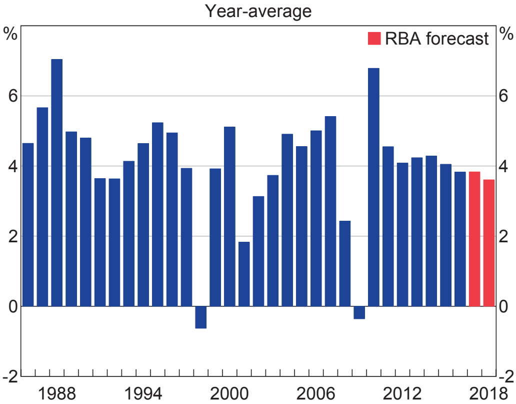
6. Economic Outlook

The International Economy

Growth of Australia's major trading partners in 2016 was higher than forecast. Growth forecasts for 2017 and 2018 have been revised a little higher (Graph 6.1). These upward revisions reflect the recent better data and incorporate the prospect of more stimulatory fiscal policy in the United States. Major trading partner growth is now forecast to be little changed in 2017 and to ease only slightly in 2018. Near-term growth in China is expected to be supported by the authorities' actions in the lead-up to the 19th National Congress of the Chinese Communist Party in the second half of 2017. Further out in the forecast period, growth in China is expected to slow and more than offset stronger growth in the advanced economies. Growth in the east Asian economies (other than China and Japan) is expected to pick up to be around potential as external demand conditions recover and accommodative monetary and fiscal policies provide support.

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



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

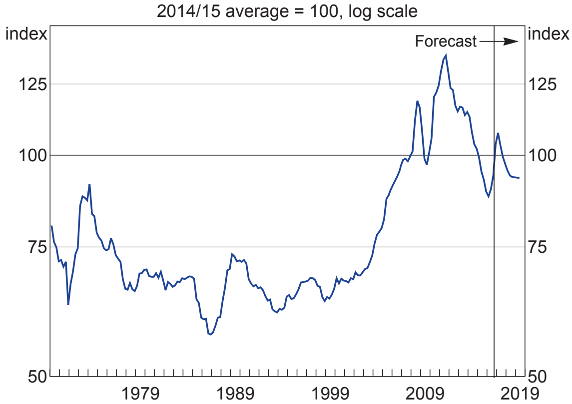
GDP growth in the major advanced economies is likely to remain above potential over the next couple of years because monetary policies are expected to remain accommodative and US fiscal policy is expected to become expansionary. Potential growth rates in these economies are lower than their long-term average growth rates due to lower growth in the working-age population, capital stock and productivity. In some cases, lower growth in the capital stock and productivity reflect the lingering effects of the global financial crisis on investment.

While considerable uncertainty remains about the economic policies of the new US administration, reductions in personal and corporate taxes are likely. These fiscal policy changes could be expected to boost growth in the United States at a time when there is limited spare capacity in the US labour market. This is expected to increase inflationary pressures and could have spillovers to higher growth and inflation in other economies. However, there is a rising risk that more restrictive and protectionist trade and immigration policies under the new administration could harm global growth prospects.

The increase in the prices of oil and other commodities in 2016 has contributed to a pick-up in global headline inflation. Although wage pressures have generally remained subdued so far, they are expected to pick up as spare capacity in labour and product markets continues to decline in the major advanced economies. The amount of spare capacity in these economies is a source of uncertainty. For example, inflation could rise more quickly than currently forecast and could lead to tighter monetary policy in some advanced economies and a depreciation of the Australian dollar.

Higher commodity prices also boosted Australia's terms of trade in the December quarter (Graph 6.2). Higher prices for bulk commodities and base metals have reflected a range of factors including domestic supply disruptions, higher-than-expected Chinese steel production and cuts to the production of bulk commodities in China. More recently, spot prices of coking and thermal coal have declined. The terms of trade are expected to decline gradually over 2017, but are expected to remain above their recent trough and be higher than previously forecast.

Graph 6.2
Terms of Trade
2014/15 average = 100, log scale



Sources: ABS; RBA

Domestic Activity

The domestic forecasts are conditioned on a number of technical assumptions. The cash rate is assumed to move broadly in line with market pricing. This assumption does not represent a commitment by the Reserve Bank Board to any particular path for policy. The exchange rate is assumed to remain at its current level over the forecast period (trade-weighted index (TWI) at 66 and A$1=US$0.76). The TWI is 2 per cent higher than the assumption underlying the forecasts in the November *Statement*. The forecasts are also based on the price of Brent crude oil being US$56 per barrel over the forecast period, which is 13 per cent higher than the assumption used in November and in line with futures pricing in the near term. The population aged over 15 years is still assumed to grow by 1.5 per cent over 2016/17 and by 1.6 per cent over 2017/18 and 2018/19, drawing on forecasts from the Department of Immigration and Border Protection.

As a starting point for the forecasts, GDP fell in the September quarter, which led to a marked decline in year-ended growth of the Australian economy. Some of the factors weighing on reported GDP growth in the September quarter were temporary and have not materially affected the outlook for growth. In contrast, non-mining business investment has been fairly subdued for some time and household consumption lost some momentum in mid 2016, consistent with low growth in household income.

Overall, the forecasts for year-ended GDP growth are lower over the next three quarters than those presented in the November *Statement*, almost entirely due to the base effect of the weak September quarter (Table 6.1). The profile for consumption growth has been revised a little lower over the forecast period reflecting a view that consumption growth is unlikely to run materially ahead of household income growth over this period. This implies that the saving ratio will be relatively stable, rather than continuing to decline, as previously assumed. The effect of the adjustment of the consumption growth profile on aggregate GDP growth is partly mitigated by an offsetting, and related, downward adjustment to the forecasts for import growth. Overall,

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

	Year-ended					
	Dec 2016	Jun 2017	Dec 2017	Jun 2018	Dec 2018	Jun 2019
GDP growth	2	1½–2½	2½–3½	2½–3½	2¾–3¾	2¾–3¾
Unemployment rate[(b)]	5.8	5¾	5–6	5–6	5–6	5–6
CPI inflation	1.5	2	1½–2½	1½–2½	1½–2½	2–3
Underlying inflation	1.6	1¾	1½–2½	1½–2½	1½–2½	2–3
	Year-average					
	2016	2016/17	2017	2017/18	2018	2018/19
GDP growth	2¼	1½–2½	2–3	2½–3½	2½–3½	2¾–3¾

(a) Technical assumptions include A$ at US$0.76, TWI at 66 and Brent crude oil price at US$56 per barrel; shaded regions are historical data
(b) Rate at end of period
Sources: ABS; RBA

year-ended GDP growth is forecast to pick up as the drag from mining investment and effects from the earlier fall in the terms of trade dissipate. GDP growth is forecast to increase to 2½–3½ per cent in late 2017, and to be above potential for most of the forecast period.

Some of the factors that led to the slowing of non-mining activity over the year to September were temporary. For instance, the fall in residential construction activity in the September quarter reflected bad weather. The large pipeline of work yet to be done, particularly in apartment building, is still expected to support further growth in dwelling investment over 2017. Public demand also declined in the September quarter, but this series is volatile. Public demand is expected to grow solidly over the forecast period, consistent with state and federal government budgets, which together imply ongoing growth in public investment.

Household consumption growth lost some momentum in mid 2016. This slowdown brings year-ended growth more into line with the subdued growth in household disposable income and suggests that households have become less willing to reduce their rate of saving to support consumption, despite low interest rates and increases in household wealth. Given the stronger tone of more recent indicators, consumption growth is expected to be a little stronger than in mid 2016 over the forecast period.

Non-mining business investment has been weak for some time, despite the support provided by low interest rates and the earlier depreciation of the exchange rate. The outlook for non-mining business investment is relatively subdued in the near term, consistent with the Australian Bureau of Statistics (ABS) capital expenditure survey of firms' investment intentions and the recent downturn in non-residential building work yet to be done. Non-mining business investment is still expected to pick up later in the forecast period and there are a number of positive indicators that support this projection. Non-residential building approvals increased over 2016 and non-mining business investment has been growing in New South Wales and Victoria, which have been less affected by the end of the mining investment boom. Moreover, survey measures of capacity utilisation have been increasing over the past couple of years and are currently above their long-term averages.

Much of the weakness in mining activity in the September quarter was the result of temporary factors and mining activity is expected to contribute to growth over the forecast period. The fall in resource exports in the September quarter was partly the result of temporary disruptions to coking coal production. In the medium term, the assessment of the production capacity of the resource sector is little changed and therefore the forecasts for the volume of exports are also little changed. Liquefied natural gas (LNG) exports are expected to continue growing strongly for some time. More broadly, exports of Australian goods and services in aggregate are forecast to continue growing at a solid pace.

Recent high prices for bulk commodities are not expected to lead to a material increase in production capacity, partly because prices are expected to decline over the forecast period. Mining investment is still expected to fall further over the forecast period, as large resource-related projects are completed and few new projects are expected to commence. However, the largest subtraction of mining investment (net of imports) from GDP growth has already occurred.

Lower GDP growth in mid 2016 is consistent with the loss in momentum in the labour market outcomes observed over 2016. Leading indicators such as job advertisements and job vacancies point to some pick-up in employment growth over the first half of 2017. Employment growth is then expected to remain broadly steady over the next couple of years, which is slightly lower than forecast at the time of the November *Statement*. This forecast takes into account the expectation that LNG production, which is less labour intensive than the investment phase of the mining boom, will make a contribution of around ½ percentage point to year-ended GDP growth over each of the next few years. The unemployment rate is expected to edge lower over the forecast period, suggesting only a modest reduction in the degree of spare capacity in the labour market from current levels. The participation rate, which is influenced by both structural and cyclical factors, is assumed to remain around its current level.

There has been a small downward revision to the forecasts for various measures of wage and household income growth over the next few quarters following the slightly weaker-than-expected outcomes for wage growth in the September quarter. As a result, the pick-up in wage growth has been pushed out a little and is consistent with information from liaison that firms expect little change in wage growth over the next year. The forecast gradual recovery in wage growth from late 2017 assumes that some of the factors that have been weighing on wages will gradually dissipate. For example, the significant decline in wage growth in resource-rich states and mining-related industries is expected to fade as the economy rebalances towards other activities. Firms' and employees' near-term inflation expectations are not expected to fall any further. However, ongoing spare capacity in the labour market is expected to limit the recovery in wage growth.

Inflation

The December quarter underlying inflation outcome was broadly in line with expectations. As a result, there has been very little change to the outlook for inflation since the November *Statement*. Measures of underlying inflation are forecast to pick up gradually, to be around 1½–2½ per cent by the end of 2017 and 2–3 per cent by the end of the forecast period. Headline inflation is expected to increase to around 2 per cent in early 2017, reflecting higher oil and tobacco prices. Headline inflation is then expected to be 2–3 per cent by the end of the forecast period.

As noted above, measures of labour costs are expected to pick up gradually over the next few years. Productivity is expected to grow more slowly than average earnings, although there is uncertainty around this, and unit labour costs are expected to rise gradually, having been flat for a number of years. This is expected to feed through to non-tradables inflation, which appears to have stabilised recently. Excess capacity in the economy is expected to diminish somewhat as low interest rates continue to support activity in the non-mining sector. However, it is likely that spare capacity in the labour market will continue to weigh on wage and inflationary pressures over the coming years.

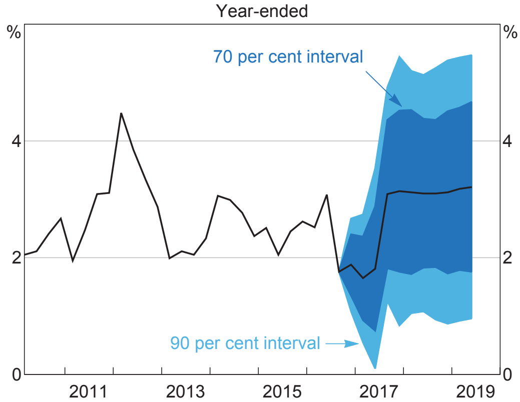
At the component level, there are a number of competing influences. Higher commodity prices, in particular for oil, are expected to contribute to inflationary pressures in the period ahead, and the legislated rise in the tobacco excise is expected to add to headline inflation in 2017 and 2018. The disinflationary effects on final retail prices from heightened retail competition and low wage pressures are expected to dissipate slowly, although there is uncertainty about the size and timing of these effects. Large additions to housing supply are expected to keep rent inflation low over the next few years.

Key Uncertainties

The forecasts are based on a range of assumptions about the evolution of some variables, such as the exchange rate and the cash 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; Graph 6.5).

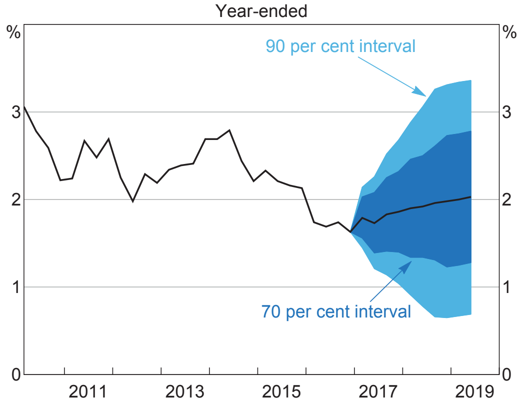
It is also worth considering the consequences that different assumptions and judgements might have for the forecasts and the possibility of events occurring that are not part of the central forecast. As has been the case for some time, a range of geopolitical and global financial stability risks could affect global growth and financial market prices, should they materialise. Recent policy announcements by the new US administration illustrate some of the uncertainties that have not been incorporated into the central forecasts for global growth. The outlook for the Chinese economy also remains a key source of uncertainty for the

Graph 6.3
GDP Growth Forecast*
Year-ended



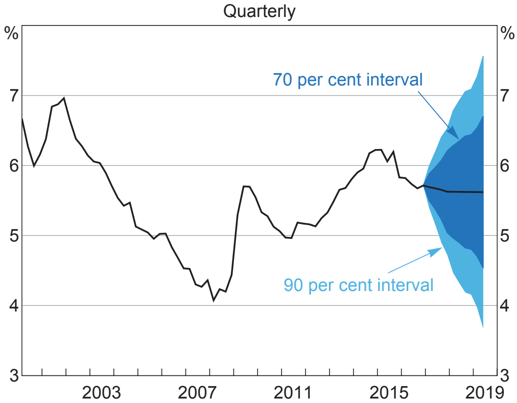
* Confidence intervals reflect RBA forecast errors since 1993
Sources: ABS; RBA

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

outlook for global growth and commodity prices. Domestically, there are various sources of uncertainty that present risks to the outlook for activity and inflation. There is uncertainty about the current momentum in the labour market and how this will translate into growth in wages, household income and consumption. There is also uncertainty about how quickly domestic cost pressures might build and feed into higher inflation.

The Chinese economy

Recent data indicate that Chinese growth has been supported by significant policy stimulus and this has led to a stronger outlook for the Chinese economy in the near term. One sector of the economy where policy has had a particularly noticeable impact is the housing market. Stronger-than-expected activity in the housing market has supported demand for steel, and the near-term forecasts for iron ore and coking coal prices are predicated on a profile for Chinese steel production that is higher than previously anticipated. Steel production is still forecast to decline gradually because the Chinese authorities have introduced a range of measures that are expected to dampen residential investment; there are already signs that these measures are having an effect on housing market activity in some cities.

There are a number of other downside risks to the outlook for Chinese growth and commodity demand. The recent policy stimulus has added to already high levels of debt. Combined with significant excess capacity in some sectors, this increases the potential for financial dislocation and economic disruption in the future. The authorities' desire to contain capital outflows and stabilise the renminbi exchange rate could require tempering the degree of monetary accommodation, which could also lead to lower growth in the future.

Commodity prices, Australia's terms of trade and global inflation

The recent strength in commodity prices has contributed to some increase in global inflationary pressures and raised the outlook for Australia's terms of trade. There is considerable uncertainty about how demand- and supply-side factors will affect commodity prices over the forecast period. On the demand side, there is uncertainty about the impact housing market policies in China will have on the demand for steel. On the supply side of commodity markets, it is not clear whether the Chinese authorities will continue to enforce policies that have contributed to lower Chinese production of iron ore and coal, particularly given the elevated levels of bulk commodity prices.

Higher commodity prices, particularly for oil, the prospect of expansionary US fiscal policy and above-average growth in unit labour costs in some major advanced economies are likely to contribute further to global inflation pressures, with potential flow-on effects to Australian prices. Higher global inflation could also affect the path of foreign central bank monetary policies. This, in turn, could affect financial market prices, particularly exchange rates, which are assumed to be constant in the forecasts. Higher commodity prices and a tightening of monetary policy in major advanced economies have an uncertain net effect on the Australian dollar exchange rate.

The effects of the higher terms of trade on the domestic economy and inflation are uncertain and will depend on how long commodity prices remain elevated and how the revenue from higher export sales is distributed. The forecasts assume the current strength in commodity prices will be largely unwound. As such, the higher terms of trade are not expected to lead to a material change in mining investment, wages or household consumption. However, the current strength in the terms of trade has already been larger and more persistent than had been anticipated and is expected to provide a significant boost to national income over the forecast period. Although it is difficult to pinpoint how this will flow through, it constitutes an upside risk to domestic demand growth and inflation.

Momentum in the labour market

Domestic activity is forecast to grow at a pace that implies only a modest reduction in the unemployment rate over the next few years, particularly after taking into account the low labour intensity of LNG production. In the near term, leading labour market indicators point to a small increase in the pace of labour demand growth. Further reductions in the unemployment rate could occur if upside risks to growth in the Australian economy are realised, particularly if the recent increase in the terms of trade has a greater flow-on effect to economic activity than currently expected or if LNG-related activity is more labour intensive than expected. However, it is possible that some of the expected increase in labour demand could be accommodated by providing part-time workers with additional hours rather than hiring new workers (that is, increasing total hours without a reduction in the unemployment rate).

The forecasts for employment and unemployment over the next few years also imply a fairly steady participation rate, but there is uncertainty around the cyclical and structural factors driving this. The downward trend in the participation rate over the past year or so has been driven by lower participation in resource-rich states and by younger people. It is possible that as the adjustment to the end of the mining investment boom is completed, the expected improvement in labour demand could be met by people rejoining the labour force, in which case the unemployment rate could rise. The usual uncertainty around the projections for net migration to Australia continue to have important implications for labour supply and hence potential output estimates, as well as the outlook for consumption growth, residential construction and rents.

Consumption, saving and housing

Household consumption growth has been supported by low interest rates and gains in household wealth. Income growth has been more subdued, however, and the household saving ratio has declined over recent years. Although it seems unlikely that wage (and thus household income) growth will slow further, there has yet to be clear evidence that wage pressures are increasing. The forecast for consumption growth has been adjusted lower and implies a stable saving ratio over the forecast period, rather than declining, as previously assumed. The risks around the forecasts are now more balanced but there is significant uncertainty about households' consumption and saving decisions.

Households' views about the outlook for the growth of their income and wealth are relevant for the consumption growth forecast, as are any liquidity or credit constraints that households might face and their expectations about interest rates. If households believe that their prospects for future income growth have weakened, particularly for those households servicing sizeable debts, then they could choose to save more in the near term and consumption growth could be lower than forecast. However, if households become more confident about their future employment, income or wealth, they could choose to save less in the near term to support higher consumption growth. Similarly, if actual income or wealth grows faster than forecast, this could also flow through to higher growth in consumption.

Housing prices have picked up over the second half of 2016, most notably in Sydney and Melbourne. This could see more spending and renovation activity than is currently envisaged. On the other hand, a widespread downturn in the housing market could mean that a more significant share of projects currently in the residential construction pipeline is not completed than is currently assumed. While this is a low-probability downside risk, it could be triggered by a range of different factors. Low rental yields and slow growth in rents could refocus property investors' attention on the possibility of oversupply in some regions. Although investor activity is currently quite strong, at least in Sydney and Melbourne, history shows that sentiment can turn quickly, especially if prices start to fall. Softer underlying demand for housing, for example because of a slowing in population growth or heightened concerns about household indebtedness, could also possibly prompt such a reassessment.

Domestic cost pressures

There is uncertainty around the timing and extent of the forecast pick-up in inflation over the next couple of years. The recent labour cost growth outcomes were slightly weaker than expected and could suggest that structural forces, such as global competitive pressures and technological advances, are putting downward pressure on wage growth. The forecasts assume that some of these factors gradually dissipate, but these factors may be more persistent. On the other hand, wage growth may pick up more quickly than currently forecast in response to an improvement in labour market conditions, particularly if employees demand wage increases to compensate for the period of low wage growth over recent years. It may also be the case that some of the more recent pick-up in the terms of trade and nominal income could result in higher wage growth in mining-related industries. Rising global inflationary pressures may also have more significant flow-on effects to domestic inflation than has been factored into the forecasts. The path of inflation over the next few years will also depend on whether heightened competitive pressures in the retail sector persist and on the path of the exchange rate, noting that the forecasts assume that the exchange rate is unchanged at current levels.