

Statement on Monetary Policy

FEBRUARY 2020



RESERVE BANK OF AUSTRALIA

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Overview

Monetary policy was eased in 2019 to support employment and income growth and to provide greater confidence that inflation will be consistent with the medium-term target. This policy response is supporting the overall growth outlook through a number of channels. The Australian dollar is lower than it otherwise would be as a result of the policy easing; it is now around the bottom of its range in recent years. Interest rates faced by both borrowers and lenders are now at very low levels. The lower interest rates have contributed to increased demand for both new and existing homes. They also lower required debt payments for many households. The resulting extra cash flows can be spent or used to pay down debt faster, although this benefit is partly offset by reduced interest income for savers. The effects of the recent rate reductions take time to work their way through the economy and have their full impact on spending. Some of the early stage channels of policy transmission, such as new borrowing, higher asset prices and a depreciation of the exchange rate, are nonetheless proceeding as normal.

The low level of interest rates in Australia reflect the low interest rates globally as well as the only gradual progress towards the Bank's goals, as the Australian economy navigates a period of slow growth. This soft patch in growth is likely to extend into early 2020 because of the ongoing drought, the effects of the bushfires, and the effects on Australian exports of the recent outbreak of a new coronavirus in China. Beyond these shorter-term effects, the medium-term

outlook for the Australian economy is broadly unchanged from three months ago.

GDP growth is expected to improve over the course of this year and next. Growth is expected to be 2¾ per cent over 2020 and around 3 per cent over 2021. This is a step up from the growth rates recorded over the previous two years. Part of this recovery reflects the expected transmission of the low level of interest rates to the housing market and household spending. A turnaround in mining investment is also expected, consistent with the publicly announced investment plans of firms in that sector. The recovery effort following the bushfires is likely to reverse the negative near-term economic effects of the fires on aggregate activity, but drought conditions are likely to continue to weigh on rural production and exports for a while yet.

The transmission of monetary policy is evident in established housing markets. Housing prices have turned around noticeably, especially in Sydney and Melbourne. Housing turnover, which is an important driver of some types of household spending, has increased, as has new borrowing, particularly by owner-occupiers. It is too soon to see any response to this in household spending, but over time the drag on consumption growth from the earlier decline in housing prices and activity should wane. That said, at this stage it cannot be ruled out that the sharp fall in housing prices has reduced the level of debt that households feel comfortable carrying, even after housing prices recover. So the effect of the cycle in housing prices on

spending might last longer than historical experience implies. The forecast for consumption takes some account of this.

A recovery in dwelling investment is likely to occur towards the end of this year in response to lower interest rates as well as the strong growth in established housing prices and population growth. Early indicators of demand and sales are already showing signs of turning around, which gives more confidence that the recovery will proceed as expected.

A key consideration for monetary policy remains the outlook for consumption. In the September quarter, consumption growth was weaker than earlier expected, and it is likely to remain subdued in the December quarter. Recent data have been consistent with households gradually adjusting their spending to the slower trend rate of income growth and it appears that adjustment may have accelerated in response to the prior period of falling housing prices. Consistent with this, there was also an increase in mortgage payments over the second half of last year. Tax cuts and interest rate reductions helped support income in the September quarter, although consumption remained subdued in the face of this balance sheet adjustment.

Consumption growth is expected to recover gradually over the course of this year and next. The low level of interest rates, a somewhat faster rate of income growth than in recent years and the recovery in household wealth are all expected to contribute to this turnaround. Lower rates have been assisting with the ongoing adjustment in household balance sheets by reducing debt-servicing costs. The Board took note that some survey measures of confidence about the future had declined, although measures of current business conditions and households' views about their finances, which tend to be more indicative of economic decisions, remain around average. The Board therefore assessed that the decline in

confidence was most likely to be a reaction to the same developments that prompted recent policy easing, rather than to the rate reductions themselves. That said, the consumption outlook remains uncertain and its evolution will continue to be an important focus of the Board.

In line with the expected pick-up in GDP growth, employment growth is expected to increase over time, after having eased a little lately. As this occurs, the unemployment rate should also come down. The unemployment rate declined slightly through the December quarter, to be 5.1 per cent in the month of December. It is expected to remain in the 5–5¼ per cent range for some time before declining to around 4¾ per cent in 2021. The central forecast does not envisage a repeat of the recent unusually strong increase in labour force participation, but this cannot be ruled out if employment growth turns out to be stronger than expected.

Wages growth has been low and steady for some time, in line with the spare capacity still in the labour market, as well as the constraints implied by the wages policies of various governments. As the unemployment rate declines and the labour market tightens, some limited upward pressure on wage outcomes can be expected.

Inflation remains low and stable. The recent inflation data were in line with our expectations and confirmed a modest lift in CPI inflation over recent quarters to 1.8 per cent. Trimmed mean inflation was a little lower at 1.6 per cent. Both measures are forecast to increase gradually to 2 per cent over the next couple of years. The outlook for inflation in part rests on the expectation that the drag coming from housing-related inflation will dissipate as the housing market recovers following the easing in monetary policy. Early signs of this are evident in reduced discounting of the prices of newly built houses in the December quarter. Retail price inflation has generally been subdued, but the

drought has been putting upward pressure on the prices of an increasing range of food items. The outlook for the Australian economy has in part been shaped by the evolving global outlook. The global economy has clearly suffered over the past year from the uncertainty and interruption to international trade caused by the US–China trade and technology disputes. Towards the end of 2019 and early 2020, indications were that global growth was poised to improve. The phase one partial trade deal between the United States and China has reduced the tensions between the two countries. This has alleviated but not eliminated an important source of uncertainty around the global outlook. It has also contributed to the accommodative financial conditions.

The outbreak of the coronavirus and the efforts of authorities in China and elsewhere to contain its spread represents a new source of uncertainty. This will reduce Chinese and global growth in the short term. With the situation still evolving, it is very uncertain how much growth will slow or for how long. Previous outbreaks of new viruses have had significant, but short-lived, negative effects on economic growth in the economies at the centre of the outbreak. It is difficult to know how representative these earlier episodes could be. The economic impact will depend crucially on the duration of its impact and measures taken to contain the spread of the virus.

The forecasts imply progress towards the inflation target and full employment, but that progress is expected to be only gradual. To maintain this progress, monetary policy is very likely to remain accommodative for some time. Given the only gradual nature of the progress, the Board has been discussing the case for a further easing of monetary policy in order to speed the pace of progress and to make it more assured in the face of ongoing uncertainties.

In considering this case, the Board has taken account of the fact that interest rates have already been reduced to a low level and there are long and variable lags in the transmission of monetary policy. The Board also recognises that a balance needs to be struck between the benefits of lower interest rates and the risks associated with having interest rates at very low levels. Internationally, there are increasing concerns about the effect of very low interest rates on resource allocation in the economy and their effect on the confidence of some people. Lower interest rates could also encourage more borrowing by households eager to buy residential property at a time when housing debt is already quite high and there is already a strong upswing in housing prices in place. If so, this could increase the risk of problems down the track.

After considering this balance, the Board decided to maintain the cash rate unchanged at its recent meetings. It recognises, though, that the balance between benefits and risks can change over time and it is dependent upon the state of the economy. If the unemployment rate were to be moving materially higher and there was no further progress being made towards the inflation target, the balance of arguments would tilt towards a further easing of monetary policy. The Board will continue to monitor developments carefully, including in the labour market. ✎

1. The International Environment

The global outlook remains reasonable but uncertain. In January, the United States and China signed a partial trade agreement thereby de-escalating their dispute over trade and technology. This has reduced, but not eliminated, a key downside risk to global growth and, together with some more positive signs in global economic data, supported forecasts for a pick-up in global growth in 2020 and 2021. More recently, however, the outbreak of a new strain of coronavirus is expected to weigh on near-term growth and has created a new uncertainty for the outlook.

Developments in global financial markets over recent months have reflected evolving perceptions of these key risks. Overall though, global financial market conditions remain supportive of economic growth. Following a period in 2019 of monetary easing, central banks in advanced economies have indicated that their current policy settings are likely to remain appropriate for some time, though they remain prepared to ease further if necessary. Long-term government bond yields had risen as concerns about key downside risks eased, but have since declined noticeably and are back at very low levels. Corporate financing conditions have generally remained favourable; credit spreads are at low levels and equity prices have generally risen further over the past couple of months, notwithstanding recent declines.

US–China trade and technology tensions have eased which is supportive of global growth ...

Since October there have been some positive developments on the US–China trade and technology disputes. Threatened tariff increases in October and December 2019 were cancelled as the United States and China negotiated the limited phase one trade agreement signed in January. The agreement provides for a small reduction in overall tariffs, increased Chinese purchases of US products and some steps to address US concerns about market access and the protection of intellectual property. Despite the agreement, tariffs between the two countries remain around the highest they have been in about 30 years after they were increased to nearly 20 per cent in 2018 and 2019.

There have also been signs of stabilisation in global manufacturing and trade since late 2019 (Graph 1.1). However, most of these indicators remain at subdued levels, as do business investment intentions. Spillovers from the weakness in conditions for export-oriented sectors have been limited so far partly because of support from stimulatory policy. Consumption growth has generally remained resilient through the past year. Employment growth has slowed a little in the major advanced economies but labour markets remain tight. Despite that, inflation remains low and below most central banks' targets.

The easing in trade tensions between the United States and China, and signs of stabilisation in a number of economic indicators, led to small

improvements in the underlying growth outlook for a number of economies. Forecasts released by the International Monetary Fund in mid January showed global growth picking up in 2020 and 2021, led by emerging market and developing economies.

... but the coronavirus outbreak has lowered the near-term growth outlook and increased uncertainty

The recent outbreak of a new strain of coronavirus has lowered the near-term growth outlook for China and some other economies, particularly in Asia. In China, economic effects include lower domestic travel and other consumption, and disruption to the movement of goods. Also, business shutdowns will negatively affect industrial production and services. The effects of the outbreak are likely to flow through to other economies, particularly in east Asia, including via sharply lower Chinese outbound tourism, weaker Chinese demand for other exports and disruption to global supply chains. As China and east Asia are large trading partners for Australia, overall growth in Australia's major trading partners is expected to be a little lower in 2020 before picking up in 2021 (Graph 1.2).

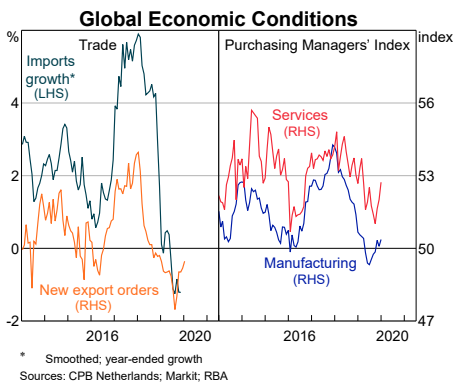
There is considerable uncertainty regarding the duration and severity of the coronavirus

outbreak. If it persists for an extended period, the effect on economic activity is likely to be larger than currently projected. The outlook for China, and how policy responses there could affect China's demand for Australia's exports and the exports of Australia's other key trading partners in Asia, remains an important consideration for the Australian economy.

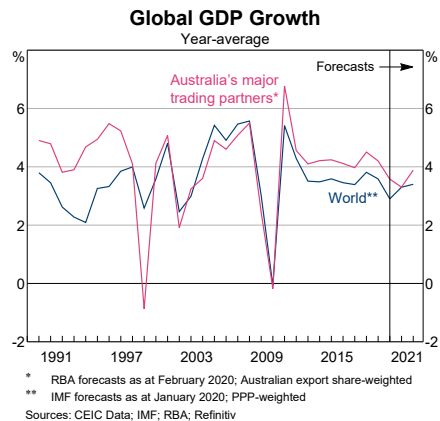
A number of other downside risks remain. Despite the recent positive developments in US–China negotiations, an escalation in the dispute remains a key downside risk to the outlook given the limited nature of the phase one deal and the potential for renewed tensions to weigh on trade and investment.

Considerable uncertainty also remains for other trade arrangements. The United States postponed a decision on possible actions affecting automotive imports from the European Union. The trade dispute between Japan and South Korea has raised uncertainty about supply in the South Korean semiconductor industry and reduced tourism flows between the two countries. The United Kingdom formally exited the European Union in January under a short transition arrangement, reducing the prospects of a disorderly near-term breakdown of the UK–EU trading relationship, although the ultimate form of the trading relationship remains

Graph 1.1



Graph 1.2



uncertain. The future functioning of the World Trade Organization is also unclear. By contrast, lingering uncertainty about the United States, Mexico and Canada trade agreement was alleviated when it was passed by the US Congress in January.

In China, growth appeared to stabilise in late 2019

In China, GDP growth slowed in 2019, to 6.1 per cent compared with 6.7 per cent in 2018. The slowdown was driven by domestic demand, and was mostly the result of longer-term structural factors and ongoing actions to reduce risks in the financial sector. Uncertainty associated with the US–China trade and technology dispute is also likely to have affected investment decisions, and growth in retail sales has been easing.

Over the course of the December quarter, however, a range of indicators of Chinese activity recovered somewhat (Graph 1.3 and Graph 1.4). This suggested that targeted fiscal and monetary easing were helping to stabilise economic conditions. Growth in fixed asset investment strengthened, driven by a pick-up in investment in the manufacturing sector. Industrial sector indicators also showed some signs of improvement in the December quarter. Growth in industrial production picked up, particularly for the output of construction materials such as steel and plate glass. Car production also increased modestly after declining over the past couple of years, and producer prices stopped declining as the deflationary effect of falling raw materials and manufactured goods prices began to abate. The January trade agreement with the United States should have alleviated some of the uncertainty affecting investment, and local governments are also in a position to rekindle infrastructure investment growth now that preliminary bond issuance quotas have been released. However, the coronavirus outbreak

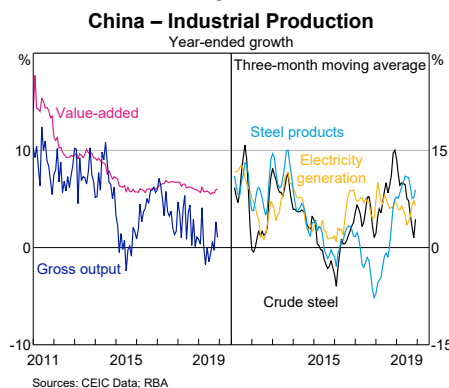
creates a new uncertainty. At this stage, growth is expected to decrease significantly in the March quarter before rebounding later in the year, although the situation is very dynamic and the timing over Chinese New Year will make the economic impact especially difficult to read.

Conditions in Chinese property markets remained mixed in the December quarter (Graph 1.5). Property prices continued to rise, although the pace of price growth has been moderating for some time. Sales declined in the quarter, while spending on construction and fittings remained robust. Local governments continued to tailor housing policies to account for local conditions, with restrictions eased in some areas to offset weak conditions.

Graph 1.3



Graph 1.4



Core consumer price inflation continued its gentle downward trend and was 1.4 per cent in December (Graph 1.6). Headline inflation increased sharply as pork supply shortages caused by the outbreak of African swine fever drove large increases in pork prices and other meat products. Pork prices have declined a little from their peak in December, reflecting signs that pork production is beginning to recover, but prices are expected to remain elevated for some time.

Chinese authorities have announced further targeted policy easing

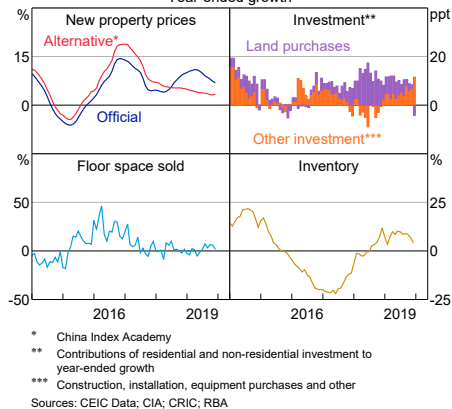
Chinese policymakers have continued to balance their objectives of supporting economic growth and reducing risks in the financial system. Fiscal and monetary policy measures have been modest overall and generally focused on specific areas of weakness in the economy – namely, public infrastructure spending and access to finance for small and private sector firms. More recently, the authorities have announced some measures to support liquidity and bank lending in the near term to alleviate disruptions related to the coronavirus. It remains unclear at this stage whether additional support will be needed in response to the virus.

To support infrastructure spending, local governments were given a preliminary allocation of their 2020 special bond issuance quota so that they could plan for, fund, and begin work on eligible infrastructure projects before the final quota is set at the National People’s Congress in March. The preliminary allocation of CNY 1 trillion was around 25 per cent higher than the equivalent allocation granted in 2019 and local governments have responded by issuing these bonds earlier than in previous years (Graph 1.7). The authorities also reduced the amount of equity capital required for some infrastructure projects including for ports, roads, rail, logistics and ecological protection.

The People’s Bank of China (PBC) reduced the reserve requirement ratio by 50 basis points for all financial institutions in January (Graph 1.8). In part, this was aimed at ensuring sufficient liquidity ahead of Chinese New Year. In late 2019, the PBC also marginally reduced the interest rates on its short-term and medium-term lending operations. Subsequently, the one-year Loan Prime Rate (LPR), the new reference rate for non-mortgage lending by Chinese banks, declined by 5 basis points. In addition, authorities implemented further measures to

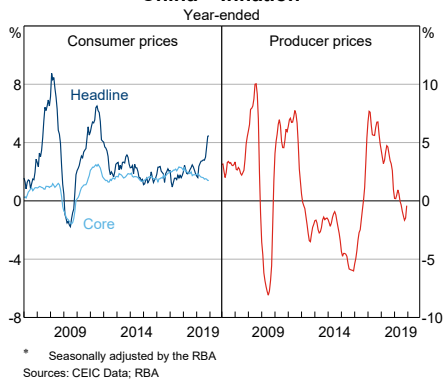
Graph 1.5

China – Residential Property Indicators



Graph 1.6

China – Inflation*



support financing conditions for micro and small enterprises (MSEs). In particular, the State Council called upon banks to lower financing costs for some MSEs by 50 basis points and instructed the five largest commercial state-owned banks to increase the value of loans extended to MSEs by 20 per cent over the next year. Growth in total social financing (excluding government bond issuance) has remained stable in year-ended terms but declined in the December quarter because off-balance sheet financing contracted more quickly than earlier in the year. More recently, authorities announced a range of measures to avoid a tightening in financial conditions as a result of the coronavirus outbreak. In particular, the PBC has pledged to maintain adequate liquidity in the system and has encouraged banks to reduce lending rates to assist firms affected by the outbreak.

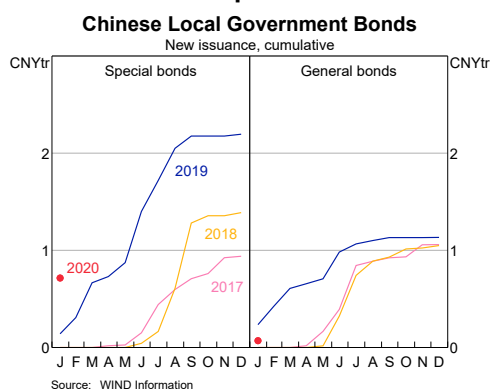
As part of ongoing efforts by the Chinese authorities to improve the transmission of monetary policy and the transition towards market-based pricing of financial products, the PBC announced the next stage of its lending rate reform in late 2019. The PBC instructed banks to begin shifting the outstanding stock of loans to reference the LPR from March 2020, and it expects this transition to be complete by the end of August. Banks were also instructed to cease issuing new loans that referenced the old benchmark rate from 1 January 2020, although

most new loans issued had already been referencing the LPR. The LPR is linked to the rate offered by the PBC on its medium-term lending facility (MLF), so interest rate changes by the PBC will directly affect lending rates. However, to avoid overstimulating the housing market, authorities have stated that mortgage rates must remain unchanged at the time of conversion and that the repricing period must be at least one year. This means that mortgage rates will not change until at least 2021, even if the PBC reduces the MLF rate.

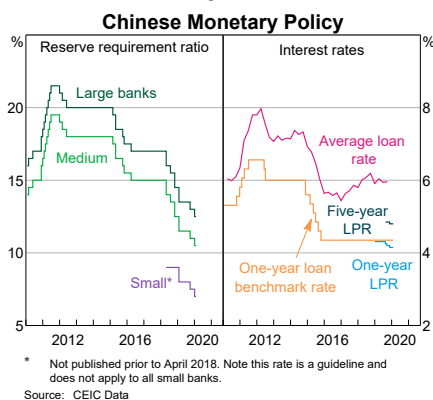
Growth in east Asia also appeared to stabilise in late 2019

Growth indicators in east Asia stabilised in late 2019 following a period when weak external demand, particularly from China, and the effects of the US–China trade dispute on global supply chains had weighed on growth. The levelling out in activity indicators in the region is consistent with more favourable trade developments evident since October 2019. After a period of decline, industrial production has been flat in recent months, while surveyed manufacturing sector conditions and new export orders have picked up somewhat (Graph 1.9). Merchandise export volumes have been largely flat over the past year, supported by relatively resilient semiconductor exports. However, weak

Graph 1.7

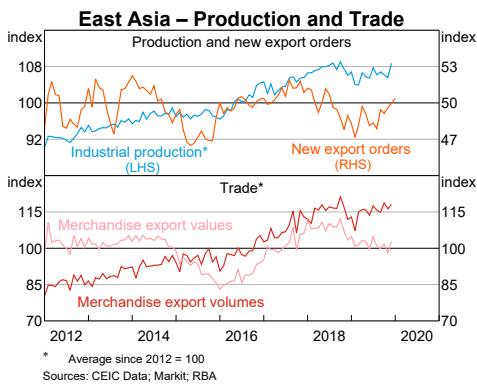


Graph 1.8

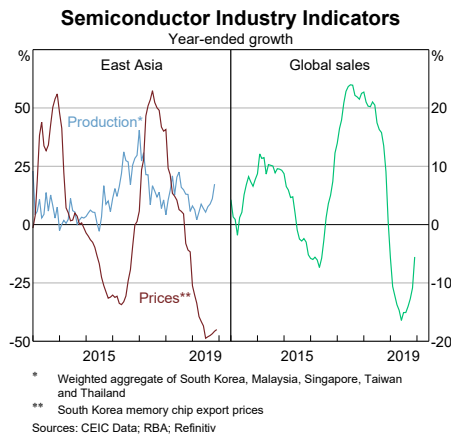


memory chip prices have weighed on export values, particularly in South Korea and Singapore, and on business profits and investment. More recently, memory chip prices appear to have bottomed out, which should support future activity and investment in this key sector for the region (Graph 1.10). The easing of US–China trade tensions, signs of a turnaround in the global electronics cycle and more stimulatory policies are supportive of slightly stronger growth in east Asia over the next couple of years. However, the coronavirus outbreak in China is expected to weigh on growth in the region in early 2020 because of the disruption to Chinese traveller flows and supply chains.

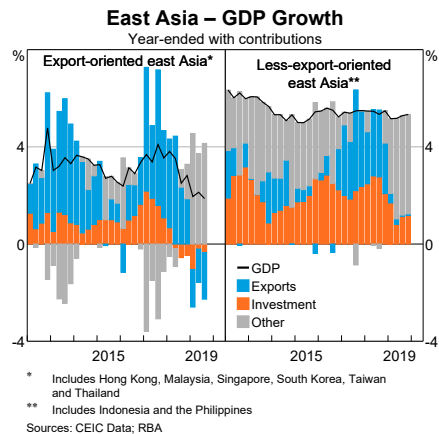
Graph 1.9



Graph 1.10



Graph 1.11



GDP growth in most of the export-oriented economies in the region was subdued over 2019 because business investment and exports have weighed on growth (Graph 1.11). In South Korea, weak residential investment and softer household consumption have also contributed to the weakest GDP growth in a decade, although public consumption has supported growth and fiscal policy is expected to be very expansionary in 2020. In contrast, GDP growth in Vietnam has been strong, boosted by export growth to the United States as some production has been relocated from China in response to the US–China trade dispute. Activity has also picked up in some of the less export-oriented economies in the region, such as the Philippines. Growth in Indonesia has been steady, driven by relatively resilient consumption growth. Ongoing political unrest continues to weigh heavily on Hong Kong economic activity.

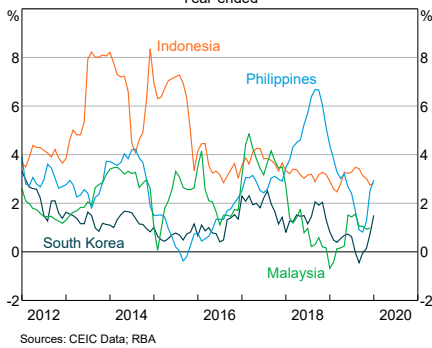
Inflation remains low in east Asia. Inflation in South Korea has been especially low and well below target, although headline inflation picked up sharply in January (Graph 1.12). Inflation in Indonesia has been relatively steady, while it has been quite volatile in Malaysia following changes in consumption taxes. In the Philippines, inflation rose again as domestic

activity picked up and as food prices increased because of weather-related factors.

Monetary policy became more accommodative in the region over 2019 to support growth against the backdrop of low inflation and amid reduced concerns about capital outflows (Graph 1.13). For a few economies in the region there was a pause in the policy easing cycle in late 2019 driven by an expectation that earlier episodes of monetary and fiscal easing would support the economic outlook. More recently, however, some central banks have highlighted a willingness to ease policy further in response to the effects of the coronavirus.

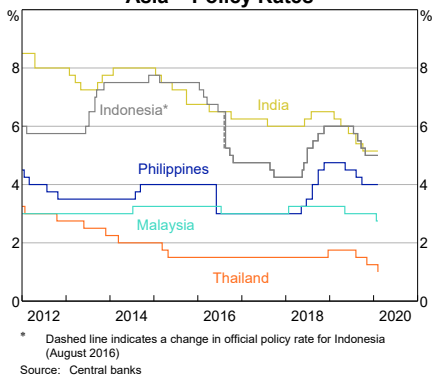
Graph 1.12

East Asia – Headline Inflation
Year-ended



Graph 1.13

Asia – Policy Rates

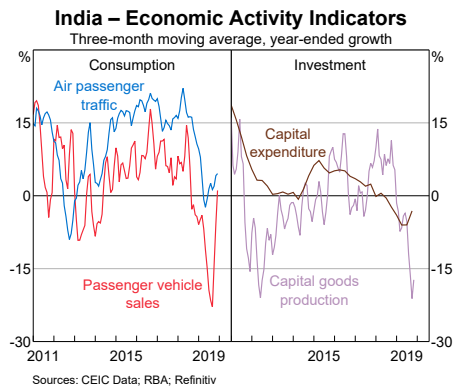


Economic activity in India slowed further

Economic growth in India has slowed sharply since early 2018, reflecting ongoing weakness in domestic demand (see 'Box A: The Recent Economic Slowdown in India'). In the September quarter, exports contracted while public consumption helped support growth. Credit provision to the services sector has contracted in recent months despite the government and the Reserve Bank of India (RBI) taking a number of measures to encourage both bank and non-bank lending. The slowdown in growth has been larger than expected. There are some tentative signs, however, that growth will stabilise soon: car sales have increased in recent months after declining since mid 2018; air passenger traffic growth has picked up in recent months; and, in the December quarter, capital expenditure increased for the first time since the June quarter of 2018 (Graph 1.14). Even so, any pick-up in growth is likely to be modest in the near term. Indicators of industrial sector activity are weak and credit conditions remain challenging.

Headline inflation increased to be above the top of the RBI's target range, reflecting damaged crops and higher vegetable prices following heavy rainfall late in the monsoon season (Graph 1.15). This was accompanied by a sharp

Graph 1.14



increase in household inflation expectations. In response, the government eased restrictions on onion imports and banned onion exports. Price pressures have moderated in most other expenditure categories and core inflation remains relatively subdued. The RBI kept its policy rate unchanged in December, citing the less favourable inflation environment and its expectation that the lagged effects of monetary and fiscal stimulus implemented in 2019 will support activity. It noted that there is space for further monetary easing if required.

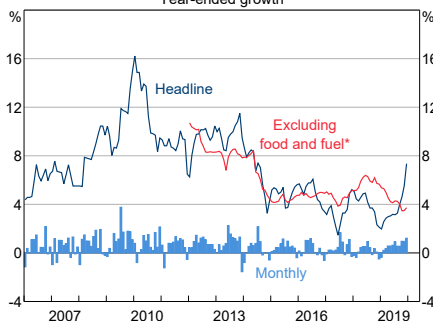
Activity in major advanced economies slowed in 2019 but there have been signs of stabilisation

Growth in the major advanced economies was slower in 2019 than in 2018 (Graph 1.16). Manufacturing activity declined, especially in the euro area, external demand has been weak and services activity has eased. In this environment, and amid uncertainty about trade and technology policies, growth of investment has eased. However, consumption growth has remained resilient because it has been supported by tight labour markets. More recently there have been signs of stabilisation in the manufacturing sectors of these economies and in US investment intentions (Graph 1.17).

GDP growth in the United States eased to around trend over 2019. Business investment declined and investment intentions eased sharply (Graph 1.18). Consumption growth slowed a little in late 2019, although it remains firm and consumer confidence is high (Graph 1.19). Lower interest rates have supported a pick-up in residential investment. The US growth outlook is also a little stronger than three months ago because reduced uncertainty around trade is expected to support business investment, and the resilient labour market is expected to continue supporting consumption. GDP growth over the next two years is expected to continue at around its

Graph 1.15

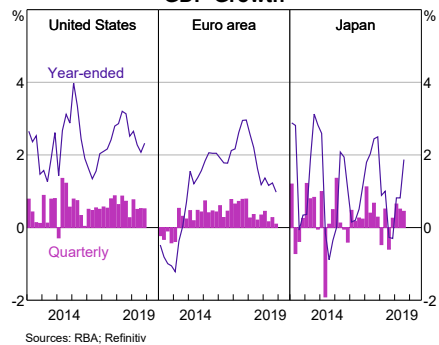
India – Consumer Price Index
Year-ended growth



* Constructed by the RBA; food and fuel comprise 52.7 per cent of the CPI basket
Sources: CEIC Data; RBA

Graph 1.16

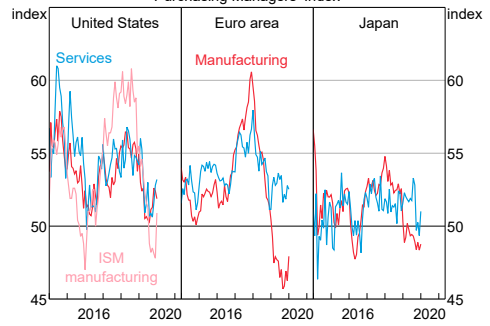
Major Advanced Economies – GDP Growth



Sources: RBA; Refinitiv

Graph 1.17

Major Advanced Economies – Business Conditions
Purchasing Managers' Index



Sources: Markit; Refinitiv

current pace, which is consistent with potential growth.

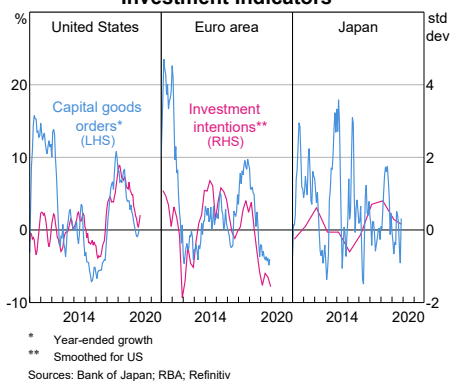
In the euro area, GDP growth has been subdued over the past two years because of pervasive weakness in external demand. This has particularly affected economic conditions in Germany, where industrial production has declined significantly. Survey indicators of conditions in the manufacturing sector remain very weak. The investment outlook in the euro area is subdued. Investment intentions and industrial confidence are well below average levels. Consumption has remained firm so far, despite some spillovers from the industrial

sector to the services sector and the labour market. Euro area growth is expected to remain weak over the next two years because external demand is expected to recover only gradually and uncertainty persists about key trading relations, including with the United Kingdom.

Japanese economic activity slowed following the consumption tax increase in October 2019. As was expected, consumption and residential investment indicators fell sharply after the tax increase following strong growth in the middle of the year as activity was brought forward. Surveyed conditions in the services sector, which had been quite resilient, declined in the December quarter but largely recovered in January. Business investment growth, while still strong, has slowed and investment intentions have eased. Industrial production has declined in recent months and conditions in the manufacturing sector remain around their recent lows, partly because of the disruption from the consumption tax increase and partly because of weak external demand. The coronavirus outbreak in China is also likely to lower traveller flows from China significantly in early 2020. However, fiscal stimulus, focused on infrastructure and equivalent to around 1 per cent of GDP, has been announced to support growth in 2020 and early 2021. Accordingly, the outlook for Japan is little changed in net terms; growth is expected to dip below trend in late 2019 and early 2020, before gradually recovering to around trend growth in 2021 as external demand improves.

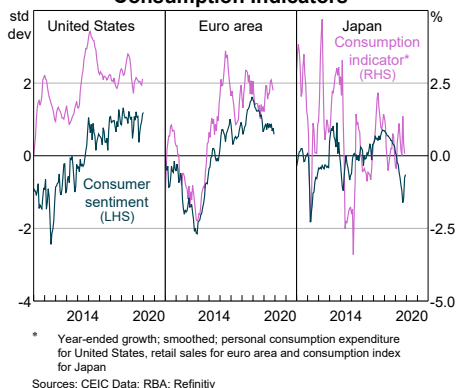
Graph 1.18

Major Advanced Economies – Investment Indicators



Graph 1.19

Major Advanced Economies – Consumption Indicators



Labour market conditions have eased but remain tight

Employment growth in the major advanced economies has slowed since early 2019, particularly in the manufacturing sector. Near-term forward-looking indicators of labour demand, such as vacancy rates and employment intentions, have eased a little but are still at high levels (Graph 1.20). Nonetheless, employ-

ment growth remains above working-age population growth and therefore unemployment rates, which are already at multi-decade lows, continue to fall. Wages growth in the major advanced economies remains around decade highs but has eased a bit in the United States (Graph 1.21). These labour market outcomes continue to support consumption growth.

Inflation remains low in the major advanced economies

Inflation remains below central banks' targets in the major advanced economies (Graph 1.22). Core inflation in the United States has eased

since August. Inflation in the euro area has increased since October, largely due to stronger services and food inflation. Inflation has been little changed in Japan despite the increase in the consumption tax because its effects were largely offset by the introduction of free preschool education.

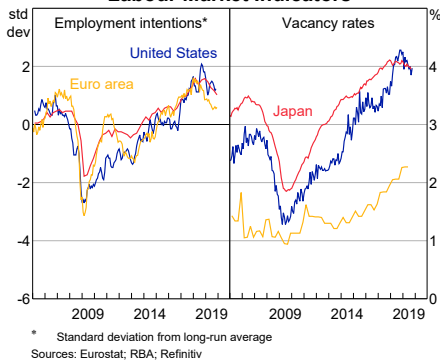
After trending higher towards the end of 2019, market-based measures of short-term inflation expectations decreased in late January following the outbreak of the coronavirus and (related) noticeable declines in oil prices. Longer-term market-based inflation expectations remain low.

After easing last year, central banks in major advanced economies are expected to leave policy settings unchanged for some time

Central banks in advanced economies left policy rates unchanged at recent meetings, but signalled that they are prepared to ease further if necessary. A number of central banks noted that the key risks that prompted pressures to ease policies in 2019 – including escalation in trade tensions and slower global growth – had receded somewhat. The US Federal Reserve (Fed), European Central Bank (ECB), and Bank of Japan (BoJ) indicated that their current policy stances are likely to remain appropriate in the

Graph 1.20

Major Advanced Economies – Labour Market Indicators



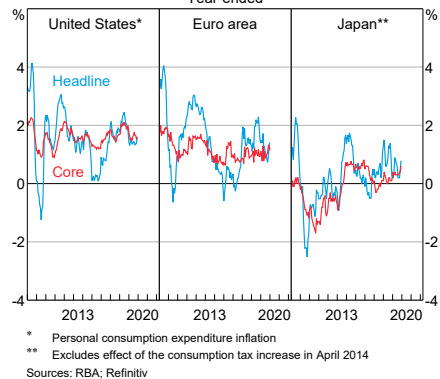
Graph 1.21

Major Advanced Economies – Labour Market and Wages



Graph 1.22

Major Advanced Economies – Inflation



near term, while noting that future policy settings will depend on the resolution of ongoing uncertainties. Market pricing now implies that central banks in advanced economies are expected to either ease a little further or leave policy rates at around current low levels for some time (Graph 1.23).

The Fed lowered the target range for its policy rate by 75 basis points to 1.5–1.75 per cent in the second half of 2019, in response to subdued inflation and downside risks to the outlook for global growth. The Fed has since signalled that it would take a material reassessment of the outlook to trigger further changes to policy settings. Market pricing suggests that the Fed is expected to lower its policy rate one or two more times over the second half of the year.

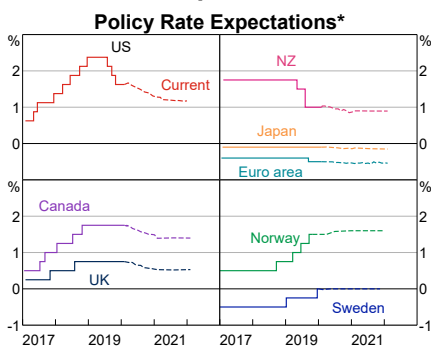
In September, the ECB announced a package of stimulus measures, which will continue to be implemented over coming years, in response to weakening domestic economic activity and downside risks to the outlook (Graph 1.24). Governing Council members have stated that there had been some tentative signs of stabilisation in economic activity following the slowdown seen in 2019, and that there had been a moderate increase in underlying inflation. The ECB’s new President, Christine Lagarde, reiterated that monetary conditions will remain highly accommodative until there is

evidence of a sustained increase in inflation towards 2 per cent. Market pricing suggests that the ECB’s interest rate policy settings will remain unchanged in the coming year.

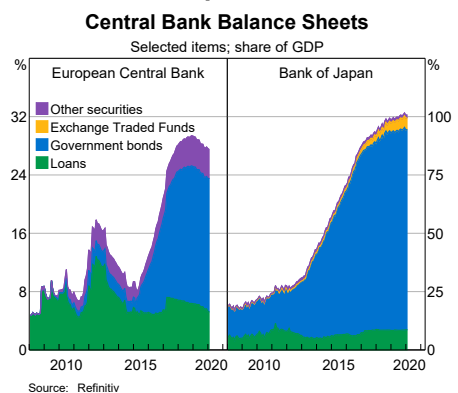
The BoJ has indicated that it is prepared to ease policy if it considers that there has been a loss of momentum in inflation reaching the 2 per cent target. The BoJ recently made further adjustments to some aspects of how it implements policy in an effort to improve the sustainability of its current policy stance by mitigating the side effects of its asset purchases on the financial sector. In October, the BoJ also reduced its purchases of long-term government bonds in an effort to steepen the yield curve. Following the Japanese Government’s announcement of a fiscal stimulus package and easing in some global risks, market pricing now implies that policy settings will remain unchanged this year.

The Bank of Canada (BoC) left its policy rate unchanged in January, after having being on hold over 2019 amid a tight labour market and inflation near target. However, the BoC stated that growth has eased a little recently and now judges there to be a little more spare capacity than previously thought. The BoC indicated that the policy rate may be lowered if the recent slowdown persists and weighs on inflation. Market pricing implies that the policy rate will

Graph 1.23



Graph 1.24



be lowered by 25 basis points to 1.5 per cent towards the end of the year.

The Bank of England (BoE) has stated that incoming information about the global and domestic economy will guide future interest rate decisions. The BoE noted that slower global growth and elevated Brexit-related uncertainties had weighed on growth in 2019, and spare capacity had been larger than expected. However, more recent indicators of domestic activity have strengthened. Market pricing implies that the policy rate is expected to be lowered by 25 basis points by the end of the year. In December, the incumbent Conservative Party secured an outright majority in Parliament, paving the way for passage of the Withdrawal Agreement Bill. This allowed the UK to formally leave the European Union under an interim agreement at the end of January. The full terms of the agreement need to be negotiated over the course of this year.

In Sweden and Norway, both central banks expect policy rates to be little changed this year, following a recent cycle of monetary tightening. The Swedish Riksbank raised its policy rate by 25 basis points to 0 per cent in December, which followed a 25 basis point increase in late 2018 and a period of around five years where policy rates had been in negative territory. In doing so, it highlighted its concerns about the side effects of a prolonged period of negative nominal interest rates. Norges Bank left its policy rate unchanged at 1.5 per cent, after having raised the policy rate three times in 2019 in response to a solid domestic growth outlook and concerns related to financial stability.

Government bond yields are around record lows

Yields on long-term government bonds remain low. Yields have declined recently following a gradual upward trend late last year, which had been in line with moderating downside risks to growth and higher market-implied inflation

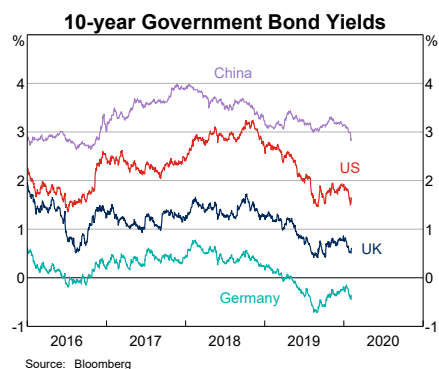
compensation (Graph 1.25). These movements were unwound in late January as concerns around the potential effects of the coronavirus weighed on growth outlooks. Looking through recent volatility, yields remain at low levels, reflecting ongoing subdued inflation, uncertainty in the outlook for global growth and expectations that monetary policies will remain accommodative. In China, yields have declined following further targeted easing by the PBC and as the outbreak of the coronavirus intensified.

Funding costs for corporations have edged lower

Corporate bond yields have declined a little further in recent months (Graph 1.26). The low cost of corporate debt combined with robust bond issuance reflects strong demand from investors that are seeking assets with higher yields than those available on government bonds.

A general narrowing in spreads has occurred despite a slight upward revision to market analysts' expectations for a rise in corporate defaults from their current low levels. This revision appears to have reflected concerns about high levels of leverage in an environment of moderate economic growth. Consistent with this, the share of firms that have received credit rating downgrades has increased. Market

Graph 1.25



analysts expect defaults to be concentrated at the lower end of the credit rating spectrum, particularly in the energy sector where spreads have remained elevated compared with the broader US high yield market.

In China, the cost of funding for corporations has been relatively stable over recent months. This is despite a pick-up in corporate bond defaults, albeit from a low base. In the coming months, firms adversely affected by the coronavirus outbreak may face difficulties in meeting bond repayments. To address this risk authorities have encouraged investors to extend repayment deadlines for affected firms, in addition to the range of measures announced to support broader financial conditions.

Global equity prices have risen further over recent months, notwithstanding recent declines related to concerns around the coronavirus. Equity prices have risen by around 8 per cent since the recent trough in September and are around 20 per cent higher than late 2018 (Graph 1.27). In the United States, equity prices are near record highs. Valuation metrics show that much of the increase in equity prices reflects investors' increased willingness to pay for future earnings, rather than expectations that earnings will grow at a faster pace than previously thought. This largely reflects valuation effects from the substantial decline in risk-free

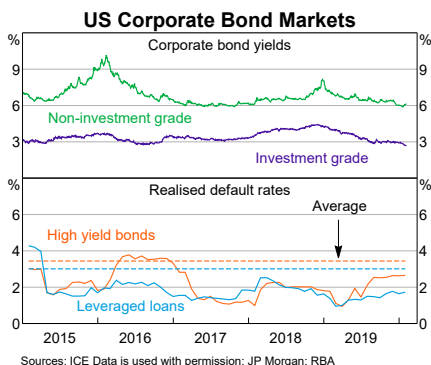
rates seen since late 2018 (which increases the discounted value of future earnings).

In short-term US dollar money markets, spreads (over and above expected policy rates) declined towards the end of 2019. US repo markets functioned smoothly despite a build-up of funding pressures in the second half of the year, partly reflecting the Fed's injection of short-term liquidity through repos as well as its purchases of Treasury bills (which are underpinning a build-up of bank reserves held at the Fed). These measures may have contributed to a reduction in the cost of funding in US dollars, including in exchange for other currencies (Graph 1.28). The Fed has signalled that it expects to pare back its repo operations over the coming months as reserve balances in the banking system become more plentiful.

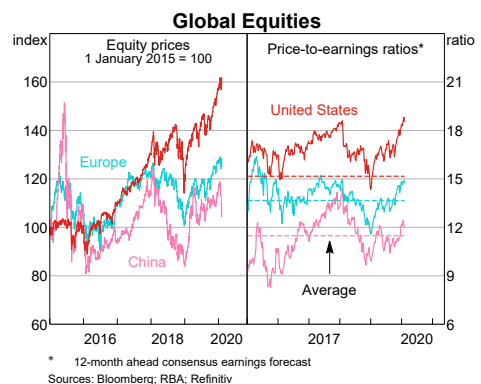
Movements in exchange rates reflected an easing in trade tensions and an escalation in concerns about coronavirus

The US dollar and Japanese yen depreciated over December and early January, before partly reversing these moves later in January as concerns related to the spread of coronavirus increased (Graph 1.29). The euro has been little changed and has remained in a relatively narrow range over the past year or so. In contrast, the

Graph 1.26



Graph 1.27



UK pound has appreciated since around the middle of 2019 as the near-term risk of a disorderly Brexit diminished. Measures of volatility for the major currencies have continued to decline and are at historically low levels.

The Chinese renminbi appreciated further against the US dollar around the turn of the year, although it has depreciated more recently as concerns about coronavirus intensified (Graph 1.30). Much of the earlier appreciation occurred alongside progress on phase one of the US–China trade agreement. Among other things, the agreement includes pledges by both parties to refrain from devaluing their currencies

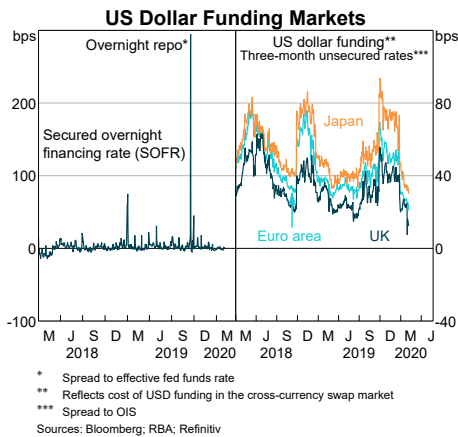
for competitive purposes, and to disclose relevant information related to exchange rates and external balances in a timely manner. The US Government also determined that China would no longer be designated a ‘currency manipulator’. China’s foreign reserves have remained stable at around US\$3 trillion and capital outflows have remained within the range experienced over the past couple of years.

Financial conditions in many emerging markets have eased

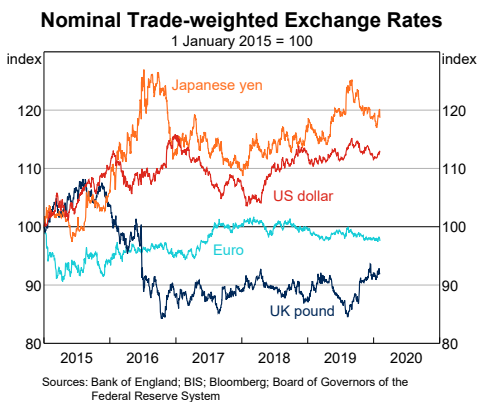
Emerging market equity prices continued to rise through to early January, but have fallen more recently as concerns about coronavirus intensified. Local currency government bond yields have declined and exchange rates have been little changed (Graph 1.31). There have been inflows into emerging market equity funds in recent months following an extended period of outflows. This easing in financial conditions reflects a range of factors including the continued accommodative global financial environment and policy easing by many emerging market central banks during 2019 and early 2020.

While financial conditions in emerging markets have generally eased, the outbreak of coronavirus has introduced a new source of uncertainty and risks remain for some

Graph 1.28



Graph 1.29



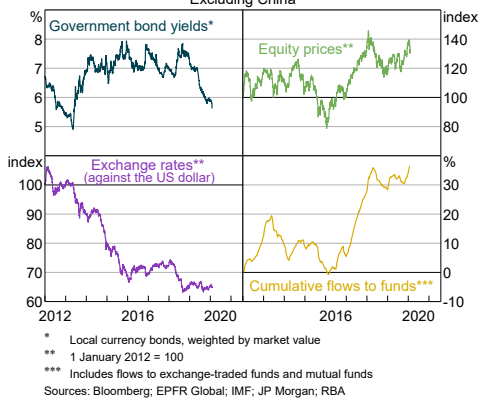
Graph 1.30



economies with specific political and/or macrofinancial vulnerabilities. Social unrest and political uncertainty have increased in Latin America in recent months. In Argentina, the new administration has suggested that another round of debt restructuring is close to hand. The central banks of Chile and Brazil have intervened in the foreign exchange market to support their currencies against recent depreciations (Graph 1.32). In Turkey, the exchange rate has continued to depreciate despite general sentiment toward emerging markets turning more positive in recent months.

Graph 1.31

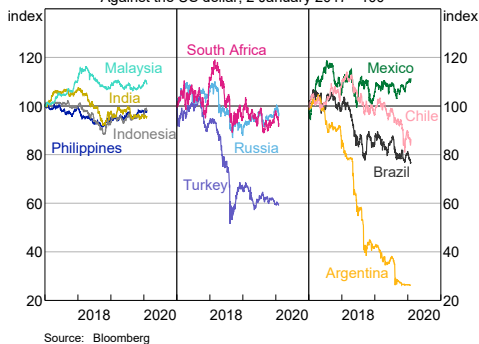
Emerging Financial Markets
Excluding China



Graph 1.32

Emerging Market Exchange Rates

Against the US dollar; 2 January 2017 = 100



The outbreak of coronavirus has affected commodity prices

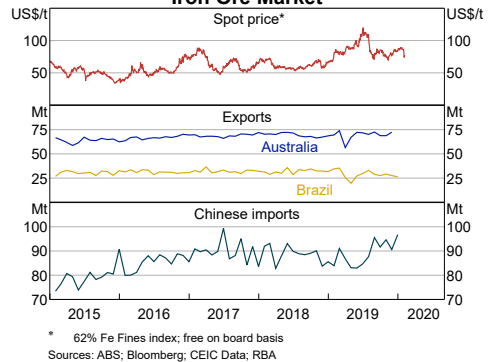
The iron ore price has declined recently in response to concerns about the near-term outlook for demand, particularly from China, following the coronavirus outbreak (Graph 1.33, Table 1.1). The outbreak has disrupted some industrial production and construction activity, which could reduce steel demand, at least in the near term. Policy measures announced in China in recent months to support the economy are expected to provide some support to steel demand, although uncertainty about the outlook for China and any potential policy responses is likely to result in some volatility in the iron ore price in coming months.

Thermal and coking coal prices have increased since the previous *Statement*, but are around 30 per cent lower than a year ago (Graph 1.34). Rising thermal coal supply from Indonesia, Russia and Australia has outpaced demand over the past year; thermal coal demand has also eased as competition from gas-fired and renewable electricity generation has increased. Meanwhile, weaker steel production in some other steel producing economies, including India, has weighed on coking coal demand.

The prices of commodities that tend to be most responsive to changes in the outlook for global demand – particularly oil and base metals –

Graph 1.33

Iron Ore Market



have declined recently in response to concerns about the potential impact of the coronavirus outbreak on global activity (Graph 1.35 and Graph 1.36). This more than offset increases in oil prices earlier in the year, after the US–China trade agreement was announced and OPEC members agreed to deepen production cuts in the first quarter of 2020.

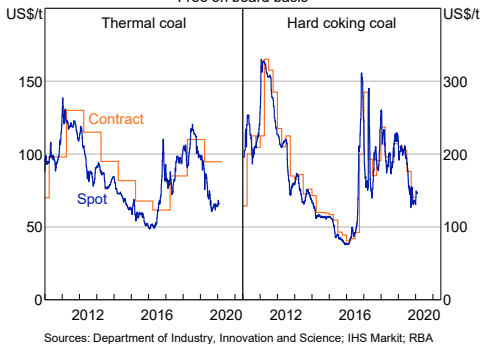
Prices for Australian rural exports have increased in recent months. Wheat prices have been supported by supply concerns stemming from unfavourable weather conditions in key global producing regions, including in Australia. Beef prices increased sharply in late 2019 because of strong demand from Asia; however, prices have declined more recently because of an increase in supply owing to drought-related destocking.

Lamb prices have declined from their recent peak because of a seasonal increase in supply and drought-related destocking.

Based on partial export price data (including the prices of non-commodity exports), the terms of trade are expected to have declined in the December quarter reflecting lower iron ore and coal prices for much of the period. The terms of trade are expected to moderate further over the next couple of years as demand for bulk commodities eases and more supply comes online. ↘

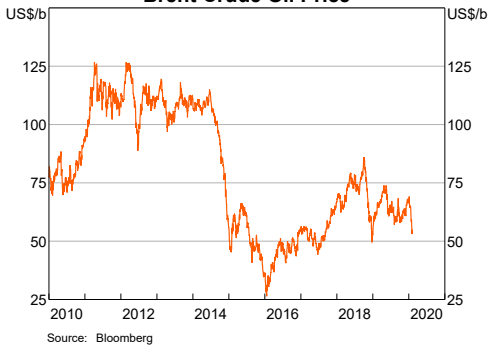
Graph 1.34

Coal Prices
Free on board basis



Graph 1.35

Brent Crude Oil Price



Graph 1.36

Base Metals and Rural Prices

January 2014 = 100

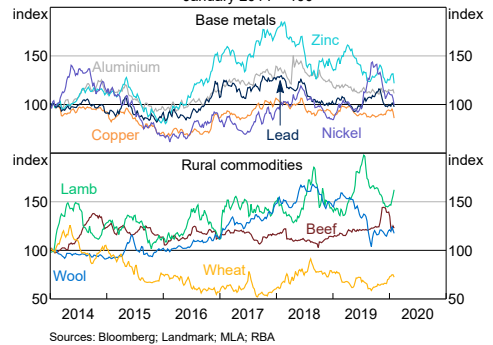


Table 1.1: Commodity Price Growth^(a)

	Since previous <i>Statement</i>	Over the past year
Bulk commodities	4	-17
– Iron ore	2	-8
– Coking coal	11	-28
– Thermal coal	2	-32
Rural	3	-4
Base metals	-9	-13
Gold	6	18
Brent crude oil ^(b)	-12	-11
RBA ICP	-1	-9
– Using spot prices for bulk commodities	1	-14

(a) Prices from the RBA Index of Commodity Prices (ICP); bulk commodity prices are spot prices

(b) In US dollars

Sources: Bloomberg; IHS Markit; RBA

Box A

The Recent Economic Slowdown in India

Economic growth in India has slowed significantly in recent quarters. Year-ended GDP growth has fallen from 8.1 per cent in the March quarter of 2018 to 4.5 per cent in the September quarter of 2019. The slowdown has been broad-based across the expenditure components of GDP – consumption, investment and export growth have all slowed notably (Graph A.1). Growth in the agricultural and industrial sectors has weakened considerably although services sector growth has remained relatively steady.

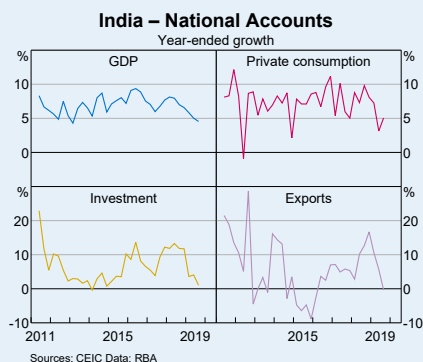
India is Australia's fifth largest export destination. The value of Australian exports to India has grown by an average annual rate of 17 per cent since 2014. Education services and coking coal are Australia's main exports to India, accounting for more than 70 per cent of 2018/19 exports. Growth in these exports has been closely tied to India's long-term economic development. Rising incomes in India have contributed to increased demand for Australia's education exports, and urban construction and infrastructure investment have increased demand for steel, and thus coking coal. While education exports continued to grow in 2018/19, weakness in the industrial sector and the extended monsoon season weighed on export volumes of coking coal in mid 2019 (Graph A.2).

The slowdown reflects a range of economic, policy and financial factors

The slowdown in India reflects a number of developments over the past 18 months. A

series of factors resulted in slower growth of private and public consumption in mid 2018. The Reserve Bank of India (RBI) increased interest rates in response to rising core inflation. Around the same time, the government implemented various reform policies, including the introduction of a goods and services tax and compulsory insurance requirements for owners of cars. While these reforms are expected to have longer-term benefits, in the short term they have weighed

Graph A.1



Graph A.2



on small business activity and car purchases. Oil prices also increased sharply, which contributed to weaker consumption, placed downward pressure on corporate profit margins, and lowered petroleum excise revenues. Growth in government expenditure declined as the government sought to meet its fiscal deficit targets.

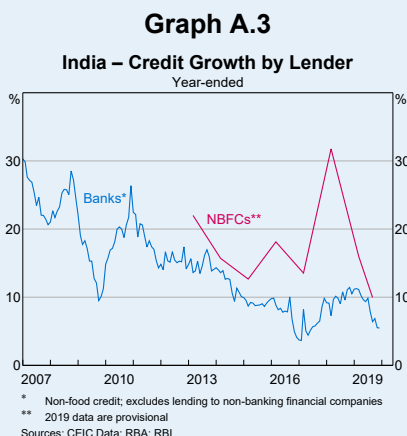
More recently, a tighter supply of credit has contributed to the economic slowdown, particularly the sharp reduction in investment growth in 2019. This followed an acceleration of credit growth in 2017, a sizeable share of which was provided by non-bank financial companies (NBFCs) that received a surge in funding following the demonetisation process in 2016.^[1] Investor sentiment towards NBFCs soured in late 2018 after a high-profile NBFC, Infrastructure Leasing & Financial Services (IL&FS), defaulted on some of its short-term debt obligations. As a result, funding costs for NBFCs rose and lending by NBFCs slowed materially (Graph A.3). NBFCs provide around a fifth of total lending in India, so this deceleration in credit growth has had a material effect on overall lending activity.^[2]

Lending growth has also slowed at public and private sector banks. At public sector banks, there has been a sustained rise in non-performing loans and restructured loans, which has placed pressure on their profitability and capital positions. Regulatory attention around corporate governance has increased for both public and private sector banks given incidences of poor practices. These factors have reduced the ability and willingness of banks to supply credit.

In recent quarters, additional factors have contributed to the prolonged nature of the slowdown. Global policy uncertainty and weak external demand contributed to a contraction in exports through 2019. Both business and consumer confidence have fallen noticeably. Most recently, very heavy rainfall at the end of an extended monsoon disrupted both agricultural production and construction activity.

The authorities have responded, but there are few signs of a turnaround to date

The Indian Government has announced a range of measures to support economic activity. Most significantly, the government reduced the corporate tax rate from 30 per cent to 22 per cent and lowered the tax rate for new manufacturing firms from 25 per cent to 15 per cent. In addition, the recent budget provides for income tax cuts aimed at stimulating consumption. The government has also announced plans to invest heavily in infrastructure over the next five years and has pursued more targeted measures to support growth as well. For example, a ban on government purchases of new vehicles was lifted in an effort to support the auto sector.



Steps have been taken to strengthen the banking sector and support the flow of credit to the real economy and between banks and NBFCs. Capital has been injected into public sector banks, limits on the exposure of banks to NBFCs have been relaxed and the RBI has permitted some bank lending to NBFCs to count towards 'priority sector' lending requirements. Authorities have also intervened directly in NBFCs: the government took control of IL&FS in 2018 and, in late 2019, the RBI removed the management of another NBFC and initiated insolvency resolution.

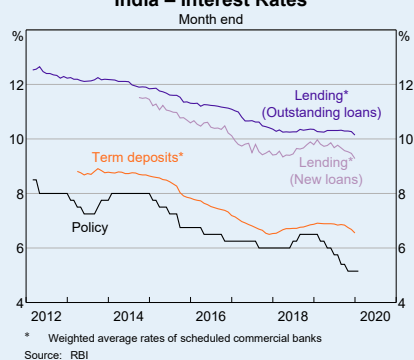
Monetary policy has also responded to the slowdown, with the RBI reducing its policy rate by 135 basis points in 2019. However, in contrast to the tightening cycle in mid 2018, pass-through to the retail banking sector has been muted so far. Lending rates on the stock of outstanding loans have been largely unchanged and term deposit rates have fallen only by around 35 basis points (Graph A.4). The lack of pass-through to lending rates reflects rigidity in deposit rates (and thus funding costs) because of competition for deposits between the banking sector and government-administered small savings schemes. These are deposit products offered by the government directly to the public. The government has left interest rates on these schemes unchanged in recent quarters, limiting the ability of banks to reduce their deposit rates.

The RBI has taken steps to improve the pass-through of monetary policy. For example, towards the end of 2019, the RBI announced

that lending rates for all new floating-rate small business and personal loans issued by banks should be linked to external benchmarks, such as market interest rates. Pass-through to these market interest rates has been more complete over the past year. In addition, lending rates must now be reset at least once a quarter (previously this typically occurred only once a year). This reform is intended to improve transparency around loan pricing and to increase the extent to which lending rates are influenced by policy rates. The RBI expects GDP growth to begin to turn around in coming quarters as the stimulus measures implemented by the government and the RBI gain traction. Encouraging developments in recent months include improvements in car sales, air passenger traffic and capital expenditure. So far, however, any turnaround appears modest. ✎

Graph A.4

India – Interest Rates



Endnotes

- [1] In 2016, the government of India withdrew the legal tender status of the country's two highest denomination banknotes. This resulted in a notable rise in the assets under management of mutual funds. In turn, mutual funds invested in debentures and commercial paper, including that issued by NBFCs.
- [2] For more detail on non-bank lenders in India, see Reserve Bank of Australia (2019), 'Box A: Risks in Non-bank Lending in India', *Financial Stability Review*, April, viewed 21 January. Available at <<https://www.rba.gov.au/publications/fsr/2019/apr/box-a.html>>

2. Domestic Economic Conditions

The Australian economy grew by 0.4 per cent in the September quarter and by 1.7 per cent in year-ended terms (Graph 2.1; Table 2.1). A number of factors have weighed on growth over the year. Households have been going through a period of adjustment to the prolonged period of low income growth, which has contributed to weak consumption growth. Following the earlier decline in housing prices, dwelling investment is currently in a downswing phase of the cycle. Mining investment is passing through a trough and is expected to contribute to growth in coming quarters. Other forms of business investment have been subdued. The farm sector has contributed to the downturn because of the ongoing effects of the drought and, more recently, bushfires (see 'Box B: Macroeconomic Effects of the Drought and Bushfires'). Working in the other direction, export growth was relatively strong over 2019 and supported growth in the economy.

Employment grew more strongly than output over 2019, despite some moderation in employment growth in the December quarter. Private domestic demand is expected to strengthen in the second half of 2020. The most recent leading indicators suggest that mining and dwelling investment will turn around in 2020 (see 'Economic Outlook' chapter). Consumption growth is expected to gradually pick up. The bushfires and coronavirus will weigh on growth in the near term, but the effects are expected to be temporary.

Household consumption growth has been weak ...

Household consumption was broadly flat in the September quarter and year-ended growth slowed to 1.2 per cent (Graph 2.2). This was the slowest rate of growth in consumption in a decade. The downturn in the housing market, which reduced households' wealth, and the extended period of weak growth in household income have contributed to the slowdown in consumption growth since mid 2018. The pick-up in the household saving ratio in the September quarter and the increase in household payments on mortgages in the December quarter are consistent with more subdued consumption growth being partly explained by households adjusting their behaviour after lowering their expectations about future income growth (see 'Domestic Financial Conditions' chapter).

Graph 2.1

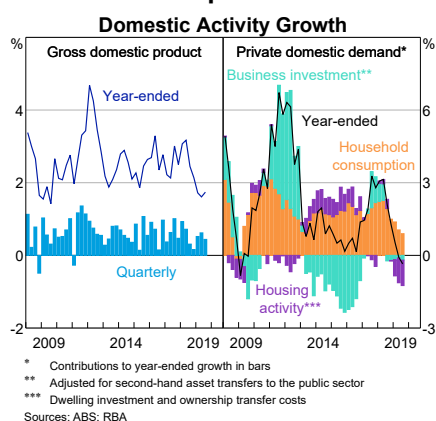


Table 2.1: Demand and Output Growth

Per cent

	September quarter 2019	June quarter 2019	Year to September quarter 2019	Share of GDP
GDP	0.4	0.6	1.7	100
Domestic demand	0.2	0.3	0.9	98
– Consumption	0.1	0.3	1.2	56
– Dwelling investment	–1.7	–3.7	–9.6	6
– Mining investment	–7.8	3.7	–11.2	3
– Non-mining investment	–0.4	–1.5	1.1	9
– Public consumption	0.9	2.5	6.0	19
– Public investment	3.8	–1.5	0.6	5
Change in inventories ^(a)	0.1	–0.4	–0.3	n/a
Exports	0.7	1.3	3.3	24
Imports	–0.2	–1.1	–1.5	22
Mining activity ^(b)	0.7	1.7	2.3	15
Non-mining activity ^(b)	0.4	0.4	1.7	85
Farm GDP	–1.4	–0.2	–5.9	2
Non-farm GDP	0.5	0.6	1.9	98
Nominal GDP	1.1	1.5	5.5	n/a
Terms of trade	0.4	1.4	7.8	n/a

(a) Contribution to GDP growth

(b) RBA estimates

Sources: ABS; RBA

Consumption per person declined over the year, and the weakness in spending was broadly based by state. Following a period of weak growth in discretionary consumption, growth in spending on essential items has also slowed. In the September quarter, growth in the consumption of services slowed noticeably, reflecting less spending on transport services and at hotels, cafes & restaurants, which each declined by around 1 per cent in the quarter. Goods consumption remained subdued.

More recent data suggest that household spending remained subdued in the December

quarter. Retail sales volumes increased by 0.5 per cent in the quarter, but were only 0.4 per cent higher over the year. Sales volumes of food contracted further in the quarter as ongoing strong price pressures from the drought weighed on volumes. Retail sales values growth was relatively strong in the month of November, because of the increasing popularity of the 'Black Friday' sales. The subsequent decline in monthly sales values in December is the result of purchases being brought forward to Black Friday. The effects of bushfires and associated poor air quality was evident in a

decline in sales at cafes & restaurants in New South Wales in December. Motor vehicle sales to households have continued to decline over recent months.

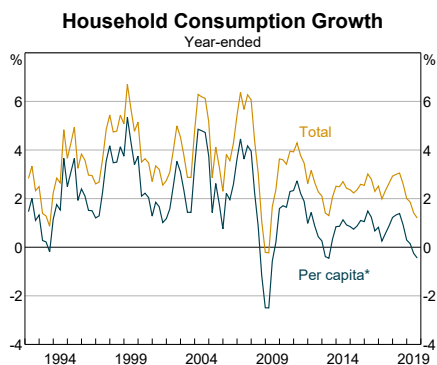
Measures of consumer sentiment have also declined over recent quarters (Graph 2.3). Headline consumer sentiment tends to decline during the first few months following the start of an interest rate easing phase, with sentiment and monetary policy both responding to the same news (Graph 2.4). Households' views on economic conditions have also deteriorated since the middle of 2019, which is consistent with the slowing in private demand, and their expectations for the longer-run economic outlook having been revised lower. However, households' views on their current personal financial situation, which historically have tended to be more indicative of actual spending decisions, have not changed much over the past six months.

... following a prolonged period of low growth in household disposable income ...

Growth in nominal household disposable income has been low for more than five years, reflecting subdued growth in wages, weak growth in a number of other sources of household non-labour income and strong

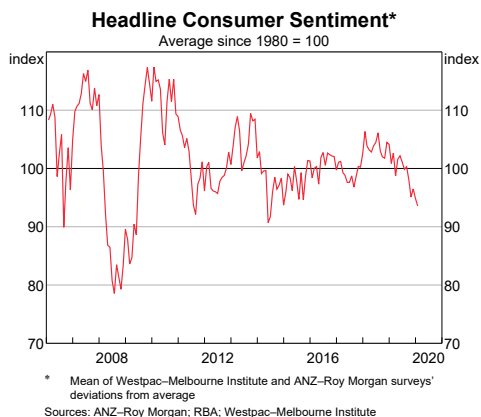
growth in tax payments (Graph 2.5). Household disposable income growth picked up noticeably in the September quarter to a little over 5 per cent in year-ended terms, largely driven by eligible households receiving the low- and middle-income tax offset payments in that quarter and by lower interest payments from the recent reductions in the cash rate. While wages growth remained subdued, growth in employment supported growth in labour income, which was 1.1 per cent in the September quarter. Non-labour income growth remained modest, which partly reflected lower income to

Graph 2.2



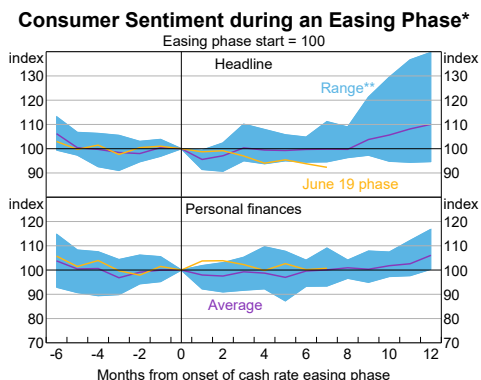
* Based on population forecasts for June and September 2019
Sources: ABS; RBA

Graph 2.3



* Mean of Westpac-Melbourne Institute and ANZ-Roy Morgan surveys' deviations from average
Sources: ANZ-Roy Morgan; RBA; Westpac-Melbourne Institute

Graph 2.4



* Mean of Westpac-Melbourne Institute and ANZ-Roy Morgan consumer sentiment measures
** Covers five easing phases beginning 1996M7, 2001M2, 2008M9, 2011M11 and 2015M2
Sources: ANZ-Roy Morgan; RBA; Westpac-Melbourne Institute

self-employed farm and construction-related workers.

The household saving ratio increased in the September quarter, to 4.8 per cent (Graph 2.6). While household disposable income was boosted by the tax offset and lower interest rates, this did not contribute much to consumer spending in the quarter.

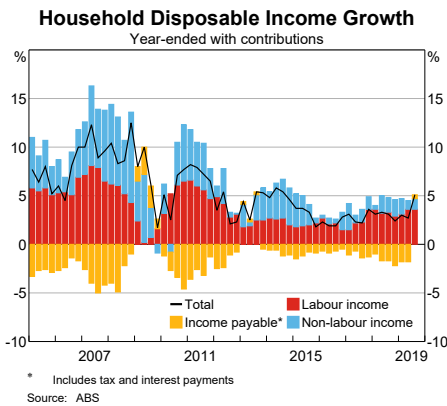
... but conditions in the established housing market strengthened further

The turnaround in the established housing market has become more widespread geographically over recent months. Nationally, prices have increased by around 4 per cent since the previous *Statement on Monetary Policy* and are close to their previous peak in mid 2017

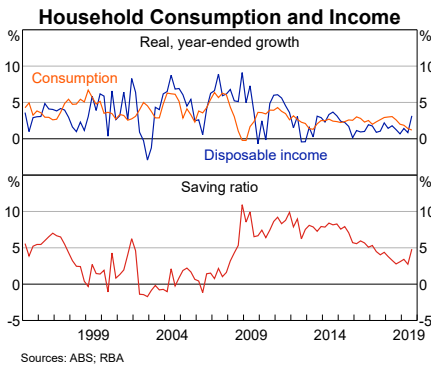
(Graph 2.7; Table 2.2). Housing price growth has picked up in most capital cities and in regional Australia over recent months. It is likely that lower interest rates have contributed to the turnaround in housing markets, but the large variation in housing prices across the country over recent years suggests other fundamentals such as population growth, incomes and supply-side constraints remain important drivers.

Other indicators of conditions in established housing markets have also strengthened in recent months (Graph 2.8). Auction clearance rates picked up further towards the end of 2019 in both Sydney and Melbourne, as did the number of auctions held in both cities. New residential listings have increased, as the rise in prices has encouraged sellers to enter the market. The housing turnover rate has increased notably since the middle of 2019, albeit from very low levels. Although recent observations of turnover are subject to large revisions, the increase in turnover is consistent with the historical relationship with housing prices as well as partial indicators of market activity. Since the previous *Statement*, the share of households that are expecting housing prices to rise over the coming year has increased further.

Graph 2.5



Graph 2.6



Graph 2.7

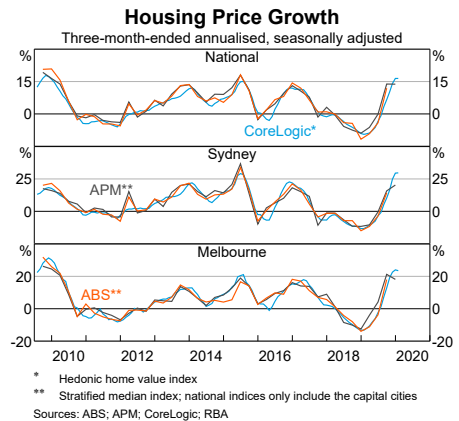


Table 2.2: Growth in Housing Prices^(a)

Percentage change, hedonic

	January	December	November	October	Year-ended	Past five years
Sydney	1.5	2.2	2.9	1.4	7.9	24
Melbourne	1.7	1.7	2.0	1.8	8.2	32
Brisbane	0.5	0.7	0.6	0.6	1.1	10
Adelaide	0.3	0.3	0.3	0.3	0.4	11
Perth	0.2	0.0	0.1	-0.3	-5.7	-20
Darwin	0.0	-0.4	-0.7	-0.3	-8.1	-30
Canberra	0.4	0.2	1.0	0.4	3.1	23
Hobart	0.8	0.2	2.1	0.5	5.0	45
Capital cities	1.2	1.4	1.9	1.2	5.2	18
Regional	0.5	0.4	0.4	0.3	0.4	13
Australia	1.0	1.3	1.6	1.0	4.1	17

(a) Seasonally adjusted by the RBA

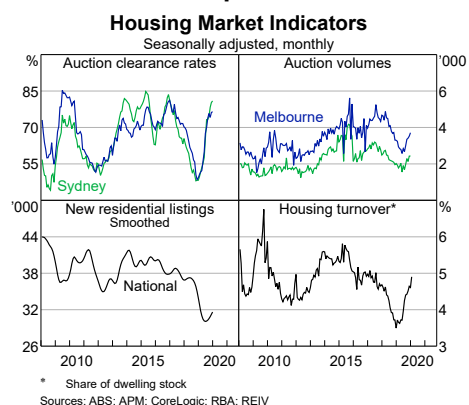
Sources: CoreLogic; RBA

However, dwelling investment continued to decline

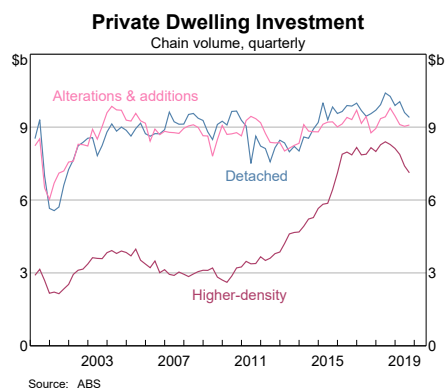
Dwelling investment declined in the September quarter, for both detached housing and higher-density housing (Graph 2.9). Dwelling investment has subtracted 0.6 percentage points from GDP growth over the year. A bit over half of the decline over the year reflected the decline in activity in New South Wales, where detached activity fell by 15 per cent and higher-density activity fell by 23 per cent.

Dwelling investment is expected to continue to decline in the near term. Leading indicators nonetheless point to activity stabilising later in 2020, consistent with the strengthening in the established housing market feeding into building activity with a lag. Private residential building approvals increased a little towards the end of 2019 and developers in the Bank's liaison program have reported an increase in sales activity in recent months, albeit from a low base. Greenfield land sales also increased in the second half of 2019.

Graph 2.8



Graph 2.9



Consistent with the turnaround in established markets over recent months, spending on costs involved with transferring properties such as stamp duties and fees paid to real estate agents and lawyers (known as ‘private ownership transfer costs’) increased by 4.5 per cent in the September quarter. This contributed 0.1 percentage points to quarterly GDP growth after having subtracted 0.3 percentage points from growth over the year to June.

Employment growth remained firm over the year ...

Employment growth moderated to 0.3 per cent in the December quarter, but remains 2.1 per cent higher over the year, and the ratio of employment to the working-age population remains close to its record high levels. After a decline in October, employment increased in November and December. All of the growth in the quarter was in part-time employment, which follows a year of strong full-time employment growth (Graph 2.10).

Less-timely data for the September quarter showed continued strong employment growth in the health care & social assistance and education & training industries. The increase in health-related employment appears to have been fairly broad based but, in recent years, growth has been particularly pronounced for

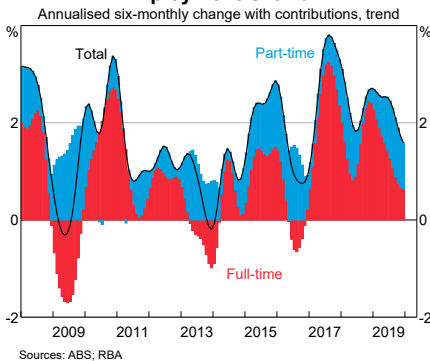
aged & disability carers and nurses. This reflects both the ageing of the population and the rollout of the National Disability Insurance Scheme (NDIS). The rate of job creation over the past year has been high in business services and, in particular, in segments of the professional, scientific & technical services industry, such as IT-related business services. However, employment in construction and retail trade declined over the year, reflecting the slowing in residential building activity and subdued retail conditions. Information from the liaison program suggests employment intentions for residential construction firms have stabilised after weakening for over a year.

Over the past few years, jobs growth has been concentrated in the private sector, rather than the public sector (Graph 2.11).^[1] However, some of the growth in private sector employment over this period has been a result of government spending. For example, in health and education services over three-quarters of new jobs have been private sector jobs, although higher government spending may have funded around one-quarter of all additional jobs created by private firms in these industries.

Labour force participation has increased significantly over recent years, but declined a little in the December quarter. The increase in participation has been most pronounced for

Graph 2.10

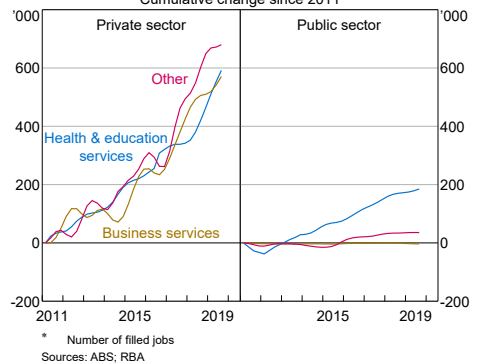
Employment Growth



Graph 2.11

Employment*

Cumulative change since 2011



females aged between 25 and 54 and older workers of both sexes (Graph 2.12). Increases in labour force participation rates have also been largest in the tighter labour markets in the south-eastern states, as strong demand for labour encouraged more people to enter or defer leaving the workforce.

Leading indicators of employment growth are mixed

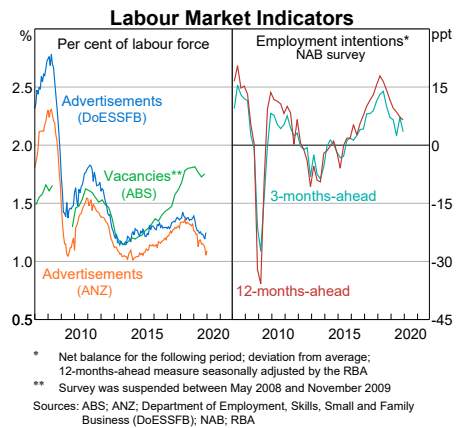
Leading indicators of labour demand have been a bit mixed (Graph 2.13). Indicators of job advertisements fell over the second half of 2019. Employment intentions in the NAB survey and the Bank’s liaison program have generally moderated over recent months, but remain positive. In contrast, job vacancies increased a little over the three months to November but remain a bit lower than one year ago. Taken together with the modest growth in domestic activity over the second half of 2019, it is expected that employment growth will remain moderate over the first half of 2020, but pick up thereafter.

Spare capacity remains in the labour market

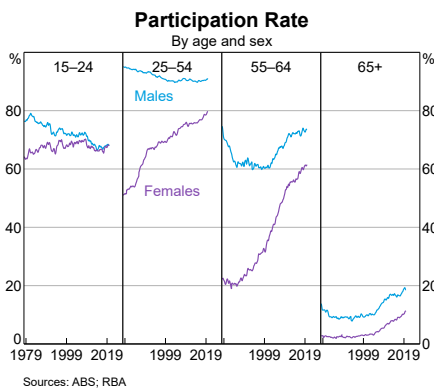
The unemployment rate declined a little in the December quarter, but has remained in the 5–5¼ per cent range since April 2019 and is

slightly higher than it was one year ago (Graph 2.14). The slight decline in recent months reflects a noticeable fall in the unemployment rate for females. In contrast, the unemployment rate for males has been broadly unchanged since April 2019, which is likely to reflect weaker demand for residential construction workers. The share of underemployed workers – who want and are available to work additional hours – was broadly unchanged over 2019. However, a broader measure of underutilisation that captures both the number of hours of work sought by the unemployed and the additional hours that the underemployed would like to work has decreased slightly over the past year.

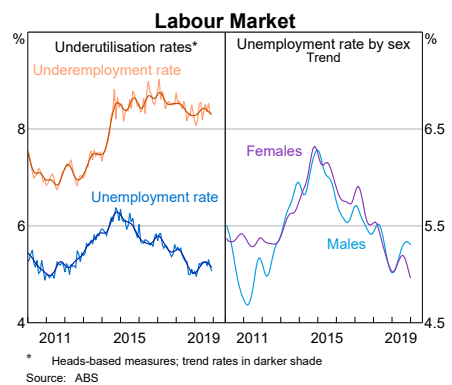
Graph 2.13



Graph 2.12



Graph 2.14



Over the past year or so, unemployment rates have increased or remained stable across most states (Graph 2.15). In Western Australia the unemployment rate has trended gradually lower as labour market conditions in the state have tightened. The aggregate unemployment rate remains above estimates of full employment, meaning that the labour market has capacity to absorb additional labour demand before anything more than gradual upward pressure is generated for wage and price inflation.

Business investment growth has been subdued

Business investment was a little lower over the year to the September quarter because declines in mining investment more than offset modest growth in investment by the non-mining sector (Graph 2.16). Mining investment has been passing through a trough; work on new LNG facilities declined over the year, while capital expenditure picked up for other projects. Slower domestic demand has weighed on non-mining investment. Forward-looking indicators and business liaison suggest that business investment growth is likely to pick up over the coming year, led by mining investment.

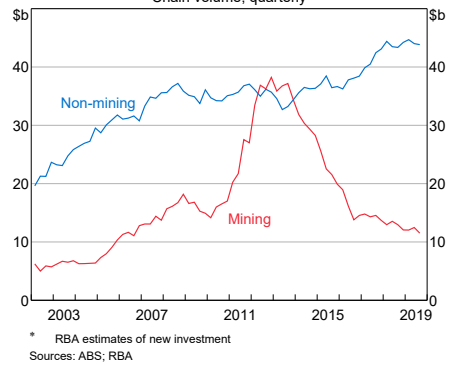
Total mining investment declined by 11 per cent over the year to the September quarter, because less construction work associated with the wind-

down of the remaining LNG projects more than offset further growth in machinery & equipment investment (Graph 2.17). Despite the decline in the quarter, the Australian Bureau of Statistics (ABS) Capital Expenditure (Capex) survey continues to suggest that mining investment will increase in 2019/20, although there may be some quarterly volatility. Information from the Bank's liaison program and company announcements also suggest that resource firms are likely to increase investment over the next couple of years to sustain and, in some cases, expand production.

Private non-mining business investment grew by around 1 per cent over the year to the

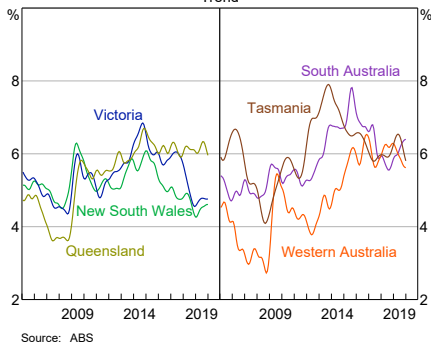
Graph 2.16

Private Business Investment*
Chain volume, quarterly



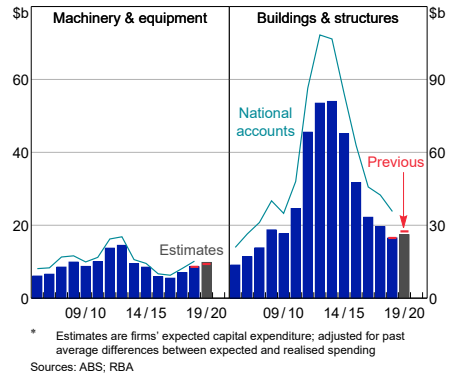
Graph 2.15

Unemployment Rates by State
Trend



Graph 2.17

Mining Capital Expenditure*
Nominal



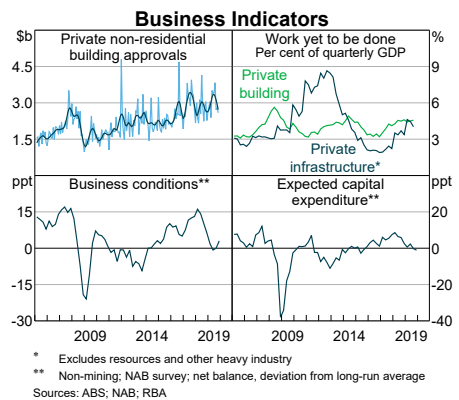
September quarter (Graph 2.18). Within this, machinery & equipment investment declined by 5 per cent over the year; slower consumption and dwelling investment are likely to have contributed to this weakness, with investment in industries exposed to those sectors being particularly soft. In contrast, non-residential construction grew by 6 per cent in the year to the September quarter, led by construction of commercial and industrial buildings, as well as work on infrastructure-related projects, particularly roads.

Forward-looking indicators of non-mining investment are mixed and on balance suggest that growth is likely to remain subdued over the next few quarters (Graph 2.19). On the one hand, there appears to be a reasonable amount of non-residential construction work in the pipeline. Non-residential building approvals have overall been solid in recent quarters, despite easing at the end of 2019, leading to an increase in the pipeline of work yet to be done; the pipeline of private infrastructure work yet to be done also remains elevated, despite easing recently.

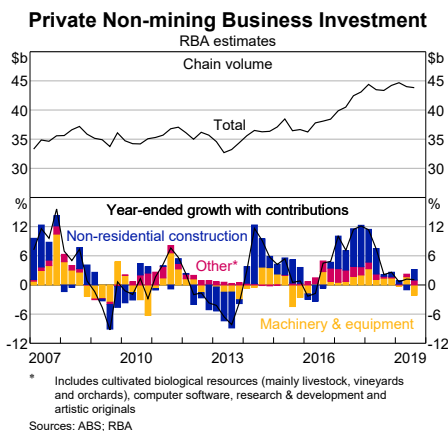
On the other hand, investment intentions for 2019/20 reported by firms in the Capex survey would suggest a weaker near-term outlook for non-mining business investment than was

previously expected; investment in both machinery & equipment and in buildings & structures is expected to decline (Graph 2.20). By industry, firms in retail, wholesale and construction expect investment to decline in 2019/20; this might be a reaction to recent weakness in consumption and residential construction activity (Graph 2.21). Expectations are more mixed among firms in service-related industries; utilities (including renewables) and rental, hiring & real estate firms expect investment to expand further in 2019/20, while firms in other service industries expect investment to decline. However, the Capex survey does not cover all industries or all types of investment.

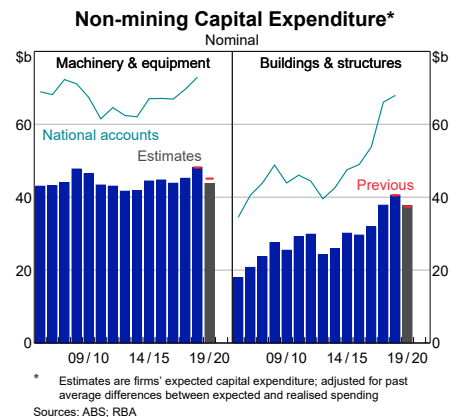
Graph 2.19



Graph 2.18



Graph 2.20



Survey measures of business conditions and expected capital expenditure remain around long-run average levels, but well below their high levels in early 2018. Strong growth in non-mining profits over the past year should support conditions for firms to invest.

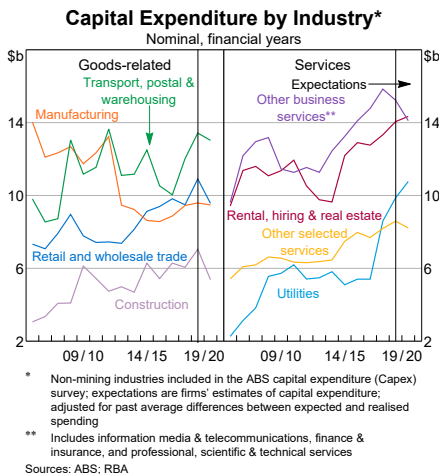
Public demand remained strong

Ongoing growth in public demand provided an offset to the weakness in private demand over the past year (Graph 2.22). Public demand increased by 1.5 per cent in the September quarter to be 5 per cent higher over the year. Defence spending, partly related to purchases of defence assets and training exercises undertaken in the quarter, accounted for about one-third of public demand growth. Over the year, public consumption grew strongly, underpinned by spending on defence and social assistance benefits, such as the NDIS. Public investment picked up in the quarter, but this followed weak growth in previous quarters.

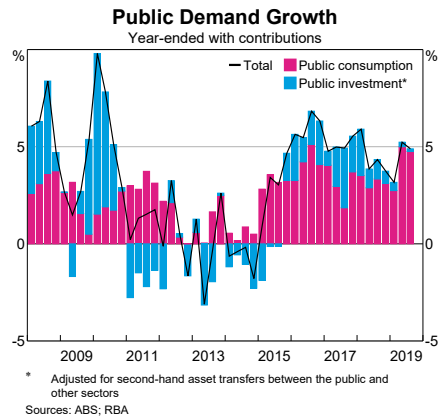
The strong growth in public spending over recent years has been accompanied by stronger growth in tax revenue, although revenue collected from households declined in the September quarter due to implementation of the low- and middle-income tax offset

(Graph 2.23). Stronger growth in tax revenue has contributed to the trend reduction in the underlying cash deficit in the consolidated set of government budgets over recent years. Recent updates to state and federal budgets indicate that the reduction in the consolidated cash deficit of the government sector will continue over coming years. Over recent months both the federal and some state governments have announced additional expenditures in response to the bushfires, which is expected to boost public demand in the near term.

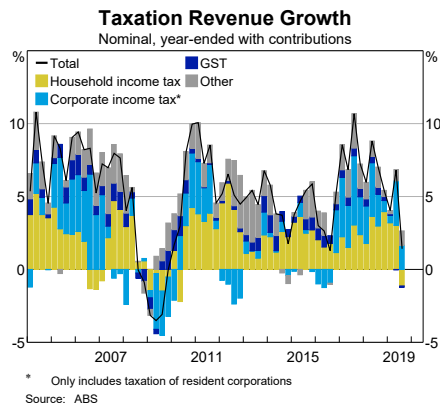
Graph 2.21



Graph 2.22



Graph 2.23



There was broad-based growth in exports over the year

Resource export volumes increased by around 4 per cent over the year to September, led by LNG and condensate exports as the final LNG projects continued to ramp up production (Graph 2.24). Coal exports declined in the September quarter largely because of lower demand from India. Iron ore export volumes also declined in the quarter, partly affected by planned maintenance undertaken by the major miners, but this was more than offset by an increase in exports of other non-ferrous metal ores and minerals. Non-monetary gold exports increased strongly in the quarter; this can be volatile from quarter to quarter but grew by one-third over the year to September, supported by bullion demand from the United Kingdom. Resource exports are expected to grow further over 2020, as LNG exports continue ramping up. The outbreak of coronavirus poses some near-term risks to commodity exports, although current information suggests that any disruptions are likely to be temporary.

Australia's manufactured and service exports have continued to grow steadily in recent years, supported by the lower Australian dollar, growth in Australia's major trading partners and, in the case of service exports, an increase in student and visitor arrivals. Manufactured exports grew by 6 per cent over the year, led by continued

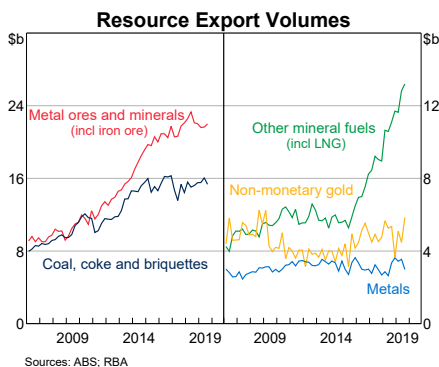
growth in exports of professional & scientific instruments and medicinal & pharmaceutical products. Travel service exports also increased by around 6 per cent over the year to the September quarter 2019, underpinned by growth in education-related exports (Graph 2.25). However, as discussed further in the 'Economic Outlook' chapter, the outbreak of coronavirus is likely to adversely affect tourism and education exports in the near term.

Rural exports were 3 per cent lower in the September quarter, and are expected to decline further over 2020, in line with further declines in rural production associated with dry conditions; for further discussion see 'Box B: Macroeconomic Effects of the Drought and Bushfires'.

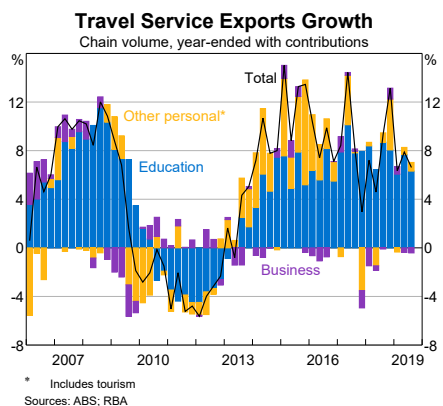
Import volumes declined modestly in the September quarter, consistent with a decline in private investment, which is a relatively import-intensive component of expenditure. Capital imports were particularly weak in the quarter, led by a continued decline in imports of industrial transport equipment. Partial data suggest that import volumes also declined in the December quarter.

The trade surplus increased further in the September quarter to 4.2 per cent of nominal GDP (its highest share since 1959 when quarterly data began) because export values

Graph 2.24

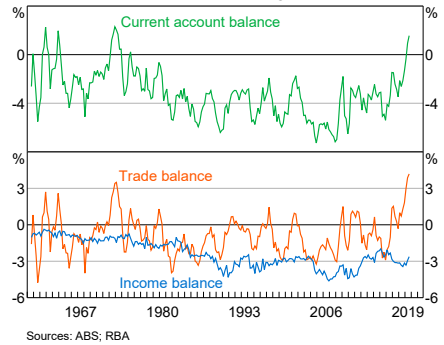


Graph 2.25



increased by more than import values (Graph 2.26). Partial trade data suggest that the trade surplus remained elevated in the December quarter. The increase in the trade surplus, alongside a narrowing in the net income deficit, resulted in a further increase in Australia's current account surplus, to around 1.6 per cent of GDP. ✎

Graph 2.26
Current Account Balance
Per cent of nominal GDP



Endnotes

[1] There is a discrepancy between the public and private employment split in the Labour Account data (which uses data gathered from businesses and households) and the Labour Force survey data (which

relies upon data from households). The view of the Australian Bureau of Statistics is that the Labour Account data provides a more accurate account of which industry the job is actually in.

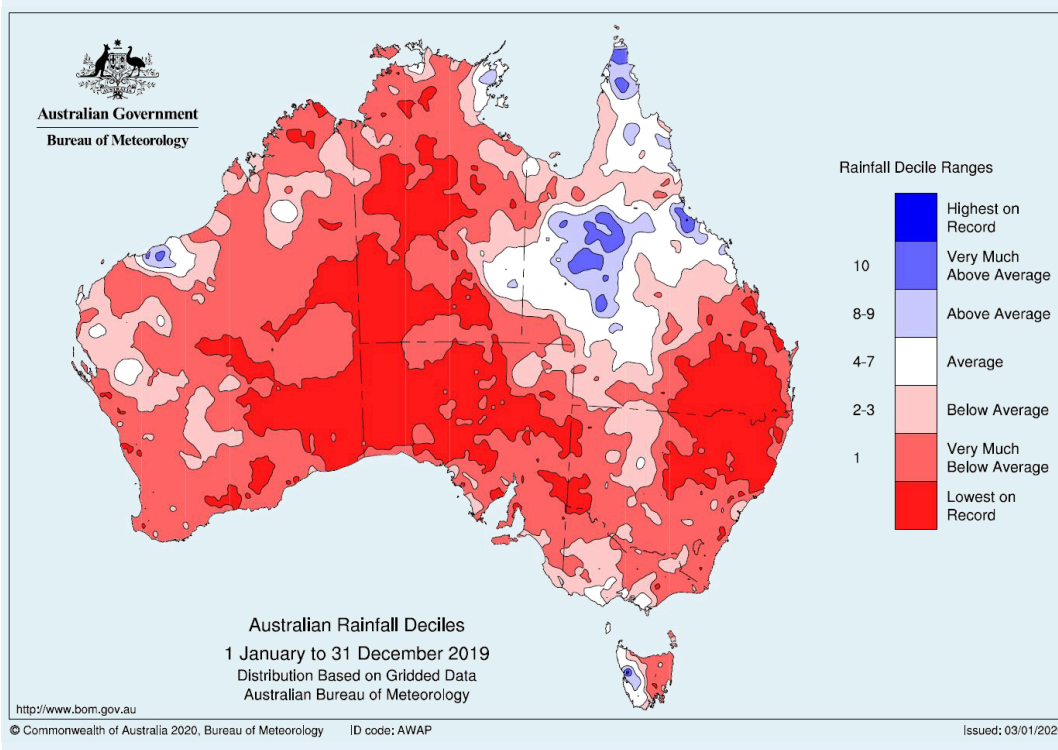
Box B

Macroeconomic Effects of the Drought and Bushfires

Most of Australia is currently being affected by a severe drought. Drought conditions began in the eastern states in early 2017 before becoming more widespread across the country. Many areas of the country have experienced high temperatures and rainfall that is well below average; 2019 was the warmest and driest year on record for Australia (Figure B.1). These conditions have contributed to one of the worst bushfire seasons on record.

Economic activity has been adversely affected by these conditions for two years or more. Farm GDP has declined by 22 per cent since early 2017, and is expected to decline by a further 7 per cent over the remainder of 2019/20. This would take the decline in farm GDP since early 2017 to around 30 per cent – comparable to the decline observed during the 2002/03 and 2005/06 episodes of the Millennium Drought. The direct effects of the recent bushfires are expected to reduce GDP growth across the December 2019 and March 2020 quarters by around

Figure B.1



0.2 percentage points, with some recovery in the June quarter and beyond. However, there is uncertainty around this estimate.

Effects of the drought on the farm sector

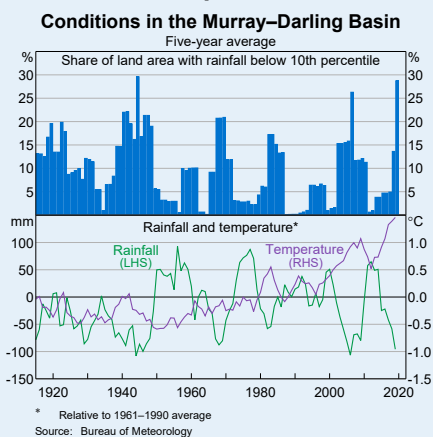
Some of Australia’s most important agricultural regions have been hardest hit by the drought. The Murray–Darling Basin, which includes parts of New South Wales, Victoria, Queensland, South Australia and the Australian Capital Territory, accounts for around one-third of the total value of Australia’s agricultural production. This region has experienced drought conditions since early 2017, with low levels of soil moisture and severely limited water resources (Graph B.1). This has contributed to lower rural exports in recent years and reduced the domestic supply of some food items, which has placed upward pressure on food prices.

The impact of the drought on the Murray–Darling Basin and other parts of Australia has contributed to a decline in farm production and rural exports, particularly for cereal grains. Farm production declined by around 12 per cent from 2016/17 to 2018/19.

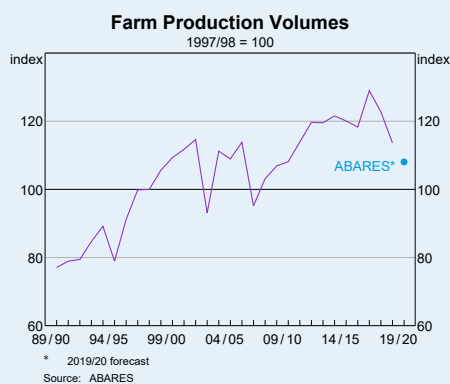
The Australian Bureau of Agricultural and Resource Economics and Sciences (ABARES) expects a further decline in farm production of almost 5 per cent in 2019/20 because of the drought (Graph B.2). Production of cereal grains, such as wheat and barley, has fallen, and some crops have been used to feed livestock in response to high prices of traditional sources of feed. This has contributed to a decline in rural exports of around 18 per cent since early 2017. Imports of some grains have occurred for the first time since 2007.

Meat exports, in contrast, have increased significantly because of increased supply related to the drought and strong global demand. Australian producers have increased slaughter rates in response to poor grazing conditions and high feed costs. At the same time, the outbreak of African swine fever in Asia has increased demand for Australian meat products because elevated pork prices have encouraged Asian consumers to substitute towards alternative protein sources (Graph B.3). Over the past year, Australian beef and lamb exports to China have increased by around 70 per cent and 50 per cent, respectively.

Graph B.1



Graph B.2



Lower rural production overall and higher input costs, particularly for water and livestock feed, have placed significant pressure on farm profits, which have declined by around 30 per cent since early 2017. This has had flow-on effects to regional and rural communities; as farmers have scaled back spending, this has reduced the income of businesses that supply goods and services to the farm sector.

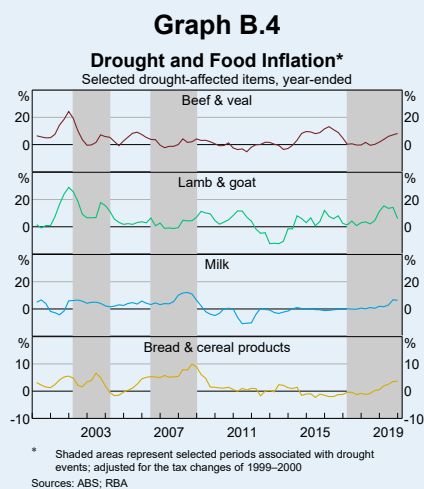
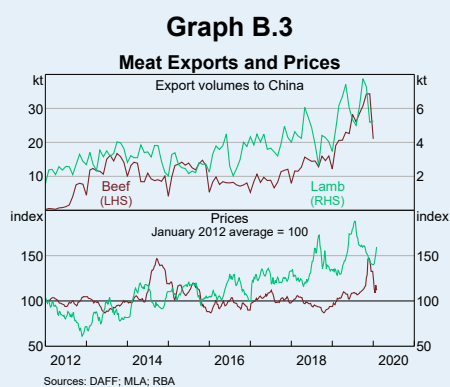
Periods of drought also affect supermarket food prices, which make up around 9 per cent of the Consumer Price Index (CPI) basket. Prices for bread and cereal products have increased over the past year in response to higher grain prices (Graph B.4). Milk prices have also increased; several major supermarkets have introduced ‘drought levies’ of 10 cents per litre. Beef and lamb prices have increased because of the drought and strong international demand. Information from the Bank’s liaison program suggests that the drought is likely to result in these consumer food prices remaining elevated for some time.

Effects of the bushfires

In recent months, bushfires have devastated many regional communities. In addition to loss of life, homes and business assets have

been destroyed, livestock and native animals have perished, and forestry and natural assets have burned. In some cases, assets might not be replaced because of insufficient insurance coverage. Significant local infrastructure has also been destroyed, including roads, energy, telecommunications and community assets. The fires have disrupted tourism and agriculture, which account for an important share of economic activity and employment in many of the affected regions. In particular, bushfire conditions intensified during the summer holiday period, which is an important time of year for regions that rely on tourism. The combined impact has been severe for the affected areas.

In assessing the economic impact of the bushfires for Australia as a whole, the recovery also needs to be taken into account. After a period of disruption, some normal activities can resume, and insurance payouts, government payments and reconstruction activity are likely to have material effects. This might also include some additional investment that improves resilience to bushfires. By the end of 2020, it is likely that the recovery will have broadly offset the



decline in GDP due to the immediate impact of the bushfires. There is, however, likely to be a noticeable effect across the December 2019 and March 2020 quarters. In particular, the bushfires are expected to reduce consumer spending and lower rural exports. International media coverage of the fires is also likely to have an adverse effect on international tourism. In addition, domestic tourism expenditure in affected regions is likely to decline, although some of this might be diverted to unaffected areas.

The fires are expected to have an effect on the prices of some goods and services, particularly in the affected regions. Prices for domestic tourism and accommodation are likely to fall in the areas directly affected by the fires. Transport disruptions are likely to result in a temporary increase in some food prices. Bushfire damage to interstate transmission lines led to a sharp, but brief, increase in NSW wholesale electricity prices, although this is likely to have a limited impact on retail prices because most retailers hedge their exposure to wholesale price fluctuations. Overall, the effect of these price impacts on the CPI, which measures capital city prices, is anticipated to be relatively small and temporary. Further out, the likelihood of longer and increasingly extreme fires could also lead to an increase in insurance premiums.

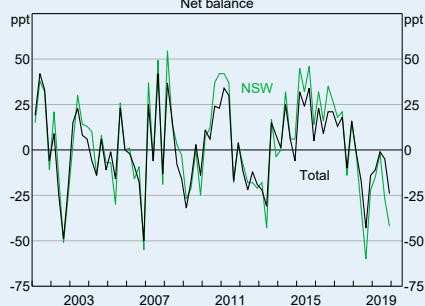
Long-term challenges

The recovery from the drought is likely to be prolonged, even if weather conditions improve in the near term. The low level of soil moisture and stored water means that significant rainfall will be required to enable crop plantings and successful harvests. In addition, herds and flocks – which have declined significantly in size over recent years

– will need to be rebuilt, which would weigh on meat exports. This outlook is partly reflected in the declining share of farmers that expect conditions to improve or be unchanged over the next year, particularly farmers in New South Wales (Graph B.5).

Over the longer term, changes in Australia's climate are likely to present a more challenging environment for many regions that rely on agriculture or are vulnerable to extreme weather. The latest *State of the Climate* report published by the Bureau of Meteorology and the Commonwealth Scientific and Industrial Research Organisation presented evidence that seasonal variations in rainfall and temperatures are occurring against a backdrop of a trend towards drier average conditions in south-east and south-west Australia. This includes large parts of the Murray–Darling Basin and important agricultural regions in Western Australia. The report also documented a long-term increase in extreme fire conditions and the length of the fire season. ✨

Graph B.5
Rural Confidence*
Net balance



* Per cent of surveyed farmers expecting conditions in the agricultural economy to improve over the next year minus the per cent expecting conditions to worsen
Source: Rabobank

3. Domestic Financial Conditions

Financial conditions for households and large businesses are more accommodative than a year ago, following three reductions in the cash rate in 2019. Government and corporate bond yields declined over 2019 across all maturities and remain around historic lows. Consistent with the low level of the cash rate, banks' funding costs are at historically low levels, as are housing and business interest rates. Financial market prices imply that market participants expect that the cash rate will be reduced by a further 25 basis points around the middle of 2020.

There has been a pick-up in owner-occupier housing loan commitments since May 2019, alongside the stronger conditions in some housing markets. Growth in housing credit extended to owner-occupiers has also increased over this period, although, at the same time, the stock of credit extended to investors declined. To date, only a small share of borrowers have actively reduced their scheduled loan payments following the mortgage rate reductions in 2019 and total loan payments have increased. Growth in business debt has slowed, despite accommodative financial conditions for large businesses. Small businesses' access to funding remains difficult. Australian equity prices increased over the past year, and reached a historically high level in January, but have declined more recently as concerns about the economic effect of the coronavirus have increased. The value of the Australian dollar has depreciated of late and is around its lowest level in some years.

Investors expect a cash rate reduction around the middle of the year

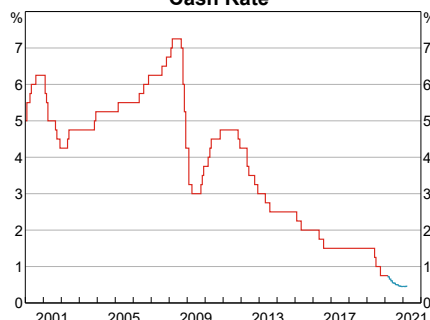
The Reserve Bank Board reduced the cash rate target by 75 basis points in 2019, to 0.75 per cent. Financial market prices imply that participants expect that the cash rate will be lowered by another 25 basis points around the middle of 2020 (Graph 3.1).

Government bond yields remain low

After declining for much of 2019 to reach historic lows, yields on Australian Government Securities (AGS) fluctuated near this low level in recent months (Graph 3.2). This was in line with developments in yields on government bonds in other advanced economies, which reflected evolving perceptions about downside risks to the global economy. The spread between US Treasury and AGS yields has been little changed over the past year, after declining substantially over preceding years, and remains close to its multi-decade low; the AGS 10-year yield is

Graph 3.1

Cash Rate*



* Data from March onwards are expectations derived from interbank cash rate futures

Sources: ASX; Bloomberg

currently around 60 basis points below the 10-year US Treasury yield.

Short-term money market spreads have been little changed overall

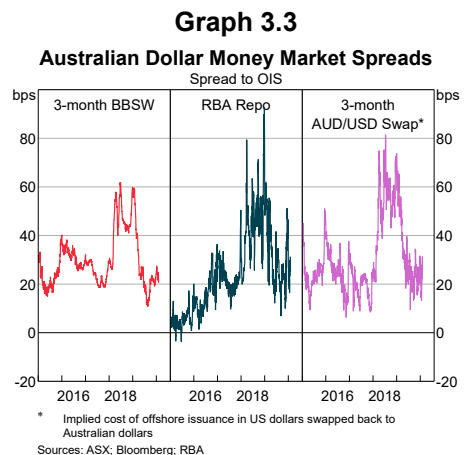
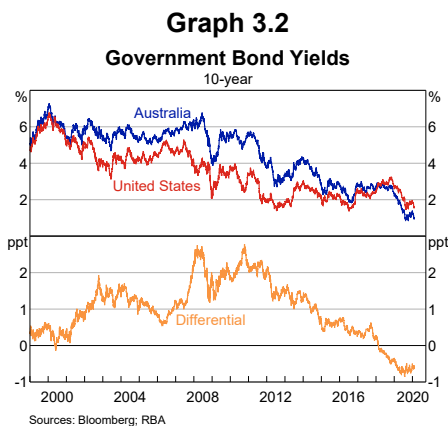
Short-term money market spreads have been little changed overall in recent months (Graph 3.3). In December, the spread between interest rates in the markets for repurchase agreements (repo) and overnight indexed swaps (OIS) increased temporarily to around 50 basis points, as demand for repo funding over the turn of the year increased. Spreads have since narrowed, to be around 25 basis points above OIS. In contrast, there was little evidence of year-end funding pressures in other short-term funding markets, with spreads of interest rates to OIS in the markets for bank bills and foreign exchange (FX) swaps little changed over that period. The supply of short-term liquidity into US money markets by the US Federal Reserve has contributed to stability in the FX swap market. The cash rate continued to trade at the Reserve Bank Board's target.

Banks' demand for new wholesale funding was low in the past year

Australian banks' demand for new wholesale funding was lower in 2019 than in recent years, largely reflecting lower growth of their balance

sheets and the associated reduced need for additional funding. The composition of their new wholesale funding was also different to prior years. The banks issued around \$83 billion worth of bonds in the year, which was the lowest level of issuance since 2011 (Graph 3.4). By contrast, banks' issuance of Tier 2 hybrid securities picked up significantly in the second half of 2019. This followed an announcement by the Australian Prudential Regulation Authority (APRA) in July 2019 that major banks would be required to increase their total capital by the beginning of 2024. Hybrid securities have both equity and debt features and can be used to fulfil a part of banks' regulatory capital requirements. The total value of bonds and hybrids issued in 2019 was more than offset by the value of securities that matured or were called, such that net issuance was negative in the year.

The December quarter saw the strongest issuance of asset-backed securities (ABS) since 2007 (Graph 3.5). The strength of issuance in the quarter was driven by non-authorized deposit-taking institutions (non-ADIs) and was broadly based across residential mortgage-backed securities (RMBS) and other ABS. Prices for new deals, expressed as a spread to bank bill swap (BBSW) rates, were relatively stable over the year.



Banks' funding costs have declined to historic lows

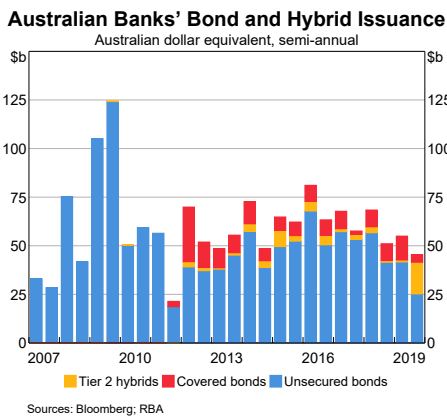
Banks' (non-equity) funding costs have declined to historically low levels (Graph 3.6). This largely reflects the effect of reductions in the cash rate on wholesale debt costs and (retail and wholesale) deposit rates. Much of the major banks' wholesale debt and deposit costs are ultimately linked (either directly or via hedging) to BBSW rates, which declined by more than the cash rate over 2019. Bank bond yields declined over the year, owing to a decline in both reference rates and spreads (Graph 3.7). In the past year, the cost to Australian banks of raising

long-term debt (in US dollars or Australian dollars) has been similar to that paid by comparable foreign banks raising finance in the same currency.

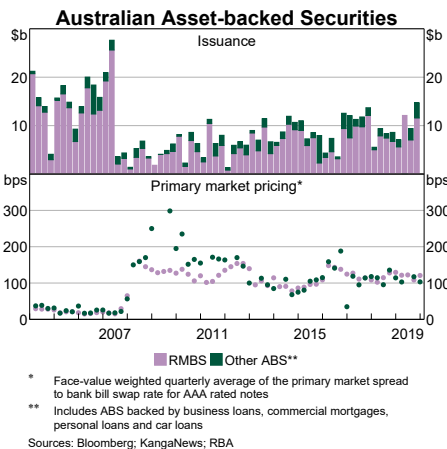
Retail deposit rates are at historic lows

Banks have passed through most of the reductions in the cash rate to retail deposit rates. Banks are estimated to have lowered the interest rates on at-call retail deposits by an average of 60 to 70 basis points since May last year. The major banks are estimated to have reduced their term deposit rates by around 100 basis points in 2019. However, as is typical, the interest rates on many transaction accounts (which are usually close to zero) did not change following the reductions in the cash rate.

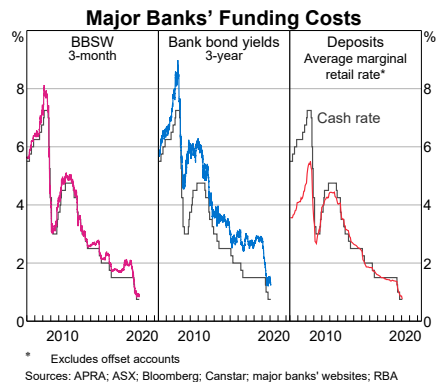
Graph 3.4



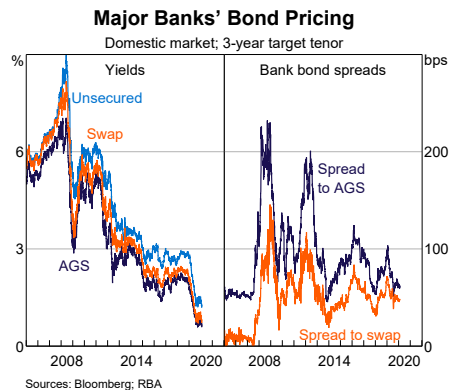
Graph 3.5



Graph 3.6



Graph 3.7



Following the reductions in the cash rate last year, the major banks are estimated to be paying low interest rates (between zero and 25 basis points) on a little over one-quarter of their deposit funding, compared with around 10 per cent before the reductions in the cash rate (Graph 3.8). However, a little over half of all deposits (by value) currently receive interest over 1 per cent.

Housing lending rates are also at historic lows

A large share of the 75 basis point reduction in the cash rate in 2019 has been passed through to mortgage rates paid by households. By December, interest rates on outstanding variable-rate housing loans had declined by almost 70 basis points (Graph 3.9; Graph 3.10; Table 3.1).

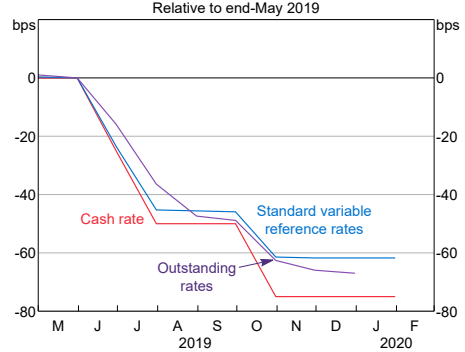
Lenders lowered their standard variable rates (SVRs) by an average of 60 basis points following the reductions in the cash rate, which automatically flowed through to all variable-rate loans. The average rate paid on outstanding loans declined by more than this, reflecting strong competition for high-quality borrowers and households switching away from interest-only loans (which generally have higher interest rates). If this downward drift continues, by around mid 2020 the average rate paid on

outstanding variable-rate mortgages will have declined by 75 basis points since May last year (other things equal).

The fact that average mortgage rates paid have declined by more than SVRs reflects two trends. First, interest rates on new loans (to new borrowers or to existing borrowers that refinance their loan with another lender) tend to be lower than those on existing loans, amid strong competition for high-quality borrowers. Also, in this environment some households with existing loans have been able to renegotiate a lower rate with their current lender. On average, rates on existing loans remain substantially

Graph 3.9

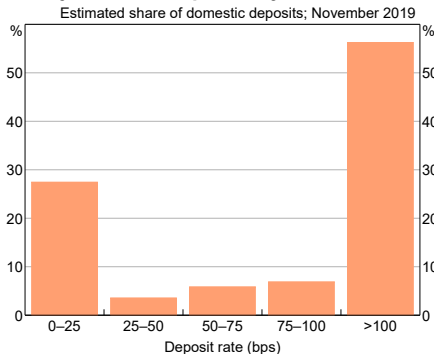
Major Banks' Variable Housing Rates



Sources: APRA; major banks' websites; RBA; Securitisation System

Graph 3.8

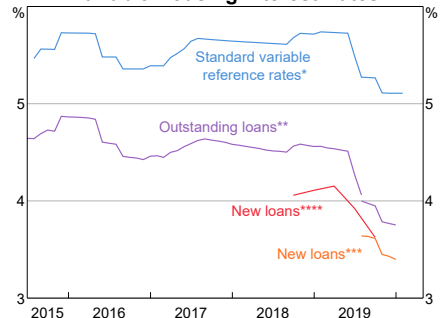
Major Banks' Deposits by Interest Rate



Source: RBA estimates based on major bank liaison

Graph 3.10

Variable Housing Interest Rates



* Data to January; average across major banks' rates
 ** To July 2019, average of securitised loans. Data from July to December 2019 based on the EFS collection
 *** Data to December; based on the EFS collection
 **** Data to September quarter; quarter-average APRA data
 Sources: APRA; major banks' websites; RBA; Securitisation System

Table 3.1: Average Outstanding Housing Rates

December 2019

	Interest rate Per cent	Change since May 2019 Basis points	Change since December 2018 Basis points
Variable principal-and-interest loans			
– Owner-occupier	3.60	–64	–67
– Investor	4.02	–65	–69
Variable interest-only loans			
– Owner-occupier	4.12	–64	–67
– Investor	4.30	–78	–82
All variable loans	3.83	–68	–73
Fixed rate ^(a)			
– Owner-occupier	3.80	–	–
– Investor	4.06	–	–

(a) Data from the Economic and Financial Statistics collection, available from July 2019.

Sources: APRA; RBA; Securitisation System

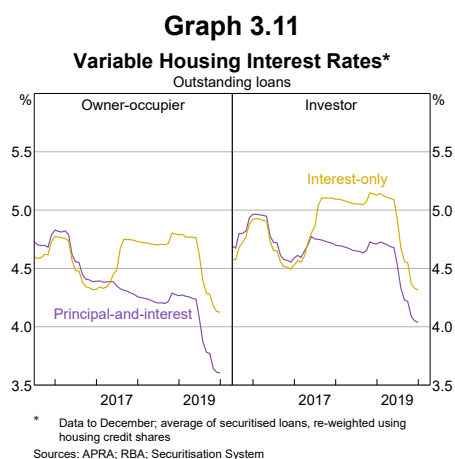
higher than rates on new loans (see ‘Box C: Do Borrowers with Older Mortgages Pay Higher Interest Rates?’). The Reserve Bank has started publishing more comprehensive data on mortgage interest rates that has become available with the new Economic and Financial Statistics (EFS) collection (see ‘Box D: Enhancing the Transparency of Interest Rates’).

The second reason for the drift lower in outstanding variable rates is that households are continuing to switch from interest-only loans to principal-and-interest loans (which tend to have lower interest rates) (Graph 3.11). This switching is estimated to have decreased major banks’ outstanding interest rates by nearly 5 basis points over the past year.

Rates for fixed-rate housing loans have also continued to decline. Over the past year, the major banks have reduced their advertised rates for new 3-year fixed-rate loans by around 100 basis points. This decline is consistent with a similar decline in swap rates, often used as a benchmark for pricing fixed-rate loans.

Households’ total mortgage payments picked up in the second half of 2019

The decreases in interest rates following the reductions in the cash rate mean that minimum required mortgage payments for households with variable-rate mortgages – which account for around 80 per cent of the stock of outstanding housing credit – have declined. When mortgage rates decline, households pay less in interest. They also have the option of



reducing their scheduled repayments, given that the minimum required repayments have declined. However, if they choose to maintain their payments at the same rate, they will repay their loan principal at a faster rate than previously.

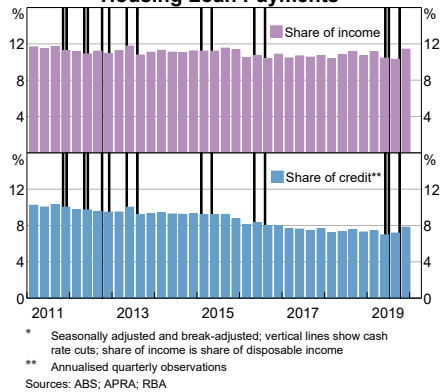
Over time, households have tended to reduce their payments in response to lower interest rates, albeit with some lags. Over the past decade, total loan payments have declined as a share of credit alongside declines in interest rates (Graph 3.12). Total loan payments include both the component that covers the interest and ‘principal and excess’ payments. ‘Principal’ refers to the amount that the borrower is contractually required to pay regularly in order to pay down the loan principal. The additional or ‘excess’ payments beyond that are typically sizeable and can be paid into an offset account or the loan account itself. Offset accounts (from which funds can be withdrawn at any time) and the ability to redraw excess payments from loan accounts have become more common than in the past. This has enabled households to adjust their spending patterns even if they choose to maintain their scheduled payments. Measuring principal and excess payments against credit outstanding provides an indication of the rate at which loans are being repaid. Measuring total loan payments against household disposable income (before interest payments) puts them in the context of household cash flows.

Total housing loan payments – interest, plus principal and excess payments – rose in the second half of 2019 (Graph 3.12). That occurred despite the decline in interest payments following the reductions in the cash rate last year, and reflected a rise in principal and excess payments (Graph 3.13). While the measure of total loan payments is volatile from quarter to quarter, the rise in the second half of 2019 meant that principal and excess payments were higher than they had been for a few years. This may partly reflect the recent tax refunds for

low and middle income earners. It is also consistent with data from lenders and information from liaison, which continue to suggest that only a small share of borrowers have actively adjusted their scheduled mortgage payments since mid 2019. Historically, adjustments to scheduled payments can take some time, and they may still come to pass. It should also be noted that with the transition to the EFS collection, there may be higher-than-usual uncertainty attached to the data on loan payments around the time of the move away from the previous collection of data.

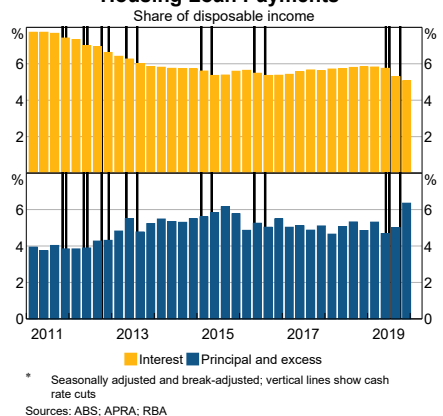
Graph 3.12

Housing Loan Payments*



Graph 3.13

Housing Loan Payments*



Housing loan commitments have increased

Consistent with stronger conditions in some housing markets, housing loan commitments have increased strongly since May 2019 (Graph 3.14). These data are now being collected through the new EFS collection, which measures loan commitments (a commitment by the bank to extend finance that is accepted by the borrower). This replaces the previous concept of loan approvals, which captured the commitment by a bank to extend finance, whether or not the applicant had accepted the loan. While the new commitment measure is slightly lower than the old approval measure – largely because it covers slightly fewer reporting institutions – it does not alter the characterisation of recent trends in housing finance.^[1]

The increase in housing loan commitments since May has been driven by a sharp rise in owner-occupier loan commitments. Investor loan commitments have increased a little over the same period. The increase in overall loan commitments has been broadly based across states and lenders.

The First Home Loan Deposit Scheme, launched by the Australian Government in January 2020, provides a guarantee to participating lenders for

eligible first home buyers that have a deposit between 5 per cent and 20 per cent of the value of a property. This will allow eligible first home buyers to purchase a home without needing to pay for lenders mortgage insurance. The scheme has income and price caps, and will support up to 10,000 loans a year. Around 5,000 first-home buyer loans have been reserved for this program to date.

Credit growth is slow, but owner-occupier housing credit growth has picked up

Total credit growth slowed to around 2½ per cent on a six-month-ended annualised basis at the end of 2019, from 4 per cent at the start of 2019. This was driven by slower growth in business credit and a decline in investor housing credit (Graph 3.15; Graph 3.16; Table 3.2). However, owner-occupier housing credit growth has increased in recent months. Growth in housing credit extended to owner-occupiers was around 5½ per cent on a six-month-ended annualised basis in December, up from around 4½ per cent in mid 2019. The stock of investor housing credit has declined modestly since early 2019 although it was unchanged in December.

Non-major ADIs have been the largest contributor to housing credit growth in recent months, while the contribution from major banks has picked up slightly from very low levels (Graph 3.17). Housing credit extended by non-ADIs is growing relatively quickly, albeit at a slower pace than in 2018.

Business debt growth has slowed, despite accommodative funding conditions

Despite accommodative funding conditions for large businesses, growth in business debt slowed in 2019 (Graph 3.18). This owed largely to slower growth in intermediated lending to businesses (which includes business credit and

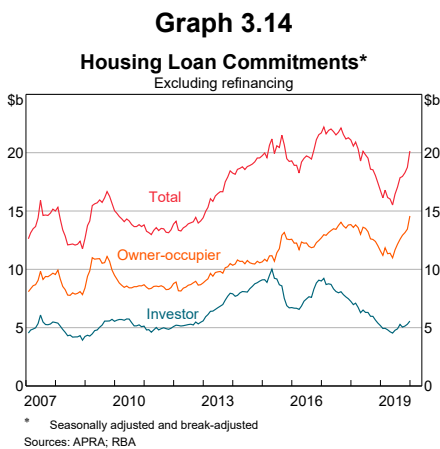


Table 3.2: Financial Aggregates

Percentage change^(a)

	Three-month-ended annualised		Six-month-ended annualised	
	Sep 2019	Dec 2019	Jun 2019	Dec 2019
Total credit	2.7	2.3	2.3	2.5
– Housing	3.1	3.4	2.9	3.2
– Owner-occupier housing	5.5	5.7	4.3	5.6
– Investor housing	–0.9	–0.2	–0.1	–0.6
– Personal	–5.6	–6.1	–4.3	–5.8
– Business	3.6	1.6	2.4	2.6
Broad Money	3.3	3.6	5.1	3.5

(a) Seasonally-adjusted and break-adjusted

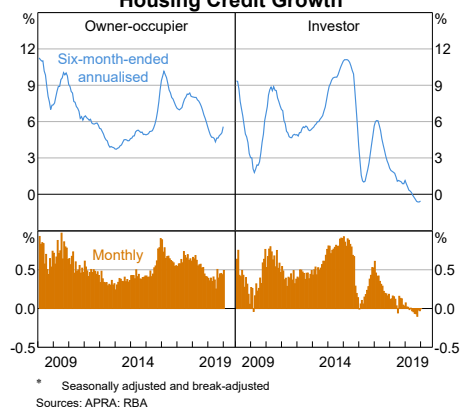
Sources: ABS; APRA; RBA

syndicated lending). The growth of credit extended by foreign ADIs remains higher than the major banks and other Australian ADIs.

The slowing in the growth of intermediated lending to businesses is consistent with the decline in business loan commitments (including refinancing) over the past six months (Graph 3.19). This decline reflected lower loan commitments from major banks and foreign banks. Under the new EFS collection, these data are now measured on the basis that the bank is committed to extending the loan, and the business has accepted the bank's offer of finance. The previous measure of loan approvals

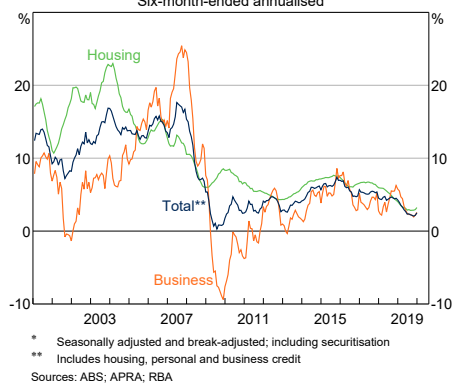
Graph 3.16

Housing Credit Growth*



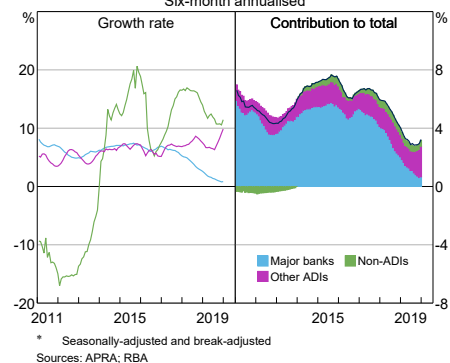
Graph 3.15

Credit Growth by Sector*
Six-month-ended annualised



Graph 3.17

Housing Credit Growth*
Six-month annualised



was based on just the commitment by the bank to extend the loan and, in some cases, businesses may not have taken up that option. Another change is that these data measure gross commitments, which include refinancing.

Small businesses' access to funding remains difficult

The level of loans extended to small and medium businesses has been little changed over the past year or so (Graph 3.20). The EFS collection provides information on credit outstanding by business size, and identifies a higher level of banks' business lending as the measure of credit outstanding is more comprehensive.^[2]

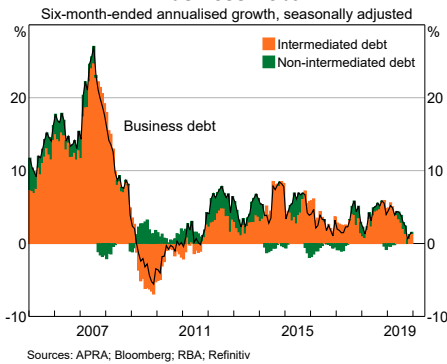
The EFS data show that credit outstanding to small and medium businesses has been little changed over the past few months. This is in contrast to lending to large businesses, which increased over that time.

Small businesses have reported in surveys that their access to finance has become more difficult over the past couple of years (Graph 3.21). This is consistent with banks reporting that, while their appetite to lend has not changed, they have chosen to apply to small business loans the additional verification of income and expenses which they are required to apply when assessing housing loan applications. This is because the personal and business finances of small business owners are often interlinked and so banks often apply consumer lending standards to such loans. However, the Australian Securities and Investments Commission's updated guidance on responsible lending obligations – released in December 2019 – reiterated that these obligations for verification should not apply to lending for business purposes.

The government has agreed to terms with six commercial banks to launch a \$540 million Business Growth Fund. The intention is for the fund to invest between \$5 million and \$15 million in eligible small-to-medium-sized

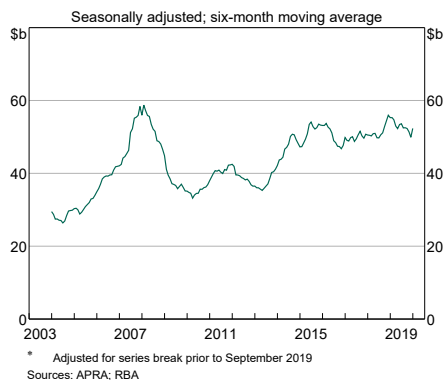
Graph 3.18

Business Debt



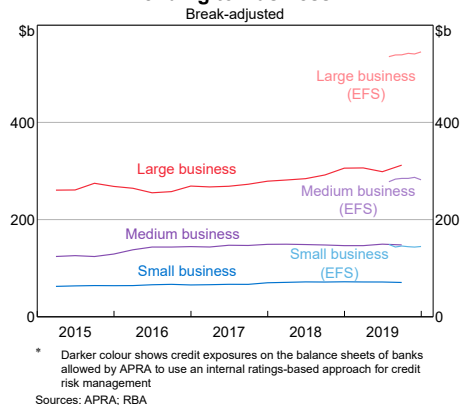
Graph 3.19

Business Loan Commitments*



Graph 3.20

Lending to Business*



businesses. These investments would be in the form of long-term equity, whereby the fund would take a stake of between 10 and 40 per cent.

Interest rates on business loans have declined to record low levels

The new EFS collection provides more frequent and more disaggregated data on the lending rates paid by businesses; data is monthly instead of quarterly and broken down into small, medium and large businesses, instead of large and small business loans (see 'Box D: Improving the Transparency of Interest Rates').

Interest rates on loans to large businesses – which tend to move with BBSW rates – are estimated to have declined over recent months, and are at very low levels (Graph 3.22). Lending rates for medium-sized businesses have also declined in recent months. (Both of these series are new, so earlier data – which combined the interest rates on loans for many of these businesses into the 'large business loan' category – are not comparable.^[3]) The EFS data suggest that lending rates on outstanding loans to small businesses decreased by around 10 basis points following the 25 basis point reduction in the cash rate in October, after

declining broadly in line with the cash rate in June and July.

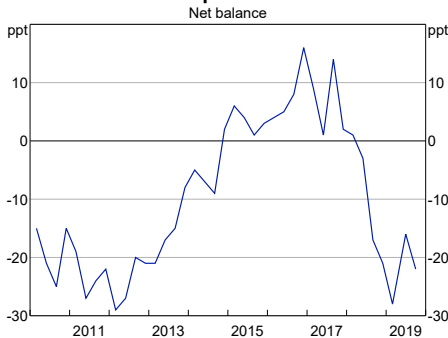
Australian equity prices increased over the past year

The ASX 200 increased by around 25 per cent since the start of 2019, and has performed broadly in line with overseas markets when dividend payments are taken into account (Graph 3.23). The ASX 200 reached a new high in January before declining by around 2 per cent following increased concerns about the economic impact of the coronavirus outbreak.

Share prices are higher than they were at the start of 2019 in each of the major sectors of the ASX 200 (Graph 3.24). The 'other' sectors

Graph 3.21

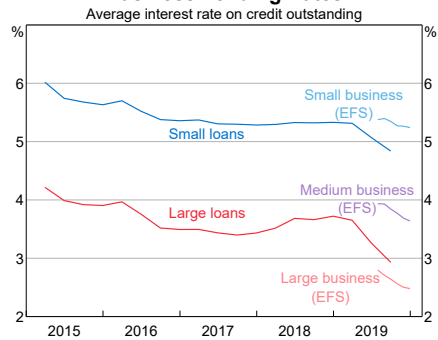
Small Business' Perception of Access to Finance*



* Net balance is the difference between the percentage of firms indicating access is relatively easy and the percentage of firms indicating access is relatively difficult; from July 2019, survey asks about change in access relative to a previous period
Sources: RBA; Sensis

Graph 3.22

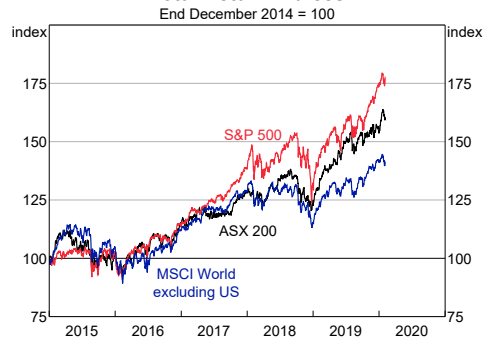
Business Lending Rates



Sources: APRA; RBA

Graph 3.23

Total Return Indices



Source: Refinitiv

performed particularly strongly, led by healthcare and information technology companies. Share prices of resource companies have increased by around 20 per cent, supported by higher iron ore and oil prices. By contrast, banks' share prices underperformed the broader market. Concerns about the adverse effect of the coronavirus outbreak on arrivals from China and on Chinese demand for commodities has led to a recent sharp decline in equity prices of firms in the travel, tourism, education and resource sectors.

Price-to-earnings ratios increased over 2019, consistent with the decline in interest rates, which increases the discounted value of future earnings (Graph 3.25). Estimates of the equity risk premium (such as the difference between the forward earnings yield and the real 10-year government bond yield) suggest that it is broadly in line with its average of the past few years.

The Australian dollar is around its lowest level in some time

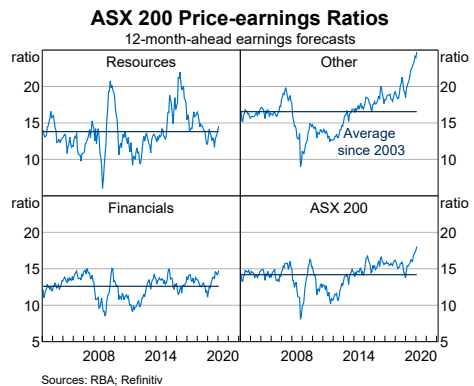
The Australian dollar is around its lowest level since 2009, having depreciated by around 6 per cent since late 2018 on a trade-weighted (TWI) basis (Graph 3.26). The depreciation over the past year or so is consistent with the noticeable decline in Australia's interest rate

differentials, as government bond yields in Australia declined by more than those in major advanced economies, while commodity prices were a little lower overall. More recently, the Australian dollar depreciated alongside falls in commodity prices as concerns increased about the effect of the coronavirus on the Chinese economy.

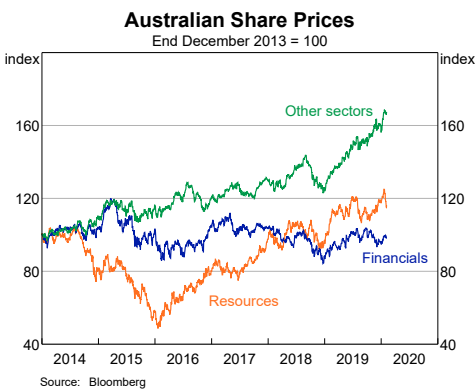
Australia was a net lender of capital for a second consecutive quarter

Gross capital outflows exceeded capital inflows in the September quarter, resulting in Australia being a net lender of capital for a second consecutive quarter (Graph 3.27). This is consistent with Australia recording a current

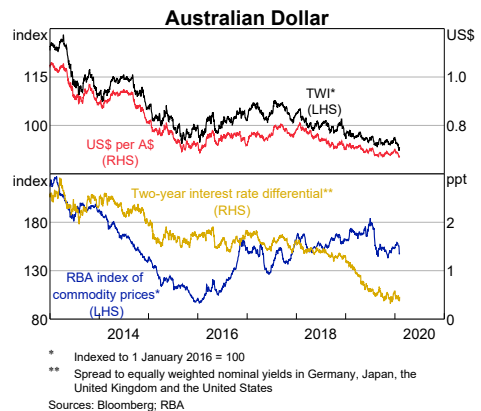
Graph 3.25



Graph 3.24



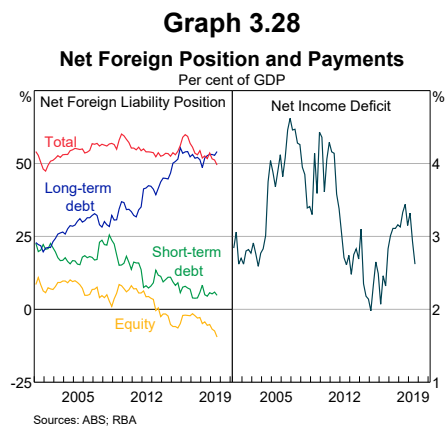
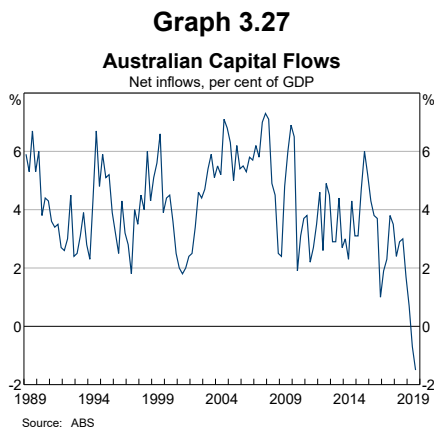
Graph 3.26



account surplus in the quarter (see ‘Domestic Economic Conditions’ chapter). There were net outflows from banks and other financial institutions, such as superannuation funds, which were partly offset by net inflows to the government, as occurs when foreign residents buy Australian government bonds.

Australia’s net foreign liability position has continued to gradually decline as a share of GDP and is around its lowest level since 2002 (Graph 3.28).^[4] The decline has occurred

alongside an increase in Australia’s net foreign equity asset position, which has offset increases in net debt liabilities. The net income deficit, which is comprised of payments and receipts made on the net foreign liability position, has narrowed over the past few quarters. Payments on the stock of debt have declined because of lower interest rates, and equity receipts have remained high alongside the growing stock of equity assets held abroad. ✨



Endnotes

- [1] For more details, see the ABS Information Paper 5601.0.55.002: ‘Upcoming changes to Lending to Households and Businesses, Australia, 2019’. Available at <<https://www.abs.gov.au/ausstats/abs@nsf/mf/5601.0.55.002>>.
- [2] In general, businesses with turnover greater than or equal to \$50 million are classified as large businesses. For businesses with turnover less than \$50 million, when the lender has an exposure of more than \$1 million, the business is classified as medium. When the exposure is less than \$1 million, the business is classified as small. This definition applies to both the new credit data and the new interest rate data for

businesses. The previous measure of business lending was based on prudential data reported by a limited number of banks, and did not include business lending for some business purposes.

- [3] Previously, small business loans were defined as those loans that were less than \$2 million, while all larger loans were defined as large business loans.
- [4] Debelle G (2019), ‘A Balance of Payments’, Address to the Economic Society of Australia, Canberra, 27 August.

Box C

Do Borrowers with Older Mortgages Pay Higher Interest Rates?

For variable-rate mortgages, older loans typically have higher interest rates than new loans, even for borrowers with similar characteristics. This means that existing borrowers who are able to refinance with another lender or negotiate a better deal with their existing lender can achieve interest savings. This box examines the extent to which borrowers with older mortgages pay higher interest rates and considers the drivers of this.

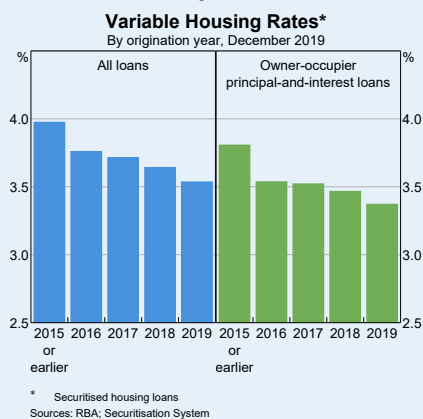
Interest rates are higher on older loans

The difference in interest rates between new and outstanding variable-rate home loans increases with the age of the loan. Just under half of all variable-rate home loans in the Reserve Bank's Securitisation Dataset were originated four or more years ago. Currently, these loans have an interest rate that is around 40 basis points higher than new loans (Graph C.1). For a loan balance of \$250,000, this difference implies an extra \$1,000 of interest payments per year.

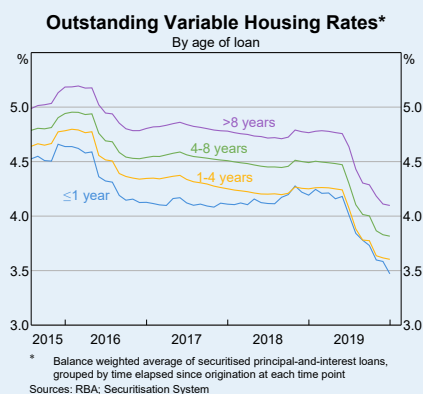
Some of the difference in rates between older and newer mortgages can be explained by a shift in the mix of different types of variable-rate mortgages over time. In particular, the share of interest-only and investor loans in new lending has declined noticeably in recent years and these tend to have higher interest rates than other loans. Nevertheless, even within given types of mortgages, older mortgages still tend to have higher interest rates than new

mortgages. The right-hand panel of Graph C.1 shows this for principal-and-interest owner-occupier loans, which account for around 55 per cent of mortgages. Moreover, higher interest rates for older loans has been a feature of variable-rate mortgages for several years (Graph C.2).

Graph C.1



Graph C.2



There is strong competition for new borrowers

In part, the variation in interest rates paid by different borrowers reflects their creditworthiness or the riskiness and features of loans. In addition, it reflects the different interest rates offered by different lenders. However, the time at which the mortgage was taken out also has an important influence on the interest rate paid. This reflects the tendency for competitive pressures to be strongest for new and other borrowers who are in the process of shopping around for a loan.

The discounts that borrowers receive have increased in recent years

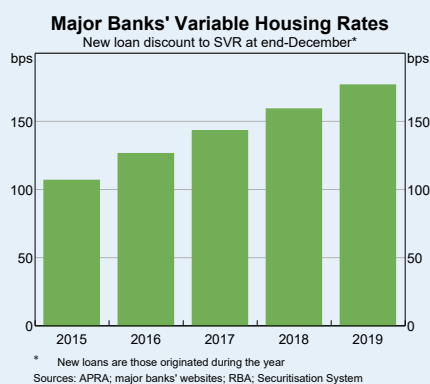
Very few borrowers actually pay interest rates as high as the standard variable rates (SVRs) published by lenders. While SVRs are the reference rates against which variable-rate loans are priced, lenders also advertise a range of interest rates that are materially lower than their SVRs.^{[1], [2]} In addition, most individual borrowers are offered, or may be able to negotiate, further discounts on the interest rate applied to their loan. For instance, the major banks' 'package' mortgage interest rates for owner-occupier loans currently attract a discount of around 50–100 basis points to SVRs.^[3] The lowest *advertised* rates are around 100 basis points lower than those package rates, and a few borrowers receive even larger discounts.

Indeed, in recent years, the average discounts relative to SVRs offered by major banks on new variable-rate mortgages have grown, widening from around 100 basis points in 2015 to more than 150 basis points in 2019 (Graph C.3). By increasing the discounts on

rates for new or refinancing borrowers over time, rather than lowering SVRs, banks are able to compete for new borrowers without lowering the interest rates charged to existing borrowers. So the rise in the average differential between SVRs and interest rates charged on outstanding variable-rate loans reflects the increased discounting on more recently originated loans. The discounts borrowers receive on loans are usually fixed over the life of the loan, although they can be renegotiated. Indeed, interest rates charged on outstanding variable-rate loans have declined by more than SVRs in recent times in part because well-informed borrowers have been able to negotiate a larger discount with their existing lender, without the need to refinance their loan.

In January 2020, the Reserve Bank began publishing more detailed monthly data on mortgage interest rates paid by households on new and existing mortgages (see 'Box D: Enhancing the Transparency of Interest Rates'), which may help more households to make better-informed choices about their mortgages. ✎

Graph C.3



Endnotes

- [1] Lenders usually advertise a number of SVRs; often the applicable rate will depend on whether the property will be used for an owner-occupied or investment purpose, and whether the borrower elects to repay the principal of a loan or the interest only.
- [2] For more information see RBA (2019), 'Box D: The Distribution of Variable Housing Interest Rates', *Statement on Monetary Policy*, November, pp 59–60.
- [3] A typical package mortgage has additional features beyond a 'basic' mortgage, such as an offset account, but will attract a higher fee. It may be offered in conjunction with discounts on other products, such as credit cards and insurance policies.

Box D

Enhancing the Transparency of Interest Rates

Over the past few years, the Australian Prudential Regulation Authority (APRA), the Australian Bureau of Statistics and the Reserve Bank have worked to enhance the interest rate data collected from banks and other financial institutions. The new Economic and Financial Statistics (EFS) collection provides a more comprehensive view of interest rates on mortgages, personal and business loans in a way that was not previously available.^[1]

In January 2020, the Reserve Bank began publishing interest rates paid by households and businesses based on this new EFS collection (see new Statistical Tables F6-F8 and Lenders' Interest Rates).^[2] A broader range of interest rates are now published monthly, including for new and existing loans, and across a larger set of lenders, accounting for around 95 per cent of credit outstanding.^[3]

These new data will help to enhance the transparency of interest rates paid by borrowers in Australia. The absence of readily available data on actual interest rates paid by borrowers in relation to their mortgages had been highlighted in a 2018 Productivity Commission report as one factor impinging on competition in the Australian financial system. The Council of Financial Regulators is working with the Australian Competition and Consumer Commission to develop an online tool for mortgage borrowers based on this new collection of interest rate data.

This box presents some key findings from these new interest rate data.

Lenders continue to differentiate mortgage rates by the type of loan repayment

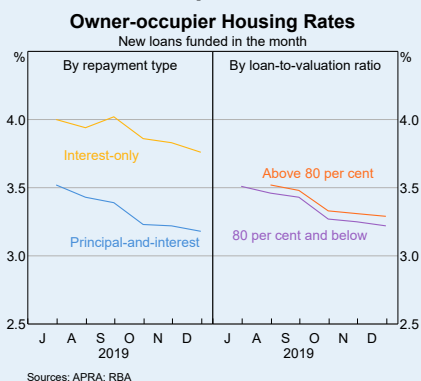
The Lenders' Interest Rates page on the Reserve Bank's website and the new Statistical Table F6 provide mortgage interest rates paid by borrowers on new and outstanding loans. Mortgage rates vary across interest-only and principal-and-interest repayments, variable- and fixed-rate loans, loan sizes and loan-to-valuation ratios (LVRs). The information on new loans available from the EFS data is especially valuable given that competitive pressures are greater for these loans.

The EFS data show significant differences in interest rates across new interest-only and new principal-and-interest loans (Graph D.1 and Graph D.2). For example, new owner-occupier borrowers pay around 65 basis points more, on average, for interest-only loans than for principal-and-interest loans. Since 2015, lenders have charged higher interest rates for interest-only loans, following measures taken by APRA to place limits on investor and interest-only lending.^[4] By contrast, there is much less differentiation in the average interest rates paid by borrowers with different loan sizes or LVRs.

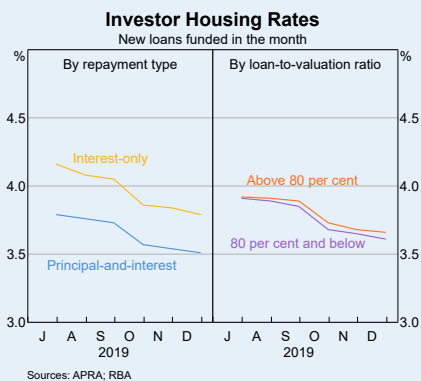
While the new EFS collection provides more detailed and comprehensive interest rate data, it has not changed the Reserve Bank's overall assessment of the mortgage interest rates paid based on the Bank's Securitisation Dataset and existing APRA data (Graph D.3). One important finding it confirms is that new

borrowers, on average, pay lower interest rates than existing customers.

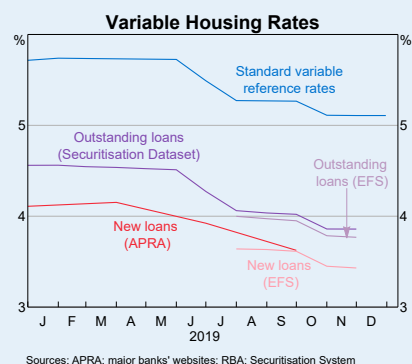
Graph D.1



Graph D.2



Graph D.3

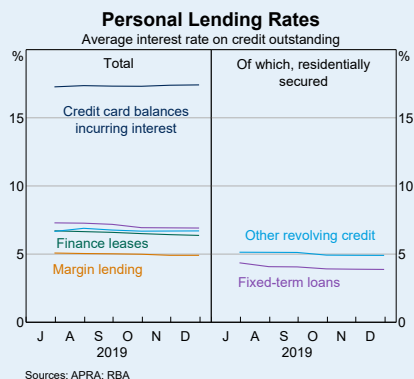


Interest rates are higher on credit cards than other personal finance products

The new Statistical Table F8 contains interest rates for personal finance products (Graph D.4). Personal finance is extended to households for purposes other than housing, and includes products like credit cards and personal loans (such as for a holiday, furniture or whitegoods). Personal finance also includes margin loans – which are loans that enable households to borrow to invest directly in shares or managed funds – and finance leases, where the borrower essentially pays to lease an asset such as a car.

On average, borrowers pay a much higher interest rate on credit cards, which are a form of unsecured finance, compared with other forms of personal finance. However, about half of all other personal loans (i.e. excluding credit cards) are secured against a residential property. The interest rates charged on these personal loans are considerably lower than on non-residentially secured personal loans.

Graph D.4

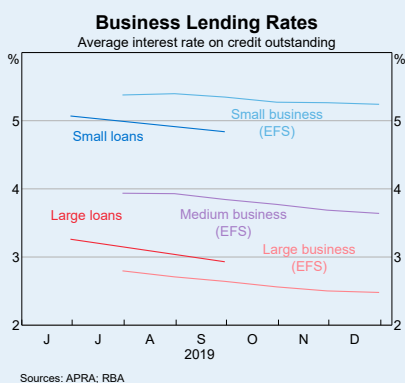


Small businesses pay higher interest rates than larger businesses

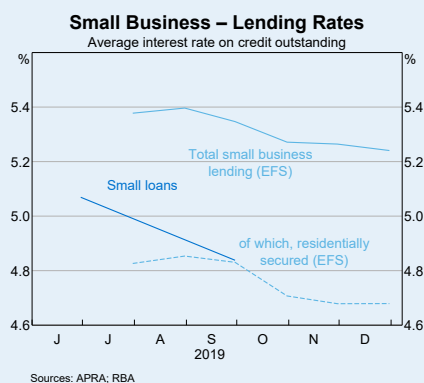
Business interest rates are published in the new Statistical Table F7 and the Lenders' Interest Rates page on the Reserve Bank's website based on three different sizes of businesses: small, medium and large (Graph D.5). Previously, the interest rate data was based on the size of the loan (not the business) and it distinguished only between small and large loans.

Smaller businesses pay higher interest rates for finance than larger businesses. However, small-business borrowers pay significantly lower interest rates on loans secured by residential property compared with their other loans (Graph D.6). This is consistent with the security provided by their property reducing the risk for lenders relative to unsecured finance.^[5] ❖

Graph D.5



Graph D.6



4. Inflation

Inflation was low and stable in 2019

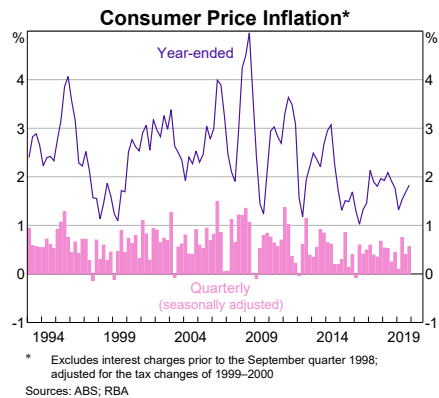
The December quarter inflation outcomes were in line with the forecast in the November *Statement on Monetary Policy*. Headline inflation increased to 0.6 per cent (seasonally adjusted) in the quarter and 1.8 per cent over the year (Table 4.1; Graph 4.1). Headline inflation in the quarter was boosted by a 4½ per cent increase in automotive fuel prices and an increase in the prices of fruit and vegetables. Trimmed mean inflation was unchanged at 0.4 per cent in the quarter and 1.6 per cent over the year (Graph 4.2).

Measures of year-ended underlying inflation were steady at around 1½ per cent in 2019. This is a little lower than in 2018. Continued spare capacity in the economy and associated low wages growth have weighed on inflation outcomes for a number of years. Over 2019, housing inflation declined to historical lows, reflecting a mix of supply- and demand-side developments, and utilities prices fell (Graph 4.3). In contrast, pass-through of the earlier exchange rate depreciation and the ongoing drought have put some upward pressure on retail prices (see 'Box B: Macroeconomic Effects of the Drought and Bushfires').

Non-tradable inflation increased a little to 0.7 per cent in the December quarter to be 2 per cent over the year (Graph 4.4). Prices for tobacco rose strongly in the December quarter because of the increase in the tobacco excise; tobacco is classified as a non-tradable item because prices predominantly reflect domestic

tax arrangements. However, there is broad-based weakness in domestically generated inflation, particularly in housing and utilities price inflation. Prices of tradable items (excluding volatile items) had trended higher since mid 2018 but fell slightly in the December quarter. The boost to retail prices from the earlier exchange rate depreciation appears to have

Graph 4.1



Graph 4.2

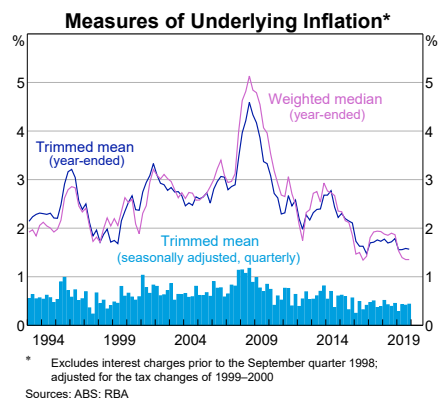


Table 4.1: Measures of Consumer Price Inflation

Per cent

	Quarterly ^(a)		Year-ended ^(b)	
	December quarter 2019	September quarter 2019	December quarter 2019	September quarter 2019
Consumer Price Index	0.7	0.5	1.8	1.7
Seasonally adjusted CPI	0.6	0.3	–	–
– Tradables	0.4	0.3	1.7	1.2
– Tradables (excl volatile items) ^(c)	–0.1	0.7	1.3	1.8
– Non-tradables	0.7	0.5	2.0	1.9
<i>Selected underlying measures</i>				
Trimmed mean	0.4	0.4	1.6	1.6
Weighted median	0.4	0.4	1.3	1.3
CPI excl volatile items ^(c)	0.4	0.5	1.7	1.9

(a) Except for the headline CPI, quarterly changes are based on seasonally adjusted data; those not published by the ABS are calculated by the RBA using seasonal factors published by the ABS

(b) Year-ended changes are based on non-seasonally adjusted data, except for the trimmed mean and weighted median

(c) Volatile items are fruit, vegetables and automotive fuel

Sources: ABS; RBA

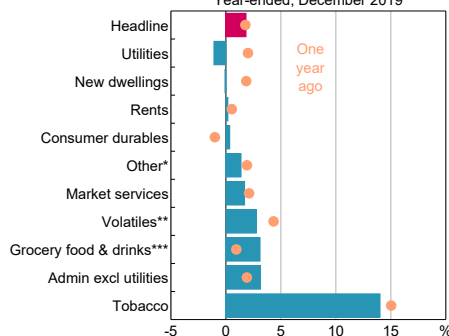
ended; however, drought-related supply shortages continue to put upward pressure on food prices.

Housing inflation remains low

New dwelling purchases by owner-occupiers and rents are the two largest components of the CPI, together accounting for around one-sixth of the basket. Over the past decade, inflation for each of these components has averaged around

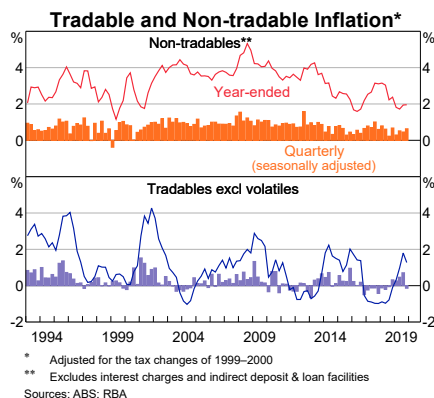
Graph 4.3

Inflation by Component
Year-ended, December 2019



* Includes alcoholic beverages, travel, telecommunications and pet products
 ** Includes automotive fuel, fruit and vegetables
 *** Excludes alcoholic beverages, fruit and vegetables
 Sources: ABS; RBA

Graph 4.4



* Adjusted for the tax changes of 1999–2000
 ** Excludes interest charges and indirect deposit & loan facilities
 Sources: ABS; RBA

2½ per cent. Inflation in these housing components has been well below average recently and has contributed notably less to CPI inflation; new dwelling inflation has averaged 1¼ per cent and rent inflation only ½ per cent over the past two years (Graph 4.5). Inflation in both of these components was around historical lows in the December quarter.

The prices of newly built dwellings increased modestly in the December quarter, but were broadly flat over the year (Graph 4.6). A decline in building activity over 2019 has led to weaker demand from developers for building materials, resulting in lower costs, and thus price inflation. During 2019, liaison reports suggested developers had increased discounts and bonuses in response to weaker demand for new housing, but these incentives (which lower the measured price of constructing a new dwelling) were partly unwound in the quarter.

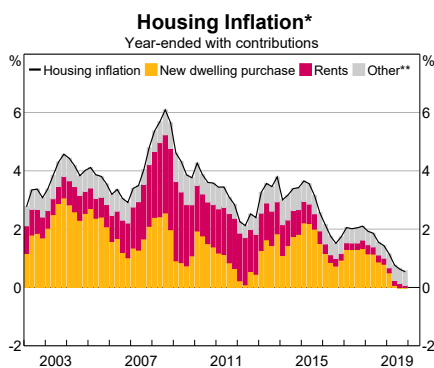
Rents were flat in the December quarter to be 0.2 per cent higher over the year. Various supply- and demand-side developments have placed downward pressure on rents over the past few years. In particular, growth in the housing stock has outpaced population growth and household disposable income growth has been low. Low rents growth could also partly reflect indexation of some rents to CPI inflation. Newly

advertised rents, which are a leading indicator of CPI rents, have been little changed over the past year, suggesting that rent inflation is likely to remain subdued over the year ahead. In Sydney, CPI rents declined over the year to December, along with an increase in the vacancy rate (Graph 4.7). In Perth, the vacancy rate has declined further and rent deflation has continued to moderate, although rents are still around 20 per cent lower than in 2014. Rent inflation remains low in Brisbane but advertised rents have picked up recently given the fall in the vacancy rate. Rent inflation has been fairly stable in Melbourne in recent years despite slower growth in advertised rents, while rents in Hobart increased by 6 per cent over 2019.

Utilities prices declined over 2019

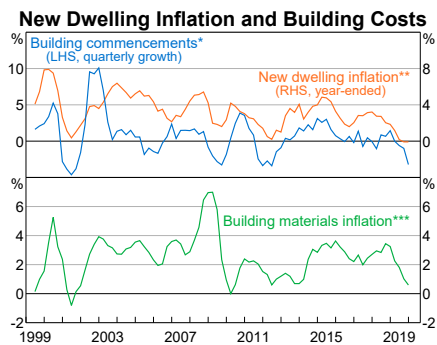
Utilities prices declined by 1 per cent over the year, which was the fastest pace of decline since 2015 (Graph 4.8). Electricity prices fell by 3.5 per cent over the year driven by regulated changes in standing offer prices, as well as declines in market offer prices. In particular, the introduction of the Default Market Offer and Victorian Market Offer on 1 July lowered standing offer prices for many consumers in New South Wales, southern Queensland, South Australia and Victoria. Gas price inflation remains

Graph 4.5



* Excludes utilities
** Includes dwelling maintenance and property rates & charges
Sources: ABS; RBA

Graph 4.6



* Volumes; six-quarter average lagged by one quarter; detached only prior to 2017; thereafter attached included with a 20 per cent weight
** Adjusted for the tax changes of 1999–2000
*** Year-ended change in producer prices for inputs to house construction
Sources: ABS; RBA

low, while water & sewerage price inflation has risen slightly.

Prices for other administered items increased by 3.1 per cent over the year to December. In non-seasonally adjusted terms, the prices of most administered items were broadly unchanged in the quarter because few regulatory or government price changes occur in the December quarter.

Market services inflation remains subdued

The prices of market services were 1.7 per cent higher over the year to December. Low labour

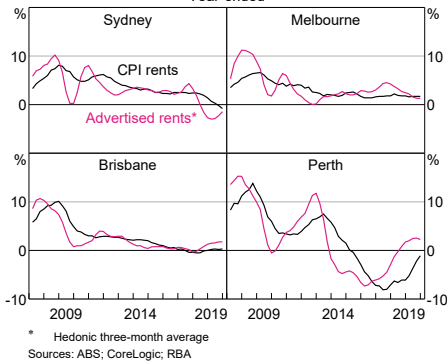
cost growth has constrained market services inflation in recent years; labour costs account for around two-fifths of final prices for market services. Growth in unit labour costs has picked up over the past year which, if sustained, could put some upward pressure on market services inflation. Prices of meals out & takeaway rose by 1 per cent in the December quarter, partly reflecting pass-through of higher input costs arising from the drought (Graph 4.9).

Retail prices have increased owing to higher import prices and the drought

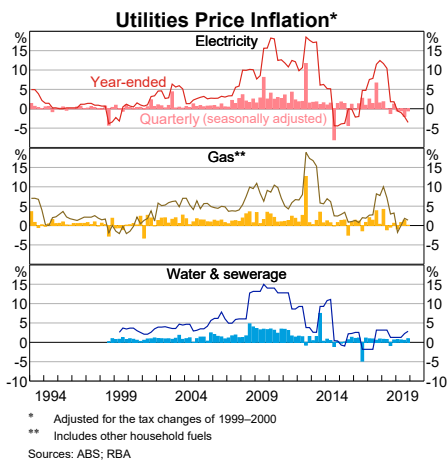
Retail prices increased by 1.3 per cent over 2019. Over the past decade, retail inflation has been very low as a result of heightened competition from new foreign entrants, technology and changing business models. Weaker household demand has also contributed to downward pressure on prices, particularly for consumer durables.

Year-ended inflation in consumer durables prices is close to its highest in a decade, consistent with the pass-through of the earlier exchange rate depreciation to higher import and consumer retail prices (Graph 4.10). However, consumer durables prices fell in the

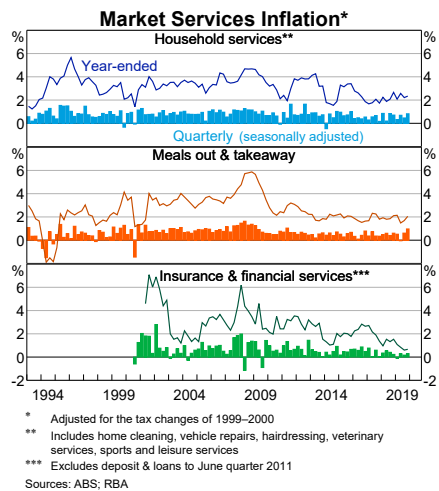
Graph 4.7
Rent Inflation
Year-ended



Graph 4.8



Graph 4.9



December quarter. Although the timing and speed of exchange rate pass-through is uncertain, it is likely that the pass-through of the late 2018 exchange rate depreciation is now largely complete. This is consistent with estimates that most pass-through occurs within a year and with liaison reports that most large retailers hedge their exchange rate exposure around six to twelve months in advance.

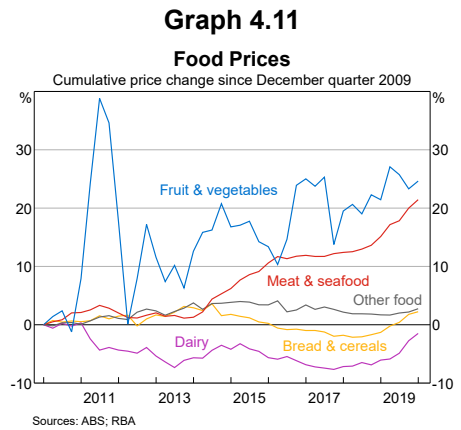
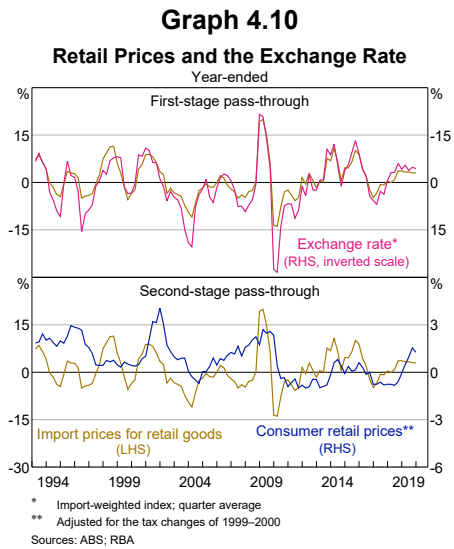
Grocery price inflation was subdued throughout much of the 2010s because of changes to business models and the entry of new supermarket chains. Prices for dairy products fell over the past decade, while prices for bread & cereal and other food items rose only slightly (Graph 4.11). Meat & seafood prices were fairly steady over the early part of the 2010s but increased over the second half of the decade. In contrast, even abstracting from a temporary increase in prices from Cyclone Yasi in 2011, fruit & vegetable prices rose fairly strongly over the decade.

Over the past year and a half, drought-related supply disruptions have put upward pressure on food prices. Grocery prices increased in the December quarter and year-ended grocery price inflation is also around its highest rate since

2009. The drought has particularly affected prices for bread & cereal products (through higher grain input costs) and meat (through higher wholesale prices). Strong international demand, especially for lamb and beef, has also put upward pressure on meat prices over this period. The outbreak of African swine fever in China has led to higher international pork prices over the past six months. Inflation in the prices of other food items has picked up a little recently but remains fairly subdued. Liaison information suggests that retailers have been more willing to pass cost increases through to consumer prices over the past couple of quarters.

Most measures of inflation expectations are low

Wage- and price-setting behaviour can be affected by expectations about the future rate of inflation. Both short- and long-term market-based measures of inflation expectations have increased since mid 2019 (Graph 4.12 and Graph 4.13). However, both measures remain low. Unions and market economists expect inflation to be around 2 per cent over the next year. Long-term survey-based measures of inflation expectations are between 2-2½ per cent and remain consistent with the Bank’s medium-term inflation target.



Wages growth has been stable at low levels ...

After increasing modestly over 2017 and 2018, growth in the wage price index (WPI) has stabilised at around 2¼ per cent over the year to September. The low rate of wages growth implies that there is spare capacity in the labour market (Graph 4.14). Despite strong employment growth, the unemployment rate is around the same level as one year ago and the underemployment rate remains elevated. This is because employment growth has largely been met by a rise in labour force participation. A prolonged period of low inflation and wage

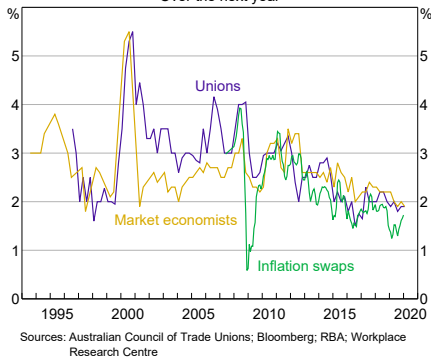
outcomes may have also led firms and workers to adjust their wage expectations to low levels.

Private sector WPI growth edged lower to 2.2 per cent in year-ended terms (Graph 4.15). However, private sector wages growth including bonuses & commissions rose to 3 per cent over the year. This measure, while more volatile, has tended to be above the measure excluding bonuses over recent years. The share of jobs that receive a bonus has increased steadily in recent years, with information from the liaison program suggesting that businesses may be using bonuses to reward workers without locking in larger changes to base pay. Public sector WPI growth has been steady at around 2½ per cent in recent years, consistent with wage policies across federal and state governments.

Wages growth remains strongest in the health care industry, consistent with strong employment outcomes over recent years. Wages growth is lowest in goods-related industries such as construction, manufacturing and mining (Graph 4.16). While there are some clear differences across industry wage outcomes, the distribution of wages growth across jobs has been more compressed over the prolonged period of low wages growth than it was during the 2000s. Information from the Bank's liaison program suggests that the share of workers that

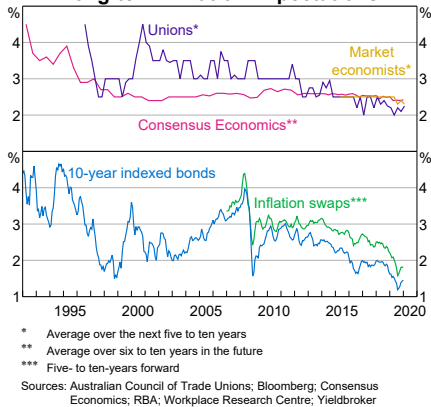
Graph 4.12

Short-term Inflation Expectations Over the next year

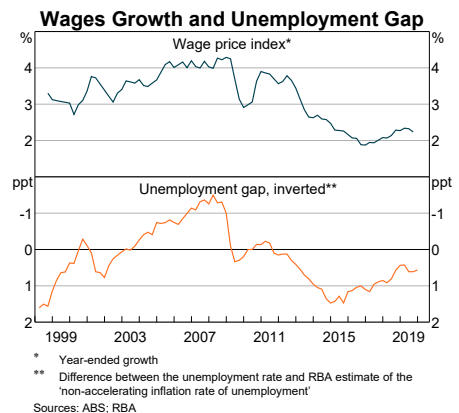


Graph 4.13

Long-term Inflation Expectations



Graph 4.14



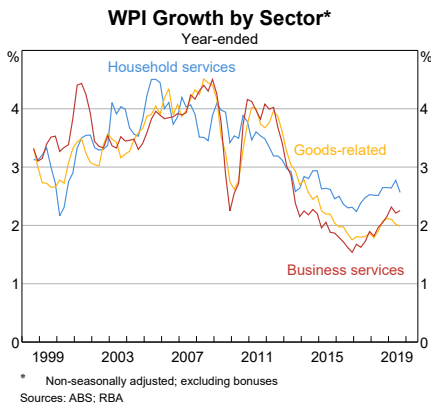
have been receiving wage growth outcomes above 3 per cent has declined to around 20 per cent. Instead, close to half of the wages outcomes are now between 2–3 per cent. This is also consistent with the wage outcomes in current private sector enterprise bargaining agreements (EBAs).

Over recent years, annual wages growth for award-reliant workers has been between 3–3½ per cent as a result of annual decisions by the Fair Work Commission (FWC). This directly affects wages growth for around 20 per cent of employees who are on an award wage. There has also been an increase in recent years in the number of wages outcomes in EBAs that are in some way linked to the FWC decision.

Graph 4.15



Graph 4.16



... but broader measures of earnings growth have picked up

Growth in average earnings per hour in the national accounts (AENA) has increased to around 3 per cent over the year to September. AENA is a broader, but more volatile, measure of labour costs because it captures non-wage payments such as allowances, superannuation and bonuses, as well as changes in the composition of employment.

Over recent years, AENA growth had tended to be lower than WPI growth, which is consistent with workers moving away from higher-paying jobs in mining-exposed industries over this period. The share of people voluntarily changing jobs or receiving a promotion has also declined. Data from the Household, Income and Labour Dynamics in Australia (HILDA) survey show that wages growth is typically higher for workers that change jobs or receive a promotion (Graph 4.17). Furthermore, the gap between the wages of those already working and those entering into employment, whether from unemployment or outside the labour force, had widened over the years to 2017/18. However, the most recent pick-up in AENA growth is consistent with stronger growth in bonuses and may also suggest that the drag on average earnings growth from these compositional effects has started to wane.

Graph 4.17



Wages growth is expected to remain stable

The proportion of firms in the liaison program expecting stable wages growth in the year ahead is close to 80 per cent, and only around 10 per cent anticipate stronger wages growth. Unions' expectations for wages growth have declined a little recently and do not suggest a pick-up in wages growth over the year ahead. The proportion of new EBAs with a term of three years or more has also increased; the average wage outcome in these agreements is around 2½ per cent. By locking in lower wage outcomes for longer, these EBAs could contribute to wages of EBA-covered workers being slower to pick up than was the case in the past. ❖

5. Economic Outlook

The outlook for the Australian economy is for growth to pick up over the next two years, supported by accommodative monetary policy, a pick-up in mining investment and a turnaround in dwelling investment. GDP growth was lower than forecast in the September quarter and this partly explains the downward revision to the forecasts for year-ended growth over the next few quarters compared to those presented in the November *Statement on Monetary Policy*. The forecasts have also been revised a little lower in the near term to account for some effect from the recent bushfires and the coronavirus outbreak in China; beyond the near term, forecasts for growth are largely unchanged.

The labour market and inflation forecasts are little changed from the November *Statement*. The unemployment rate is forecast to fall to around 4¾ per cent in 2021. Wages growth is expected to continue at around its current pace over the forecast period. Inflationary pressures in the economy remain subdued. Inflation is expected to increase a little over the next couple of years, as spare capacity in the economy declines, to be around 2 per cent by the end of 2021.

Before the coronavirus outbreak in China, there had been signs of stabilisation in the global economy, particularly in relation to trade and manufacturing following the easing of US–China trade tensions, and the global outlook appeared to be on a firmer footing. However, the near-term outlook for growth in Australia's major trading partners has been revised lower following the coronavirus outbreak and the

outlook for India has also been revised lower given domestic developments there.

The risks to global growth remain on the downside and the near-term outlook is more uncertain. The coronavirus outbreak is a significant near-term risk for Chinese growth, with spillover effects to other economies, particularly within Asia, because of fewer Chinese travellers, weaker Chinese demand for other exports and disruption to global supply chains. There will be near-term spillover effects to Australia, including through reduced numbers of tourists and a delayed arrival of students from China, along with lower commodity prices. While the recent US–China phase one trade agreement offers some near-term stability, the deal has limited scope and leaves some issues unresolved, which could result in a future escalation in the US–China trade tensions.

There are a number of uncertainties regarding the domestic economic outlook. In the near term, the bushfires and other recent climate-related events will weigh on the economy. The effects of the coronavirus on the Australian economy are quite uncertain, particularly because these events are still evolving. A shift down in households' expectations about future income growth and a restructuring in household balance sheets could weigh on consumption growth for longer than currently assumed. The risks around the expected turnaround in dwelling and business investment are balanced. The risks to the wage and price inflation forecasts are also balanced, and will depend, in

Table 5.1: Output Growth and Inflation Forecasts^(a)

Per cent

	Year-ended					
	Dec 2019	Jun 2020	Dec 2020	Jun 2021	Dec 2021	Jun 2022
GDP growth	2	2	2¾	3	3	3
(previous)	(2¼)	(2½)	(2¾)	(3)	(3)	(n/a)
Unemployment rate ^(b)	5.2	5¼	5	5	4¾	4¾
(previous)	(5¼)	(5¼)	(5¼)	(5)	(5)	(n/a)
CPI inflation	1.8	1¾	1¾	1¾	2	2
(previous)	(1¾)	(2)	(1¾)	(1¾)	(2)	(n/a)
Trimmed mean inflation	1.6	1¾	1¾	1¾	2	2
(previous)	(1½)	(1¾)	(1¾)	(1¾)	(2)	(n/a)
	Year-average					
	2019	2019/20	2020	2020/21	2021	2021/22
GDP growth	1¾	2	2¼	2¾	3	3
(previous)	(1¾)	(2¼)	(2¾)	(2¾)	(3)	(n/a)

(a) Technical assumptions include the cash rate moving in line with market pricing, TWI at 58, A\$ at US\$0.67 and Brent crude oil price at US\$54 per barrel; shaded regions are historical data; figures in parentheses show the corresponding forecasts in the November 2019 *Statement on Monetary Policy*

(b) Average rate in the quarter

Sources: ABS; RBA

part, on the pace at which spare capacity in the economy is absorbed as growth picks up.

Domestic growth is expected to strengthen

Australian GDP growth was a little lower than expected in the September quarter and recent monthly indicators point to moderate GDP growth in the December quarter. Overall, GDP growth is expected to have been 2 per cent over 2019 (Table 5.1, Graph 5.1). The bushfires and the coronavirus are expected to weigh modestly on growth in late 2019 and into early 2020, but growth should recover relatively quickly, to be around 3 per cent over 2021 (see 'Box B: Macroeconomic Effects of the Drought and Bushfires').

Growth in consumption is expected to increase gradually, supported by the ongoing improvement in housing market activity and moderate growth in household income. The

outlook for household income and consumption growth continues to be an important source of uncertainty for the domestic growth forecasts. Although dwelling investment is expected to subtract from GDP growth for a few more quarters, recent data have provided further confidence that dwelling investment will contribute to growth further out. Public demand and business investment (particularly mining-related) are expected to support growth over the forecast period. Exports are expected to increase over 2020, led by resource exports, although the recent bushfires and the outbreak of coronavirus are expected to weigh on service exports and the drought is expected to depress rural exports. Export growth is expected to taper towards the end of the forecast period as some older LNG gas fields are depleted.

The domestic forecasts are conditioned on the technical assumption that the cash rate moves in line with market pricing, which implies one

25 basis point cut in the cash rate around the middle of 2020. Market expectations for the cash rate are broadly unchanged relative to the November *Statement*. The exchange rate is assumed to be constant at its current level, which is a little lower than at the time of the November *Statement*, and is now around the bottom of its range of recent years. The population aged 15 years and over is assumed to grow by 1.7 per cent per annum over 2020 and 2021. This is broadly unchanged from the November *Statement*.

Consumption growth is expected to recover gradually

Growth in consumption was weaker than expected in the September quarter and monthly indicators suggest consumption remained subdued in the December quarter. Growth in consumption is expected to increase only gradually; in part this is because, after a prolonged period of low income growth, household spending patterns are adjusting to the realisation that future income growth is likely to be lower than previously thought (Graph 5.2). Furthermore, this process of adjustment may include a period of debt reduction, but it is uncertain how long this adjustment will take. Working in the other direction, the significant increase in household

wealth over recent quarters and stronger housing market activity are expected to provide support for consumption growth over 2020.

The forecast for household disposable income has been revised a little higher in the first half of 2020 because of expected non-life insurance claims and transfers to households that have suffered losses in the bushfires, but the effects on income growth will be temporary. Further out, small business income is expected to be supported by the recovery in the construction sector and an improvement in farm incomes. The main driver of labour income growth is expected to be a pick-up in employment growth, rather than an increase in wages growth (see below).

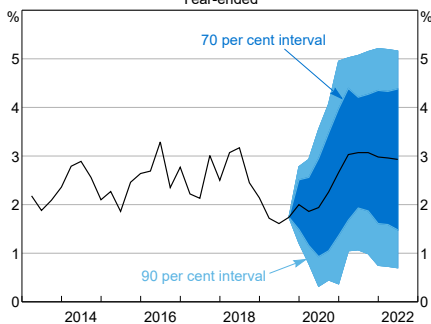
The household saving ratio increased strongly in the September quarter and is expected to remain broadly unchanged over coming years.

Employment growth is expected to pick up but wages growth is expected to be unchanged

Employment growth slowed in the December quarter, following a sustained period of much stronger employment outcomes than the weak domestic activity over 2019 would have suggested. Leading indicators of labour demand are a bit mixed (see ‘Domestic Economic Conditions’ chapter). Information from the

Graph 5.1

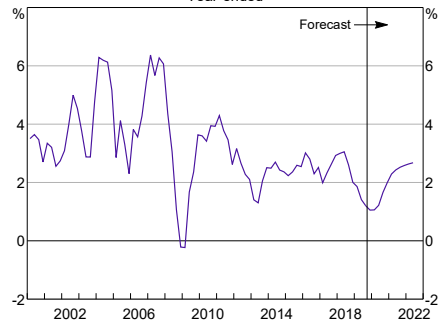
GDP Growth Forecast*
Year-ended



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

Graph 5.2

Household Consumption Growth
Year-ended



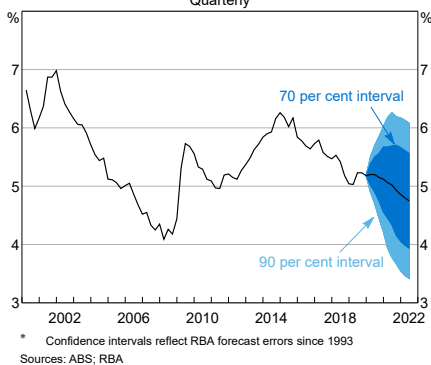
Sources: ABS; RBA

liaison program suggests firms' hiring intentions have continued to moderate but generally remain positive. The forecast for employment growth over the first half of 2020 has been revised down as a result of the overall signal from leading indicators and the downward revision to GDP growth in the near term. Employment growth is expected to pick up again as GDP growth picks up. The participation rate is expected to be largely unchanged over the next couple of years.

The unemployment rate is expected to remain in the 5–5¼ per cent range for some time (Graph 5.3). As GDP growth picks up, the unemployment rate is expected to decline to be around 4¾ per cent in 2021. This forecast implies that the unemployment rate will remain a little higher than estimates of the unemployment rate associated with full employment and that some spare capacity in the labour market will remain for a couple of years.

Wages growth was broadly as expected in the September quarter. The majority of firms in the liaison program continue to expect little change in wages growth over the next year, and only very few firms expect stronger wages growth outcomes in the year ahead. There is also no indication that there will be changes to the government wage caps that have kept public sector wages growth stable over recent years.

Graph 5.3
Unemployment Rate Forecast*
Quarterly



The superannuation guarantee is legislated to increase from 9.5 per cent of ordinary time earnings to 12 per cent between 2021 and 2025. The increase will be gradually phased in with 0.5 percentage point annual increases from July 2021. Based on evidence from previous increases in superannuation as well as the international literature on increases in mandated benefits, it is expected that increases in superannuation payments will be offset to a large extent by lower wages growth outcomes. It is expected that the adjustment to each increase will take a couple of years, although the timing and extent of the adjustment is very uncertain. If the increase in the superannuation guarantee is not fully offset by lower wages growth, overall labour costs would increase for employers.

In terms of the forecasts, the increase in the guarantee is expected to largely offset the boost to wages growth from the gradual decline in labour market spare capacity.

Dwelling investment is expected to turn around towards the end of 2020

Dwelling investment is expected to continue to decline over coming quarters because the completion of residential buildings has continued to significantly outpace the commencement of new buildings. Following the rebound in established housing markets, there is evidence of a pick-up in the early stages of residential development activity, broadly consistent with the forecasts presented in the November *Statement*. Building approvals appear to have troughed in the December quarter and greenfield lot sales have edged higher. Developers in the Bank's business liaison program report that sales of new housing have increased, although by less than what would historically be associated with very strong growth in established housing prices partly because of tight financing conditions for buyers. The trough in dwelling investment is expected

to occur in the second half of 2020, before a recovery in residential construction gets underway through 2021.

Public demand is expected to remain strong in the near term

Public demand growth was stronger than expected in the September quarter and the latest information from the state and federal mid-year budget updates points to further growth in public investment in the near term. Ongoing expenditure on transport infrastructure projects is expected to be partly offset by reduced capital expenditure on the National Broadband Network. The outlook for public consumption is broadly unchanged.

Since the mid-year updates were released, the Australian and New South Wales Governments have announced an additional \$3 billion for bushfire recovery, equivalent to 0.15 per cent of annual GDP. Much of the additional expenditure is likely to be public investment to rebuild infrastructure and public buildings. The timing of these expenditures is unclear, but they are likely to contribute to growth over the next year or so.

Business investment growth is expected to pick up from recent weakness

Mining investment was weaker than expected in the September quarter as work on some LNG plants was finalised during the quarter.

Information from company liaison and the recent Australian Bureau of Statistics (ABS) Capital Expenditure (Capex) survey nonetheless continues to support the view that mining investment is passing through a trough. Growth is expected to pick up noticeably over 2020 and 2021 as work commences on a number of sustaining and expansionary projects. There are also some projects under consideration but not yet approved, which, if they were to proceed, would further contribute to growth in the latter part of the forecast period.

Non-mining business investment was also weaker than expected in the September quarter, led by a sharp drop in investment in machinery & equipment. Although the weakness was broadly based across industries, it was particularly concentrated in industries exposed to the slowdown in dwelling investment and consumption since mid 2018. The recent Capex survey indicates machinery & equipment investment is also likely to be weaker than previously expected over the remainder of 2019/20. As a result, the forecast for non-mining investment has been lowered for the next few quarters. Other forward indicators suggest that non-residential construction activity is likely to continue growing steadily (largely driven by commercial property), in line with expectations at the time of the previous *Statement*. From late 2020, non-mining business investment growth is expected to increase modestly, in line with a broader pick-up in private demand over the forecast period. Recent bushfire events and air quality concerns have also disrupted some investment activity in the December and March quarters, but this could be more than offset in subsequent quarters once rebuilding efforts get underway (see 'Box B: Macroeconomic Effects of the Drought and Bushfires').

Exports are expected to continue growing over the coming year, although there are some near-term risks

Restrictions on travel following the outbreak of coronavirus in China will reduce tourism and education exports for the next quarter or two, before recovering. Reflecting this, export growth has been downgraded in the March quarter but, as discussed below, assessing this risk is difficult given the situation is still evolving. The recent bushfires are also likely to have weighed on service exports (particularly international tourism) in recent quarters. Over the next few years, education-related travel exports are

expected to continue growing modestly, based on government forecasts for student visas.

The broader outlook for resource exports is little changed – export volumes are expected to increase modestly over 2020 then stabilise, with little additional production coming online and global demand fairly steady. LNG production and exports ramped up faster than expected over 2019, and some further modest growth is expected over the next few quarters before stabilising around the end of this year. Over 2021 and 2022, however, LNG export volumes are expected to decline gradually as older gas fields start depleting.

Ongoing adverse weather conditions continue to weigh on rural exports, which are expected to decline by more than previously expected over the next year or so, reflecting both updated information on the effects of drought conditions as well as disruptions and losses to produce and livestock caused by the recent bushfires.

Imports were a little weaker than expected in the September quarter, and partial trade data suggest a further decline in the December quarter, consistent with slower domestic demand growth over recent quarters. Further out, growth in imports is expected to pick up in line with growth in domestic demand.

The terms of trade are expected to decline

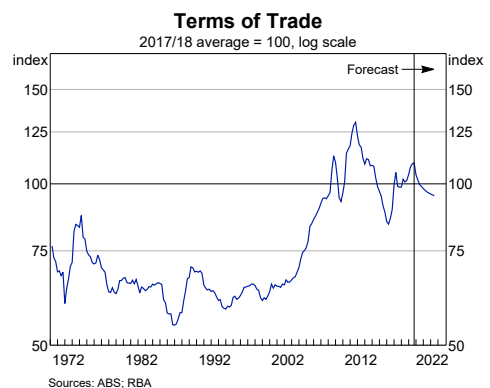
The terms of trade are expected to decrease in the near term, reflecting recent falls in some commodity prices (particularly iron ore) in response to the coronavirus outbreak (Graph 5.4). Further out, the terms of trade are expected to continue to decline, but more gradually, as Chinese demand for bulk commodities moderates and global supply remains ample.

Inflation is expected to increase only modestly

There has been little change to the underlying inflation forecast since the November *Statement* (Graph 5.5). The December quarter inflation outcome was as expected and there have been small but offsetting changes in the determinants of inflation since then. There is still expected to be some spare capacity in the labour market over the next few years, and inflation expectations remain low. As such, underlying inflation is expected to increase modestly to around 2 per cent over 2021. The decline in fuel prices in the quarter to date is expected to subtract from headline inflation in the near term; further out, headline inflation is expected to follow a similar profile to underlying inflation.

Inflation is expected to remain low across a range of components of the CPI for some time. The upward pressure on consumer durables prices from the exchange rate depreciation over the past year or so is expected to have largely run its course. While there have been some reports from liaison that retailers have reduced the degree of discounting, an environment of subdued consumer spending will continue to weigh on retail prices in the near term. The drought-related increases in a wide range of food prices are likely to persist for some time (and may be compounded by the effects of the

Graph 5.4



bushfires); however, the upward pressure is expected to wane eventually. New dwelling inflation is expected to remain subdued until residential construction activity starts to pick up in 2020. Rent growth, which is a slow-moving component of the CPI, is expected to pick up gradually as housing demand from continued strong population growth more than offsets the slower additions to the housing stock. The amount of renewable energy coming online will also put downward pressure on electricity prices.

Downside risks to global growth remain

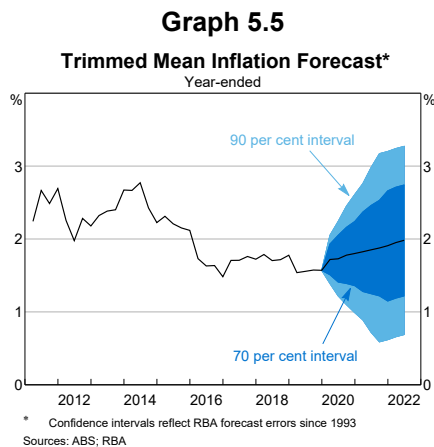
The coronavirus outbreak is a significant near-term risk to the economic outlook for China and Australia's other key trading partners in Asia. There is considerable uncertainty regarding the possible duration and severity of the outbreak, and the effect it will have on economic activity may be larger than currently projected. By comparison, the effects of the Severe Acute Respiratory Syndrome (SARS) outbreak were concentrated in the June quarter of 2003, and mainly affected a number of Asian economies and Canada. The economic effects were largest for the economies at the epicentre of the crisis. For example, it resulted in a sharp one-quarter reduction in GDP growth in China, before recovering fairly quickly, supported by

stimulatory policies. It is hard to know whether there will be any sizeable spillover effects this time. However, the integration of China with the global economy has increased since the SARS outbreak, and China is now a more important source of global demand, and also plays a more significant role in terms of global manufacturing and supply chains. On the other hand, the Chinese authorities are likely to respond to any prolonged weakness with additional stimulus.

The progress in addressing the US–China trade and technology dispute has reduced an important downside risk to global growth. However, the phase one agreement reached between the two countries has limited scope and leaves some issues to be still negotiated and resolved. The potential for an escalation of the dispute remains and continues to pose a key downside risk to the global outlook, particularly through the effects of uncertainty on trade and investment.

More broadly, the Chinese authorities face policy trade-offs that are important to the outlook for the Chinese economy, demand for bulk commodities and Australia's terms of trade. The authorities are seeking to strike a delicate balance of avoiding a sharp slowdown in economic growth while preventing an increase in leverage, continuing to facilitate a shift away from shadow banking, preventing speculative activity in the property market and protecting the environment. The emerging configuration of policies to achieve these competing objectives will be important for China's growth trajectory and the outlook for Chinese steel demand.

Globally, financial market conditions remain accommodative and could ease further if growth were to surprise to the upside or if downside risks were to recede further, in an environment of muted inflationary pressures and accommodative monetary policy. On the other hand, financial conditions could tighten over the coming year, for example, if underlying political issues were to resurface or the



stabilisation in global economic activity proves to be short-lived. In addition, valuations in many markets are at historically high levels and could reprice abruptly.

The economic impact of the bushfires and coronavirus on the Australian economy is uncertain

The forecasts incorporate a near-term impact of the recent bushfires and coronavirus on the forecasts. However, the effects on economic activity from the coronavirus are particularly uncertain because the situation is still evolving and relevant economic data are yet to be published. In the case of the bushfires, it is particularly hard to assess potential indirect effects on activity and these could present some downside risk to the forecasts in the near term. Indirect effects could include potential loss of productivity in major cities because of smoke pollution. Other indirect effects could include disruptions to regional supply networks, reduced consumer and business confidence that spills over into lower consumption and/or investment growth.

The bushfires are also expected to have an effect on some consumer prices. Liaison reports that transport disruptions in the March quarter resulted in temporary increases in some food prices. Over a longer period, the increased likelihood of longer and more extreme weather events is likely to lead to further increases in insurance premiums.

The outbreak of coronavirus is expected to lead to lower GDP growth in the March quarter, because fewer overseas students and tourists are expected to travel to Australia. There is significant uncertainty around how things will evolve. For Australia, a more severe scenario could also result in less Chinese demand for Australian exports of bulk commodities and food exports in the near term, and could lead to lower commodity prices than currently forecast. This could further weigh on GDP growth over

the next quarter or so. On the other hand, the recovery phase could be faster than expected, depending in part on how effectively the outbreak is contained and the stimulus measures introduced by the Chinese authorities. The Australian dollar exchange rate is also likely to depreciate in a more severe scenario, which would provide some offsetting support to the domestic economy.

Risks to business and dwelling investment are balanced

While there could be some near-term effects from the bushfires and the coronavirus on growth, they are currently expected to be relatively modest and short-lived. The central forecast is for a pick-up in economic activity, underpinned by an increase in mining investment in the near term, a turnaround in dwelling investment by the end of 2020 and a gradual strengthening in consumption over coming quarters. The risks to the outlook for business investment are balanced and, while the timing of the trough in housing construction activity is uncertain, the risks around the dwelling investment outlook are more balanced than they have been for some time.

There is a possibility that there will be more mining investment than is currently factored into the forecasts, particularly towards the latter part of the forecast period. The current forecasts incorporate available information on projects that are underway or imminent. However, company information and business liaison suggest that there are some additional mining projects for which investment decisions have not yet been made, but which could commence around the end of the forecast period, further adding to GDP growth. On the other hand, the sharp decline in non-mining machinery & equipment investment in the September quarter was a surprise. An extended period of slow domestic demand could weigh further on firms' investment expenditure plans, although

this would leave investment at historically low levels relative to GDP.

The signs of a trough in the early stages of residential building activity have become clearer and the recent increase in established housing prices in some markets has begun to support demand for new dwellings. Currently, dwelling investment is expected to recover more slowly than average historical relationships with interest rates and established housing prices would imply. This judgement reflects the effects of the shift in composition towards higher-density dwellings, tight credit conditions and information from the Bank's business liaison program.

Consumption growth could remain subdued for longer than expected ...

Some of the uncertainty around the consumption outlook comes from uncertainty around the outlook for the labour market and household income growth. Any deterioration in labour market conditions would weigh on labour income growth and consumption, particularly given high levels of household debt. Some of the slowing in consumption growth in recent quarters could be related to households lowering their expectations of future income growth following a protracted period of low income growth. If so, it is unclear how long this adjustment process might take. The gradual pick-up in consumption growth in the forecasts is also underpinned by the increase in housing prices and activity in the housing market. Given the recent increase in mortgage payments, it is possible that some of the recent weakness in consumption growth also reflects decisions by some households to improve their balance sheet positions. This adjustment process could also put more downward pressure on consumption growth than we have currently factored into the forecasts.

... although the risks to wages and price inflation are balanced

For wage and price inflation, the risks to the forecasts appear to be evenly balanced. Wages growth could pick up faster than expected if labour market conditions tighten by more than we currently expect. As noted above, the increase in the superannuation guarantee in 2021 is expected to constrain wages growth for many wage earners, although the timing and extent of this is highly uncertain.

Domestic inflationary pressures will depend on how fast the economy recovers from the weakness over the past year and how much businesses and households' inflation expectations remain anchored at low levels. At a more disaggregated level, the risks to inflation appear relatively balanced. The pace of inflation in housing-related CPI components, currently around multi-decade lows, will depend on how quickly residential construction activity increases relative to the demand for housing. Inflation in the prices of food and consumer durables, which has increased over 2019 as a result of the pass-through of the exchange rate depreciation as well as the drought, will also be influenced by any pick-up in consumer demand and any potential changes to competition dynamics in the retail industry. ✎

