be stronger than the average of the past decade, although the increase in the consumption tax in April resulted in very strong growth at the start of the year and a contraction in activity in the June quarter. Growth is expected to slow just a bit in 2015 to be close to its average pace. Aggregate growth in the rest of east Asia in 2014 is expected to be below its decade average, in large part reflecting very weak growth in Thailand, before picking up in 2015 to around average, aided by recovery in the advanced economies.



The forecast for US growth in 2014 has been revised down, as economic conditions in the first half of 2014 were weaker than anticipated. However, growth is expected to pick up in 2015, supported by stimulatory monetary policy and further improvements in the labour market. In the euro area, the gradual recovery in economic activity is projected to continue.

The outlook for the terms of trade over the rest of 2014 is a little lower than at the time of the May *Statement* (Graph 6.2). This predominantly reflects weaker-than-expected spot prices of bulk commodities in recent months, which is likely also to flow through to lower contract prices. Iron ore and coal prices are forecast to remain close to their current levels, as the growth of global steel demand is expected to be close to that of global supply.



Additions to supply from new and existing mines are expected to be partially offset by the further closures of higher-cost iron ore and coal mines.

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 72 and A$ at US$0.93), which is a touch higher than the assumption in the May *Statement*. The forecasts are based on the price of Brent oil remaining at US$106 per barrel, a little higher than the assumption in May. 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 over 2014 and 1.7 per cent over 2015 and 2016 (drawing on forecasts by the Department of Immigration and Border Protection), a little below the previous *Statement*.

The starting point for the forecasts of the Australian economy is above-trend growth of GDP over the year to the March quarter, driven by very rapid growth of resource exports. GDP growth excluding resource exports also increased a little over the year to the March quarter, but remained below its longer-term average. This reflected the combination of stronger growth in dwelling investment, a pick-up in consumption growth over the year as a whole, subdued growth in public demand and non-mining business investment, and a substantial decline in mining investment.

The available indicators suggest that GDP growth slowed to a more moderate pace in the June quarter. Exports appear to have declined, partly reflecting some payback from weather-related strength in the March quarter, while indicators of consumption, including retail sales growth and consumer confidence, were weak. Nonetheless, indicators of business conditions remained at around average levels, a timely measure of consumer sentiment has rebounded more recently and conditions in the housing market are consistent with further strong growth of dwelling investment.

GDP growth is expected to be a little below trend over 2014/15, before picking up to around a trend pace over 2015/16 (Table 6.1). While the central forecast is slightly lower than at the time of the May *Statement*, the differences are well within the usual ranges of uncertainty for the forecasts.

The key forces that have been expected to influence GDP growth over the next few years remain largely as they were. Mining investment is expected to decline much further as large mining projects are completed. Consolidation of state and federal government budgets, if it proceeds as envisaged in the budgets, could weigh on growth in domestic demand. Notwithstanding the depreciation since the peak seen last year, the exchange rate remains elevated, particularly given the recent declines in commodity prices. These factors will be partly offset by the stimulus from low interest rates, which is supporting activity and prices in the housing market and also bolstering household consumption. In time, the growth of dwelling investment and consumption, combined with the direct effect of the low interest rates on borrowing costs and the generally good health of business balance sheets, is expected to spur a recovery in non-mining business investment.

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	2½	2–3	2½–3½	2¾–3¾	2¾–4¼
Non-farm GDP growth	3¼	2¾	2–3	2½–3½	2¾–3¾	2¾–4¼
CPI inflation[(b)]	3	2	1¾–2¾	2½–3½	2½–3½	2¼–3¼
Underlying inflation[(b)]	2¾	2¼	1¾–2¾	2¼–3¼	2–3	2–3
	Year-average					
	2013/14	2014	2014/15	2015	2015/16	2016
GDP growth	3	3	2–3	2–3	2½–3½	2¾–3¾

(a) Technical assumptions include A$ at US$0.93, TWI at 72 and Brent crude oil price at US$106 per barrel
(b) Based on current legislation for the price of carbon
Sources: ABS; RBA

A significant increase in exports of liquefied natural gas (LNG), as the LNG plants currently under construction commence production, should also help to push GDP growth higher towards the latter part of the forecast period. GDP is expected to grow at a little above its trend pace over 2016.

Growth of household consumption appeared to have been a little lower than expected at the time of the May *Statement*, and this is reflected in the forecast for this year. Despite the modest downward revisions, consumption growth is anticipated to pick up to a slightly above-trend pace by 2016, supported by moderate income growth and increases in household wealth. Fiscal consolidation at all levels of government is expected to continue to restrain public demand growth over the forecast horizon.

Dwelling investment is expected to increase noticeably as a share of GDP. Forward-looking indicators of dwelling investment, such as approvals, commencements and work yet to be done remain at high levels and will support growth of dwelling investment in coming quarters. Dwelling construction is expected to continue to expand later in the forecast period in response to low interest rates, strong population growth and only limited construction over the past decade. The expected level of dwelling investment in 2015 and 2016 is similar to that forecast three months ago.

Business investment overall is forecast to continue contracting, owing to sharp falls in mining investment. Surveys of investment intentions and information from the Bank's liaison imply that mining investment will decline more rapidly over the next couple of years than it has to date, as some large mining projects reach completion.

Non-mining business investment is expected to pick up modestly over the coming year or so. This is consistent with the ABS capital expenditure survey of investment intentions for 2014/15. Also, survey measures of business conditions and capacity utilisation are around their long-run average levels, although Bank liaison continues to report that firms are reluctant to invest until they see a sustained period of strong demand. The stock of work yet to be done (including a number of large healthcare and office building projects) will support non-residential construction over the next few quarters. However, non-residential building approvals have declined in trend terms since the start of the year, suggesting that non-residential construction will not be as strong in the near term as previously assumed. Nevertheless, growth of non-mining business investment is still expected to pick up to around the average pace seen from the early 1990s up to the global financial crisis in response to the very low level of interest rates, strong population growth and

the very subdued growth of the capital stock outside the resources sector over recent years.

Resource exports will continue to provide an above-average contribution to annual GDP growth of around 1 percentage point over 2015 and 2016. Much of this will come from LNG exports as five of the seven LNG projects that are currently under construction are expected to begin production during that time. There has been a small downward revision to the outlook for coal export volumes over the next few years as expansions to capacity from new and existing mines are partially offset by the closure of a number of older and higher-cost mines.

Some labour market indicators have improved a little this year, but overall conditions remain subdued. There remains a degree of spare capacity, as reflected in the elevated level of the unemployment rate and broader measures of underemployment. The unemployment rate is likely to remain elevated for a time and is not expected to decline in a sustained way until 2016.

This period of subdued labour market conditions is expected to restrain wage growth for some time. Over the past two years, the growth of wages, as measured by the wage price index, has declined to its slowest pace in at least 15 years. Wage growth is expected to pick up only slightly from its current pace over the forecast period, remaining significantly below its decade average of 3¾ per cent. At the same time, productivity growth is expected to remain a bit above its average of the past decade, helping to keep overall labour cost pressures well contained. This sustained period of slow growth in labour costs should assist in an improvement in the international competitiveness of Australian firms, which will lend more support to labour demand than would otherwise be the case.

Inflation

Inflation was a little higher in the June quarter than had been expected. Headline inflation was 0.6 per cent in the quarter in seasonally adjusted terms and 3.0 per cent over the year. The year-ended rate of CPI inflation was boosted by a little under ¼ percentage point from the increase in the tobacco excise late last year. The pace of underlying inflation increased to ¾ per cent in the quarter, and was around 2¾ per cent in year-ended terms, which was about ½ percentage point above that of a year earlier.

The rise in underlying inflation over the past year has in part owed to the earlier depreciation of the exchange rate. A rise in import prices is being passed on gradually by domestic wholesalers and retailers, resulting in an increase in the prices of tradable items. Over the past year or so, pass-through appears to have been broadly in line with historical experience. Further pass-through of the exchange rate is expected to contribute around ¼ to ½ percentage point to underlying inflation over each of the next two years. By late 2016, three and a half years on from the initial depreciation, these effects are likely to have largely run their course.

Meanwhile, spare capacity in labour and product markets is expected to see domestic inflationary pressures remain contained. Inflation in non-tradables items, which tends to be affected more by domestic demand and supply, and less by the exchange rate, has declined over the past year to around its slowest pace in 10 years. This slowing has been particularly marked in those components that are generally more sensitive to growth of labour costs.

Inflation is forecast to decline over the coming year to around 2¼ per cent before picking up, to be in the top half of the target range over 2016. This forecast continues to be based on below-trend growth in the economy in the near term and low growth of domestic costs but stronger inflation in tradables prices than in recent years given the assumption of an unchanged exchange rate. The abolition of the carbon price has lowered the forecast for the CPI; the outlook for inflation is lower than earlier expected in 2014/15 but higher in 2015/16 (given that the previous legislation entailed a move to a floating price in mid 2015).

The Bank's forecasts use modelling by Treasury, which suggests that the removal of the carbon price would reduce CPI inflation by around ¾ percentage point over 2014/15. This effect is similar in size to the upward influence on inflation that was expected to result from the introduction of the carbon price in 2012/13. A little more than half of the total effect is expected to reflect the direct effect from lower electricity and gas prices and so would not be expected to affect the statistical measures of underlying inflation. The remainder is expected to reflect the indirect effects on the prices of other goods and services in the CPI basket. This is expected to reduce underlying inflation by around ¼ percentage point over 2014/15.

There is uncertainty regarding the timing of both the direct and indirect effects of the repeal of the carbon price. The timing of the direct effects will depend on the extent to which savings on utilities costs are passed on to customers by way of lower prices or subsequent rebates, particularly given the retrospective nature of the repeal. The timing of the indirect effects is even less certain, as the speed with which cost savings to businesses are passed on to final consumer prices is difficult to predict, owing to the inherent lags with which cost changes pass through the supply chain. Because of this, the Bank's forecasts assume that the total effects are realised over a period of two quarters rather than the full effect occurring in the September quarter. As was the case following the introduction of the carbon price, it will not be possible to identify the size and timing of the effects of the repeal of the carbon price amid the usual variation in consumer prices driven by other factors.

Other government policy measures are expected to affect inflation over the next few years. As was the case in May, the forecasts incorporate the staged increase in the tobacco excise over the next few years. This 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

Trading partner growth has been around average for a few years, and if the forecasts for the next two years of similar growth are borne out, it will have been quite a period of stability. Much of the uncertainty surrounding the external outlook pertains to country-specific factors, although there are some broader risks to the global economy such as a reversal of the current low pricing of risk.

In China, government policies are providing a measure of support to activity, thereby increasing the likelihood that economic growth will be close to target in 2014. However, if housing market conditions were to weaken more noticeably, this could weigh heavily on the economy overall and have adverse implications for financial stability. Although the direct exposure of the banking sector to housing appears relatively low, banks are involved indirectly in the funding of much property-related lending and could be exposed to financial losses in the event of a sharp correction. Efforts by the authorities to provide a measure of stimulus could boost growth in the near term but make it harder to facilitate the desired deleveraging and, in time, prove destabilising for the financial system.

The ongoing strength of growth in Japan is somewhat uncertain given the volatility in activity caused by the increase in the consumption tax in April. This should become clearer as data for the June quarter and beyond become available in the coming months.

In the United States, much of the unexpectedly weak first half of 2014 appeared to reflect temporary factors. Since then, there have been signs of slightly soft outcomes in the housing market but greater strength in the labour market, and there is some uncertainty about the extent to which inflation might rise over the period ahead. In the euro area, the European Central Bank announced a range of stimulatory policy measures aimed at addressing the risk of a prolonged period of low inflation and supporting small and medium-sized businesses. It is not clear how large an effect they will have.

Accommodative financial conditions have contributed to a period of rapid growth in debt and property prices in several east Asian economies. A shift in market sentiment, triggered perhaps by a stronger-than-expected recovery in the United States and faster normalisation of US monetary policy, could lead to an outflow of capital and a disproportionate tightening of financial conditions in a number of emerging market economies, with adverse effects on economic activity.

The key uncertainties for the domestic economy continue to be centred on the timing and extent of the expected decline in mining investment, the associated rise in resource exports and the further strengthening in non-mining activity. While this 'transition' has been unfolding for some time, helped in part by the very low level of interest rates, there is no guarantee that the rebalancing of spending will be a smooth process. Even if it proceeds as expected, the significant change in the composition of economic activity could result in either excess demand for, or supply of, particular labour skills or types of capital, and could also have implications for the exchange rate. There is little doubt that mining investment has a lot further to fall, but it is unclear by just how much, and how quickly this will occur. In part, it depends on whether the remaining large mining projects stay on budget and on schedule.

Relative to three months ago, when near-term prospects for non-mining activity appeared to be improving, the recent softness in some indicators has increased the uncertainty around the strength and timing of the pick-up in consumption and non-mining investment. For some time now, non-mining investment has been forecast to pick up strongly beyond the next year or so, consistent with past behaviour following troughs in non-mining investment. With only tentative signs of improvement in near-term indicators, the timing of the pick-up has been pushed out a bit further. However, with generally favourable conditions for investment, such as healthy business balance sheets and low interest rates, non-mining business investment could pick up sooner and by more than is forecast.

There is some evidence that momentum in consumption growth has waned somewhat, although at this stage it is unclear whether this reflects temporary sentiment effects or a more lasting reassessment of economic conditions by households. In the latter case, the saving ratio could remain at its higher level for longer. The increase in dwelling investment is in part expected to result from house prices continuing to rise at a faster pace than household incomes because of low interest rates. Indeed, while house price growth slowed in the early part of 2014 from the rapid pace in the second half of last year, it has not slowed further and there are some tentative signs of a pick-up in conditions in the established housing market. If house price growth and turnover were to pick up strongly, this could boost dwelling investment and consumption more than currently expected. If accompanied by an increase in leverage, it could also increase future risks for the economy. However, it is possible that longer-run affordability considerations may restrain housing demand and so growth of dwelling investment.

The release of state and federal budgets has provided further information on the size and nature of planned fiscal consolidation. Nevertheless, there continues to be some uncertainty surrounding the extent and timing of fiscal consolidation. Different outcomes from those that have been assumed could result in consumption and public demand growth being either stronger or weaker than forecast.

The outlook for iron ore and coal prices is a source of uncertainty for the domestic economy. As is typical, there is a wide range of forecasts by market analysts for these commodity prices, with Bank estimates towards the lower end of the range. Iron ore and coal prices will depend on both China's steel demand as well as the response of higher-cost producers to the recent decline in prices. At current prices, there is a sizeable amount of coal and iron ore production that is unprofitable, and the outlook for prices will depend on what proportion of these mines is shut down. Given Australia's position on global iron ore and coal cost curves, it is more likely that there will be some impact on Australian coal production than on Australian iron ore production.

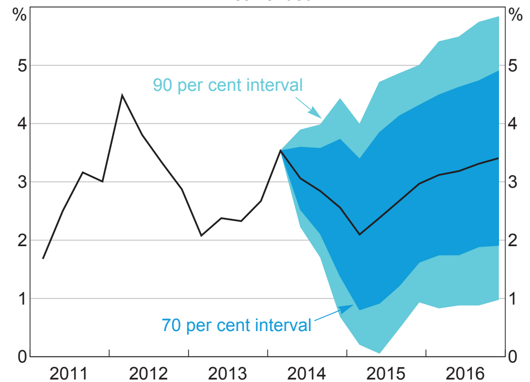
An important source of uncertainty with respect to the lower commodity prices is the response of the exchange rate. Historically, a fall in commodity prices has, in time, led to a depreciation of the exchange rate. In the absence of such a response, a fall in commodity prices would lead to weaker GDP growth since softer incomes and government revenue would weigh on domestic demand. However, if the exchange rate were to move lower, this would provide some offset to the fall in commodity prices by helping to stimulate demand in trade-exposed sectors of the economy. A decline in the exchange rate would also add to prices over a period of time.

A further delay in the transition to non-mining generated economic growth would lead to greater slack in the labour market and weigh more heavily on wage and price inflation. Working in the other direction, an improvement in labour market conditions could lead to a period of strengthening demand and an earlier-than-expected decline in the unemployment rate. Such an outcome would be more likely if the changes that firms have made in recent years have left less slack within firms given existing staffing levels.

There are a number of countervailing factors affecting inflation, the net effect of which is difficult to predict. The recovery in the housing market has already seen an acceleration in new housing cost inflation, which may have further to run. While approvals for new dwellings have eased a little, there is still a risk that capacity constraints resulting from an extended period of rapid growth in activity may emerge, with implications for activity and wage and price pressures. Inflation in prices that are strongly influenced by state and federal governments' policies is also high relative to the case over much of the inflation-targeting period. While the removal of the carbon price will work to lower some of these prices, there may be a more persistent positive effect on inflation from other administered prices. With a number of these factors placing upward pressure on inflation, the forecasts for inflation are predicated on the subdued outlook for labour cost growth.

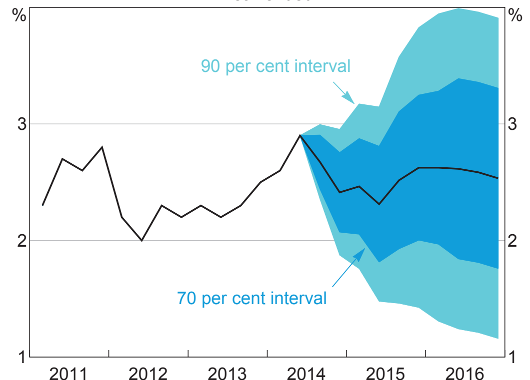
These identified, and other unknown, risks mean that there is significant uncertainty about the path for GDP and inflation. One way of demonstrating the uncertainty surrounding the GDP and inflation forecasts is to present confidence intervals based on historical forecast errors (Graph 6.3 and Graph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

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 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.