

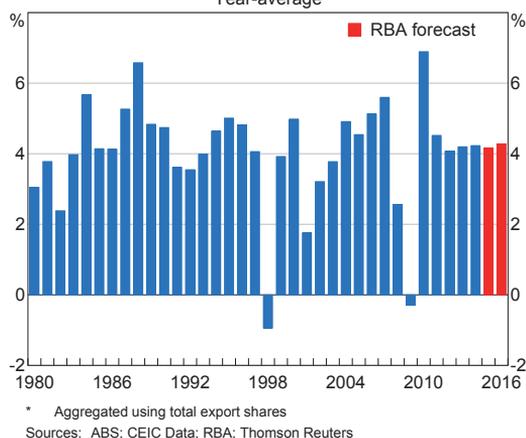
6. Economic Outlook

The International Economy

Growth of Australia's major trading partners is expected to remain around its long-run average pace in 2015 and 2016 (Graph 6.1). Forecasts have been revised down slightly since the February *Statement*, largely reflecting weaker growth in China recently. Low energy prices – particularly for oil – are likely to impart stimulus to most of Australia's trading partners because they are net oil importers. Bulk commodity prices have fallen since February, and Australia's terms of trade are lower as a result. The falls in the prices of iron ore and coking coal over the past three months appear, in part, to reflect moderating growth in industrial production in China, particularly of steel.

In China, economic growth in 2015 is projected to be a little weaker than previously forecast, reflecting slower-than-expected growth across a range of activity indicators in the March quarter. In the near term, weakness in the property market and the manufacturing industry is likely to continue to dampen growth of Chinese demand for steel, iron ore and coal. An anticipated pick-up in infrastructure investment, together with more accommodative monetary and fiscal policies and the positive impact of low oil prices, should provide some offsetting support for aggregate demand over the course of the next year or so. Nevertheless, GDP growth is expected to ease further in the next couple of years. In the near term, this reflects a weaker outlook for demand growth and policymakers' ongoing efforts to restrain the growth of financing in order to put it on a more sustainable footing. The medium-term outlook is consistent with lower growth in

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



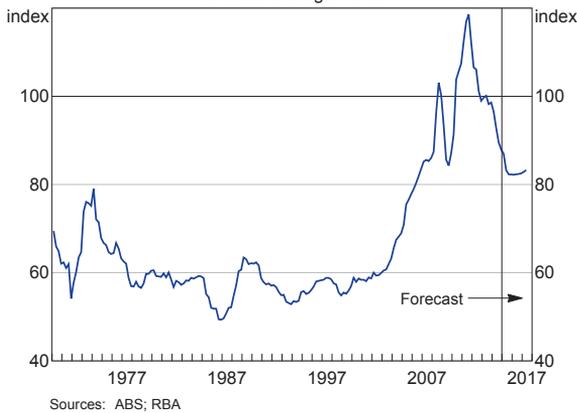
productive capacity due to supply-side factors, such as the falling working-age population.

The Japanese economy is expected to return to modest growth in 2015 and 2016, supported by accommodative monetary and fiscal policies, the depreciation of the yen and low oil prices. In the rest of east Asia, the outlook is little changed and growth is expected to remain close to its decade average. Growth in the US economy is expected to continue at an above-trend pace over the forecast period, notwithstanding a moderation in the pace of growth in the March quarter, which largely reflects temporary factors. The pace of recovery in the euro area remains moderate, but is expected to be a bit faster than forecast three months ago.

The outlook for the terms of trade has been revised down by about 1½ per cent, consistent with the overall decline in commodity prices over the past three months. The terms of trade are forecast to fall

by around 6 per cent over 2015, as the falls in spot prices for bulk commodities are passed through to export prices (Graph 6.2). The Bank's forecast assumes that global demand for steel will be more subdued than in recent years and that any reduction in supply from higher-cost iron ore operations, including those in China, will be modest as producers continue to reduce costs to maintain production.

Graph 6.2
Terms of Trade
2012/13 average = 100



Sources: ABS; RBA

Domestic Activity

In preparing the domestic forecasts, a number of technical assumptions have been employed. The forecasts are conditioned on the assumption that the cash rate moves broadly in line with market pricing at the time of writing. This assumption does not represent a commitment by the Board to any particular path for policy. The exchange rate is assumed to remain at its current level over the forecast period (TWI at 65 and A\$ at US\$0.80). The TWI is a little higher than the assumption underlying the forecasts in the February *Statement*. The forecasts are based on the price of Brent oil at US\$70 per barrel, which is around 19 per cent higher than the assumption used in February. This is in line with near-term futures pricing. The working-age population is assumed to grow by 1.7 per cent each year (drawing on forecasts by the Department of Immigration and Border Protection), which is a little lower than in the previous *Statement*.

The starting point for the forecasts is that the Australian economy grew a bit below its trend rate over 2014, and that this pace of growth looks to have continued in early 2015. In recent quarters, consumption growth has been picking up and dwelling investment growth has remained strong. However, growth of non-mining investment is still subdued, as is public spending. As a result, growth of non-mining activity overall has remained below trend. Mining activity has made a sizeable contribution to growth over the past year, as falls in mining investment have been offset by increases in resource exports. Mining investment is expected to continue subtracting substantially from growth over the next couple of years.

GDP growth is forecast to remain below trend for a bit longer than had been anticipated in the February *Statement*. GDP growth over the year to June 2016 is expected to be in the range of 2½ to 3½ per cent and 2¾ to 4¼ per cent over the year to June 2017 (Table 6.1).

Non-mining business investment is forecast to pick up later than earlier envisaged. This follows the weak reading from the ABS Capex survey of investment intentions for 2015/16 and is consistent with the still low levels of non-residential building approvals. It is also consistent with the Bank's liaison, which continues to suggest that firms are reluctant to undertake significant investment until they see a durable pick-up in the growth of demand. The forecast for an above-average pace of consumption growth from mid 2016, together with the boost to demand for domestic production provided by the exchange rate depreciation over the past couple of years, is expected, in time, to increase capacity utilisation and lead to a rise in non-mining business investment.

Mining investment is expected to fall sharply over the next two years as a number of large-scale projects are completed and few new projects are expected to start, especially given the magnitude of falls in commodity prices over the past year. The lack of a pipeline of new projects has been factored into the outlook for some time. Given this, the additional effect of recent declines in commodity prices is likely

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

	Year-ended					
	Dec 2014	June 2015	Dec 2015	June 2016	Dec 2016	June 2017
GDP growth	2.5	2	2½	2½–3½	2¾–3¾	2¾–4¼
Non-farm GDP growth	2.6	2¼	2½	2½–3½	2¾–3¾	2¾–4¼
CPI inflation ^(b)	1.7	1½	2½	2–3	2–3	2–3
Underlying inflation ^(b)	2¼	2¼	2½	1¾–2¾	1¾–2¾	1¾–2¾
	Year-average					
	2014	2014/15	2015	2015/16	2016	2016/17
GDP growth	2.7	2¼	2¼	2–3	2½–3½	2½–4

(a) Technical assumptions include A\$ at US\$0.80, TWI at 65 and Brent crude oil price at US\$70 per barrel

(b) Based on current legislation

Sources: ABS; RBA

to be modest. There have, however, been indications that some capital expenditure may be deferred and that there will be less spending on exploration activity, particularly in the oil and gas sectors. This has led to a minor downward revision to the outlook for mining investment.

The low level of interest rates and relatively strong population growth are expected to continue to support household demand. Since the February *Statement*, the outlook for dwelling investment has strengthened a little. Consumption growth is still expected to pick up gradually to an above-average pace and the saving ratio is expected to decline a little further, consistent with the forecasts presented in the February *Statement*.

Export growth is expected to continue to make a sizeable contribution to GDP growth. Liquefied natural gas exports are expected to grow strongly and contribute ¾ percentage point to GDP growth over 2016/17. However, the decline in commodity prices, particularly for iron ore, has meant that a small but increasing share of Australian production is estimated to be unprofitable. This has prompted some smaller Australian iron ore producers to reduce production, and there is potential for further announcements of this kind. The forecast for growth of bulk commodity exports over the next couple of years has been revised slightly lower as a result.

Import volumes are estimated to be lower than previously forecast, reflecting the downward revision to domestic demand. Growth of non-mining imports is expected to pick up, in line with non-mining investment in late 2016; imports related to mining activity are expected to continue falling over the next couple of years.

The latest data from the labour force survey suggest that recent trends in the labour market have been a bit better than earlier indicated. Employment has grown by more than the working-age population over the past six months. This has been accompanied by a small increase in the participation rate, while the unemployment rate has been little changed at around 6¼ per cent. Accordingly, the starting point for the labour market forecasts is slightly more favourable than had been expected. Nonetheless, the fact that output growth is likely to take longer to pick up than earlier thought means that the unemployment rate will probably rise further to peak at 6½ per cent in mid 2016 and remain elevated for longer.

A degree of spare capacity in the labour market and pressure on public and private sector employers to contain costs mean that wage growth is expected to remain subdued. It is not expected to slow further, but nor is it expected to increase much over the next couple of years. This is consistent with messages

from business liaison and surveys of firms and union officials, which suggest that wage growth is widely expected to remain slow, but generally not fall below the expected pace of inflation. These forces imply that unit labour costs will remain well contained. This will help to improve the competitiveness of Australian producers and also support labour demand.

Inflation

The inflation forecast has been revised down a little since the previous *Statement*, reflecting the weaker outlook for product and labour markets.

The decline in headline inflation over the past year can partly be explained by the temporary effects from lower automotive fuel prices and the repeal of the carbon price. Headline inflation is expected to remain below 2 per cent in year-ended terms through to mid 2015, before picking up to between 2 and 3 per cent. Measures of underlying inflation were around $\frac{1}{2}$ – $\frac{3}{4}$ per cent in the March quarter and $2\frac{1}{4}$ – $2\frac{1}{2}$ per cent over the year. Underlying inflation is expected to remain well contained over the forecast period.

Inflation in the prices of non-tradable items is expected to remain below its inflation-targeting average. Spare capacity in the labour market and the associated low growth in wages are expected to contain labour costs. Spare capacity in product markets and heightened competitive pressures are likely to constrain many firms' ability to expand margins, although strong demand for residential construction is likely to see inflation in new dwelling costs remain a little above average. Meanwhile, inflation expectations overall remain below average.

In contrast, inflation in prices for tradable items is expected to increase in the next few years. The cumulative depreciation of the exchange rate since early 2013 has led to increases in import prices, which are gradually being passed through to prices for final goods. The direct effects of the exchange rate depreciation since early 2013 are expected to add a little under $\frac{1}{2}$ percentage point to underlying inflation over each year of the forecast period.

A number of large movements in individual prices will continue to affect inflation for a time. The fall in automotive fuel prices, as a result of lower oil prices, subtracted a little under $\frac{3}{4}$ percentage point from headline inflation over the year to the March quarter 2015. Fuel prices have since increased and are expected to contribute $\frac{1}{4}$ percentage point to inflation in the June quarter. However, they remain lower than a year ago, which has reduced input costs for a range of businesses, and these lower costs may gradually be passed on to the prices these businesses charge for their goods and services. The magnitude and timing of this indirect effect is difficult to gauge. While estimates are quite uncertain, this indirect effect is expected to subtract about 0.1 percentage points per year from underlying inflation over most of the forecast period. Further increases in the tobacco excise in 2015 and 2016 are expected to contribute around $\frac{1}{4}$ percentage point each year to the rate of headline inflation, but to have little effect on underlying inflation.

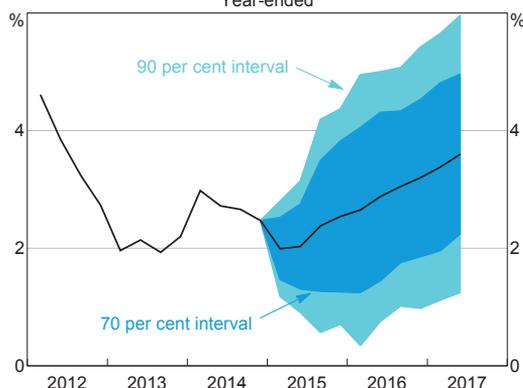
Uncertainties

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, Graph 6.4 and Graph 6.5).

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 part of the central forecast. There are always uncertainties about how events offshore will unfold, and how policymakers and financial markets will respond. One of the key sources of uncertainty for the forecasts from the global economy continues to be the outlook for the Chinese economy. Developments there also have important implications for commodity prices, particularly prices for iron ore and coal, which affect

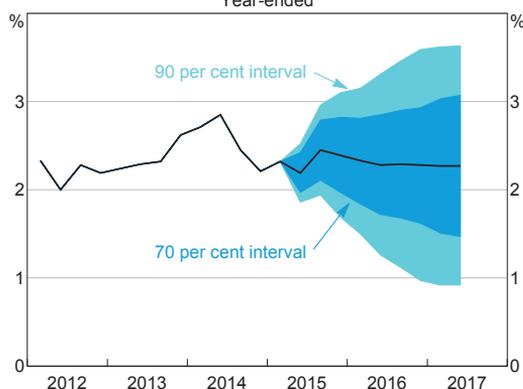
the forecast for the terms of trade and may affect the exchange rate. Domestically, key sources of uncertainty arise from: how households respond to the contrasting effects of the low growth in incomes and the effects of rising wealth from the housing market; the outlook for business investment; and the way in which the economy is adjusting to the lower terms of trade.

Graph 6.3
GDP Growth Forecast*
Year-ended



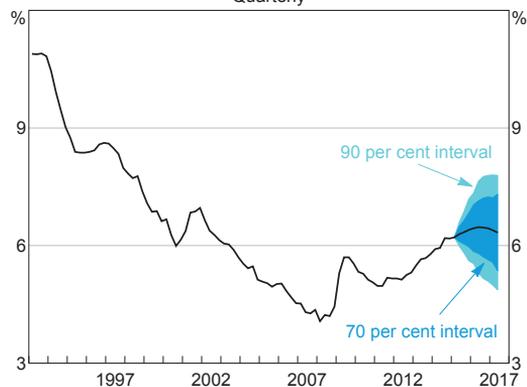
* Confidence intervals reflect RBA forecast errors since 1993
Sources: ABS; RBA

Graph 6.4
Trimmed Mean Inflation Forecast*
Year-ended



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

Graph 6.5
Unemployment Rate Forecast*
Quarterly



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

Chinese property market and local government investment

Ongoing weakness in the Chinese property market and constraints on funding for local government-led infrastructure spending continue to represent key sources of uncertainty for China's economic growth and its demand for commodities. Recently announced initiatives should provide some support for property prices and construction activity in the residential property market, although conditions in the sector (and upstream industries that supply inputs to construction) are likely to remain weak until the existing overhang of housing inventory is worked through.

With the property and manufacturing industries under pressure and growth in consumption showing tentative signs of moderating, infrastructure investment continues to be an important alternative source of growth. However, subdued conditions in the property market have the potential to weaken the revenue streams of local governments that rely heavily on land sales to raise funds. At the same time, recent reforms to local government finances, requiring greater transparency and reduced use of local government financing vehicles to issue debt,

may constrain the ability of local governments to implement planned infrastructure spending. While the central authorities have scope to loosen fiscal and monetary policies further, there is a risk that reduced capacity to fund projects at the local level will make it harder for policymakers to support growth of activity in the period ahead.

Commodity prices

The forecasts for commodity prices assume that the ongoing planned expansion to global supply will outpace demand growth over coming quarters, which is looking more subdued. Iron ore and coking coal price forecasts are particularly sensitive to the assumption that global steel demand growth will be relatively subdued over the next few years. The assumption about steel demand in China depends on the extent of the weakness in the property and manufacturing sectors and on the effectiveness of policy responses.

The forecasts assume that there will only be a limited response of the global supply of commodities to the sustained period of lower commodity prices. This assumption is partly justified by the observation that many producers of bulk commodities have been able to reduce their production costs in an effort to maintain production. However, in recent months some production cuts have occurred in China and have also been announced by higher-cost producers in Australia. This flags the possibility that there will be further cuts by some producers both domestically and globally and, all else being equal, higher commodity prices. The possibility of unexpected cuts to Australian production also represents a downside risk to the forecast for export growth.

Household sector

While recent indicators of consumption growth have been broadly consistent with previous expectations, uncertainty around consumption and saving behaviour remains. The forecasts assume a further gradual pick-up in consumption growth, which is consistent with a further gradual decline in the saving

ratio. There are downside risks to the income forecast (see below). The risks to the wealth forecast are tilted somewhat to the upside for a number of reasons. One reason is that supply constraints, particularly in Sydney, may limit the extent to which new dwelling investment can satisfy growing demand, which raises the possibility that housing prices will grow more quickly than forecast. Another reason is that growth of housing prices outside Sydney and Melbourne has been relatively subdued and may not yet have responded fully to the very low levels of interest rates.

However, in recent years, fewer households appear to have been utilising the increase in the value of their dwellings to trade up or increase their leverage for the purposes of consumption or alterations and additions to housing. It may be that although monetary policy is having its usual effects on asset prices, the effect of changes in asset prices on the growth of household expenditure is less, or at least slower, than historical relationships would suggest. This may be because households have revised down their expectations of income growth, and therefore may be less willing to carry as much debt as in the past. Similarly, they may be more concerned about the prospect of unemployment. These possibilities suggest that growth of household expenditure could be somewhat lower, and the saving ratio higher, than forecast.

Business investment

Total business investment is expected to fall over the next two years as a large decline in mining investment more than offsets a recovery in non-mining investment. Given the size of the falls in mining investment already factored into the forecasts, the assessment is that the most recent step down in commodity prices will not lead to a significant additional fall. However, the size of the fall and the impact of the declines in commodity prices remain uncertain.

The timing of the recovery in non-mining business investment has been pushed out until later in 2016 on the basis that forward-looking indicators provide

little, if any, evidence of a turning point before then. Indeed, the Capex survey implies that non-mining investment could be lower than forecast. However, many of the preconditions for a recovery in non-mining business investment are in place: borrowing rates are currently low, business credit has picked up, and the forecasts suggest that by mid 2016 domestic demand will be growing at an above-trend pace. So it is possible that non-mining business investment recovers more strongly than forecast. Given the significant uncertainty around the timing and strength of the expected pick-up in non-mining business investment growth, the risks to these forecasts are assessed to be roughly balanced.

Labour market adjustment

Since the peak of mining investment in 2012, the labour market has been adjusting to the transition from the investment to the production phase of the mining boom, the lower terms of trade and the still relatively high exchange rate. Over this period, growth in economic activity has not been sufficient to absorb all the increase in the available supply of labour and the unemployment rate has increased as a result. A key feature of this episode is that wage growth has slowed by more than would have been

expected on the basis of historical relationships. This may indicate that the labour market is more flexible than it was in the past. Lower wage growth could also be a part of the process of unwinding the relatively strong growth in Australian unit labour costs and the sustained appreciation of the Australian dollar that took place during the mining investment boom. A further depreciation of the real exchange rate, either through a depreciation of the nominal exchange rate or relatively low growth of unit labour costs, would assist with the adjustment process already under way.

The current forecasts assume that the unemployment rate will continue to increase gradually as long as the economy is growing at a below-trend pace, and that wage growth will remain low, but not slow any further. However, recent revisions to labour force data suggest that the unemployment rate has remained stable since mid last year, despite below-trend growth (as implied by GDP estimates). It is possible that employment will continue to grow fast enough to maintain a steady unemployment rate, but given the forecasts for below-trend output growth in the near term, this could probably only be achieved with ongoing moderation in wage growth. ✖

