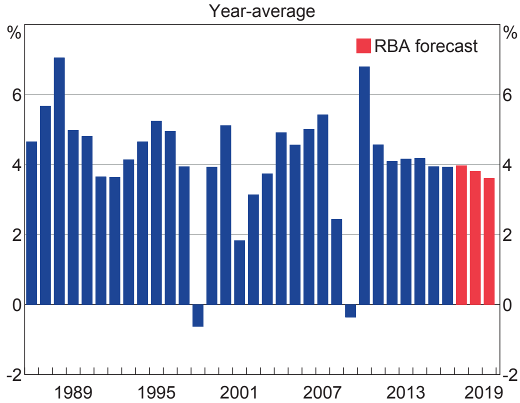
6. Economic Outlook

The International Economy

The outlook for growth in Australia's major trading partners is little changed since the previous *Statement*, following upward revisions to the forecasts in late 2016 and early 2017 (Graph 6.1). Global economic conditions have improved over the past year and major trading partner growth is forecast to maintain its current pace over the remainder of this year. Growth in Australia's trading partners is expected to ease over 2018 and 2019, largely because of longer-run factors, such as the decline in the working-age population in a number of important trading partners, including China, Japan and Korea. Potential growth rates in a number of major trading partners have also been lower than their long-term averages because growth in the capital stock and productivity has been slow. However, investment growth has started to pick up in the major advanced economies and in the high-income economies in Asia, which, if sustained, will add to their productive capacity and potential growth over time.

In China, near-term growth is expected to be supported by accommodative policy settings, although there is considerable uncertainty about how the policy configuration will evolve in the wake of the Chinese Communist Party's 19th National Congress later this year. The east Asian economies (other than China and Japan) are expected to grow at around potential over the forecast period, supported by the improvement in the global economy and an expected pick-up in domestic demand. GDP growth in the major advanced economies is

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



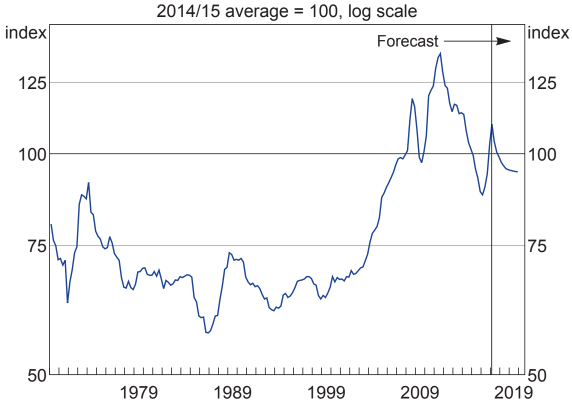
* Aggregated using total export shares
Sources: ABS; CEIC Data; RBA; Thomson Reuters

likely to continue to be above potential growth over the next couple of years, partly because monetary policies are expected to remain accommodative over the forecast period. Considerable uncertainty remains about the economic policies of the US administration, but the prospect of substantial tax reform in the United States has diminished. As a result, fiscal policy in the United States is likely to be less expansionary than previously expected, although the risk of more restrictive and protectionist trade policies has also lessened.

Although still low, wage growth has increased in some of the major advanced economies that are close to experiencing full employment. Wage pressures are expected to increase gradually as spare capacity in these economies' labour markets declines further. This should put upward pressure on inflation in the next couple of years. If there is less spare capacity in these economies than projected, inflation could rise more quickly than currently forecast. This could lead to tighter-than-expected monetary policy in some advanced economies and would typically result in a depreciation of the Australian dollar, all else being equal.

Australia's terms of trade are likely to decline over the forecast period, but to remain above their trough in early 2016 (Graph 6.2). The near-term forecast for the terms of trade is largely unchanged since the previous *Statement*, but the forecast is slightly higher further out.

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

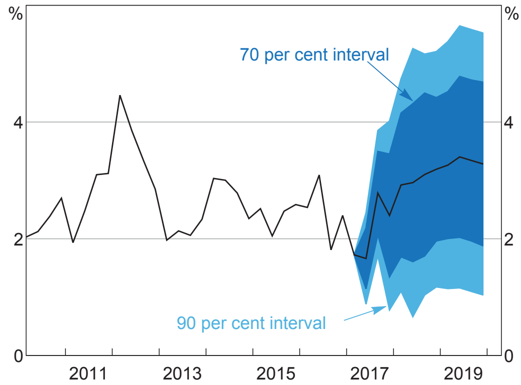


Sources: ABS; RBA

Domestic Activity

The forecast for domestic output growth is little changed from that presented in the May *Statement* (Graph 6.3; Table 6.1).[1] Economic activity grew more slowly than expected in the March quarter, partly reflecting some temporary factors; the outlook for quarterly growth is little changed, suggesting slightly lower year-ended growth in the near term. Recent indicators point to a pick-up in growth in the June quarter 2017. Further out, GDP growth should

Graph 6.3
GDP Growth Forecast*
Year-ended



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

continue to recover as the drag from falling mining investment comes to an end and the ramp-up in resource exports continues. The recent appreciation of the exchange rate has been factored into the forecasts and has had a modest dampening effect on the forecast for growth. Growth in the economy is expected to strengthen gradually to be around 3 per cent in the first half of 2018. Although this is a bit above potential growth, it is expected to take some time for the economy to encounter broad-based capacity constraints.

The domestic forecasts are conditioned on a number of technical assumptions. The cash rate is assumed to move broadly in line with market pricing. This assumption does not represent a commitment by the Reserve Bank Board to any particular path for policy. The exchange rate is assumed to remain at its current level over the forecast period, which is 5 per cent higher on a trade-weighted basis than in the May *Statement*. The US dollar price of Brent crude oil is also slightly higher than the assumption used in May. The population aged over 15 years is assumed to grow by 1.6 per cent over both 2017/18 and 2018/19.

1 One way of demonstrating the uncertainty surrounding the central forecasts is to present confidence intervals based on historical forecast errors.

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

	Year-ended					
	Jun 2017	Dec 2017	Jun 2018	Dec 2018	Jun 2019	Dec 2019
GDP growth	1¾	2–3	2½–3½	2¾–3¾	3–4	3–4
Unemployment rate[(b)]	5.6	5–6	5–6	5–6	5–6	5–6
CPI inflation	1.9	1½–2½	1¾–2¾	1¾–2¾	2–3	2–3
Underlying inflation	1¾	1½–2½	1½–2½	1½–2½	2–3	2–3
	Year-average					
	2016/17	2017	2017/18	2018	2018/19	2019
GDP growth	2	1¾–2¾	2¼–3¼	2½–3½	2¾–3¾	2¾–3¾

(a) Technical assumptions include A$ at US$0.80, TWI at 67 and Brent crude oil price at US$53 per barrel; shaded regions are historical data
(b) Rate at end of period
Sources: ABS; RBA

There has been little change to the forecasts for mining investment other than a change in timing. In the March quarter, mining investment was stronger than expected for the second consecutive quarter, but this strength predominantly reflected earlier-than-expected prepayments on existing projects rather than new investment projects. Although mining companies' profits have been strong over the past year or so, this is not expected to lead to much additional investment spending; information from the Bank's liaison and company announcements have indicated that firms have generally used the additional income to pay down debt, pay dividends and increase share buybacks. The drag on domestic activity from the falls in investment in the resources sector is expected to have finished by the second half of next year.

Resource export volumes are expected to have increased in the June quarter, despite the disruption to coal exports related to Cyclone Debbie. Further out, resource exports are forecast to continue rising, supported by higher production from Australia's low-cost iron ore producers and the ramp-up in liquefied natural gas (LNG) production, which is still expected despite some delays with a few projects. LNG exports are expected to contribute almost ½ percentage point to GDP growth per year between 2017 and 2019. The Australian Domestic Gas Security Mechanism, which seeks to secure domestic gas supply through restrictions on LNG exports, was legislated in July. At this stage, the impact on overall LNG exports remains unclear.

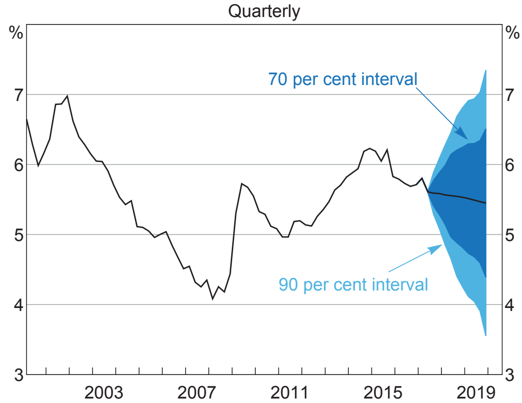
Growth in non-mining activity is forecast to pick up over the next year, supported by stronger growth in household consumption. Timely indicators, including retail sales, suggest that growth in household spending picked up in the June quarter, after growth was weaker than expected in the March quarter. For the remainder of the forecast period, household consumption is forecast to grow at a bit above its average since 2008, as had been expected at the time of the May *Statement*. Given the recent strength in total hours worked, growth in household disposable income is expected to increase and be in line with growth in consumption, implying little change in the household saving ratio. However, as discussed below, there is considerable uncertainty about a range of important factors, such as future income growth, housing prices and household debt, and how these factors might affect spending decisions.

The significant pipeline of residential building work to be done is expected to maintain a high level of dwelling investment over most of the forecast period. Home building approvals have been lower than their recent peaks for some time now, which suggests that the pipeline of work to be done will start to fall over the forecast period. The contribution to GDP growth from dwelling investment over the forecast period is expected to be minimal.

The gradual recovery in non-mining business investment is expected to continue and broaden out beyond Victoria and New South Wales, supported by low interest rates and as the spillover effects from falling mining investment dissipate. Given the gradual recovery to date and mixed signals from surveys of investment intentions, the strength of investment growth is not forecast to match that seen in previous recoveries. But, as discussed below, it is possible that non-mining business investment could, at some point, increase more noticeably than is currently projected. Reasonably strong government spending is factored in over the forecast period, which largely reflects the significant pipeline of public infrastructure work. However, the timing of expenditures on these projects can be hard to predict.

Information from leading indicators, such as job advertisements and vacancies, points to solid employment growth over the second half of 2017, following stronger-than-expected growth over the first half of the year. Further out, employment growth is expected to be broadly consistent with labour force growth. The unemployment rate was a bit lower than expected in the June quarter; it is expected to edge lower over the forecast period, to be just under 5½ per cent at the end of 2019 (Graph 6.4). This forecast suggests that there will still be some spare capacity in the labour market over the next few years. The forecasts also embody a small pick-up in average hours worked, reflecting an expectation that some of the increase in labour demand will be met with an increase in hours worked by existing workers, rather than new employees. This should lead to a lower underemployment rate over the forecast period because some workers will be closer to their preferred number of hours of work. The participation rate, which has picked up noticeably since late 2016, is assumed to remain around current levels over the forecast period.

Graph 6.4
Unemployment Rate Forecast*
Quarterly



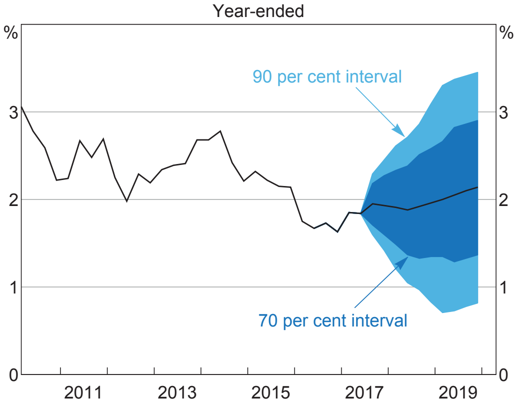
* Confidence intervals reflect RBA forecast errors since 1993
Sources: ABS; RBA

The recent improvement in labour market conditions is consistent with the Bank's forecast for a gradual recovery in wage growth. Information from the Bank's liaison program and a survey of union wage expectations suggests wage growth is likely to remain steady over the year ahead. However, the larger-than-expected increase in minimum and award wages that has now come into effect will provide a boost to wage growth in the September quarter. Wage growth is then expected to pick up gradually over 2018 and 2019. Although spare capacity in the labour market is expected to continue to weigh on wage growth over the next few years, the drag from the mining-exposed states and industries is expected to dissipate. There is uncertainty about how the improvement in labour market conditions will translate into wage pressures, as discussed below.

Inflation

The June quarter underlying inflation outcome was consistent with the Bank's expectations at the time of the May *Statement* and there has been little change to the forecast; measures of underlying inflation are expected to reach around 2 per cent over the second half of 2017 and increase a little thereafter (Graph 6.5). Headline inflation is forecast to rise gradually and be between 2 and 3 per cent over much of the forecast period. The outlook for headline inflation is slightly higher than at the time of the May *Statement*, reflecting an upward revision to expected utilities prices, notwithstanding the exchange rate appreciation that has occurred.

Graph 6.5
Trimmed Mean Inflation Forecast*
Year-ended



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

While the previous forecasts incorporated an increase in utilities inflation over the forecast period, new information suggests that the increase in electricity and gas prices over the next few years is likely to be higher than previously thought. Utilities inflation is expected to make a sizable contribution to headline inflation over the year ahead. There will also be some indirect effects on inflation because higher utilities prices will raise business input costs, although competitive pressures may limit firms' ability to pass those cost increases on to consumers. There is considerable uncertainty about when and how the range of factors that contributed to the increases in wholesale utilities prices will be resolved and how large the direct effects on retail utilities prices will be. The legislated tobacco excise increases are expected to add more than ¼ percentage point to headline inflation in each of the next couple of years.

Wage growth is expected to pick up gradually over the next few years. Consistent with this, unit labour costs are forecast to pick up, which will contribute a little to inflationary pressures. At the component level, there are a number of forces weighing on inflation. Food price inflation has been low and prices have declined for clothing & footwear over a number of years, reflecting heightened retail competition. The entry of new foreign retailers into the Australian market over the next few years is also expected to constrain retail price inflation. The exchange rate appreciation since the May *Statement*, if sustained, will put further downward pressure on retail prices over the year ahead. Large additions to housing supply, both over recent years and over the next year or so, are expected to keep rent inflation low.

The ABS will be updating the weights assigned to each expenditure class in the Consumer Price Index (CPI) in the December quarter 2017 CPI release. In calculating the CPI, the weight assigned to each expenditure class is fixed for a number of years. This means that, during that time, the CPI does not take into account changes in consumer behaviour in response to relative price changes (known as 'substitution bias'). As a result, the forthcoming re-weighting is expected to reduce measured inflation. It is currently difficult to estimate the size of this effect on the CPI because past re-weightings are not necessarily a good guide to future episodes. The ABS will re-weight the CPI annually in the future, which will reduce the ongoing effect of substitution bias.

Key Uncertainties

There are a number of key uncertainties that need to be considered in relation to the forecasts. For the global economy, the current expansion could be more self-sustaining than the Bank, or other forecasters, expect. On the other hand, it remains possible that escalating geopolitical tensions or increased global trade protectionism could derail the ongoing recovery. Domestically, there is the risk that household spending growth could be more constrained than expected by low real wage growth and high debt levels. The potential strength of the recovery in non-mining investment, future exchange rate movements and how quickly wage growth responds to a decline in spare capacity in the labour market are other key sources of uncertainty for the domestic economic and inflation outlook, which are discussed below.

The Chinese economy and commodity prices

The persistence of stronger-than-expected conditions in the Chinese residential property market, combined with accommodative policy settings (including resilient government-led infrastructure activity), has helped sustain growth momentum in the first half of 2017. This momentum is expected to continue in the lead-up to the 19th Party Congress later this year. Continued fiscal and monetary policy support, if pursued more forcefully than expected, poses upside risks to the forecasts for economic activity in China over the coming year. Similarly, if efforts to restrict housing activity are less effective than expected, this could lead to growth being stronger than forecast. At the same time, there continues to be uncertainty about how the authorities will negotiate the difficult trade-off between growth and the build-up of leverage in the Chinese economy. The adoption of a stricter regulatory approach to managing risks in the 'shadow banking' sector over the past year, together with the recent high-level directive to improve coordination among financial supervisors, could lead to tighter-than-expected financial conditions and result in growth being weaker than expected. If appropriately calibrated, however, these measures could also mitigate the longer-run risk of a sharp financial disruption or crisis, which, if it eventuated, would have much more severe outcomes for Chinese growth.

The uncertainty surrounding China's growth outlook has implications for Australian resource exports and commodity prices. If conditions in the Chinese construction and/or manufacturing sectors ease by more (less) than expected in the next few quarters, growth in demand for steel, and therefore iron ore and coking coal, could be lower (higher) than expected. On the supply side of commodity markets, coal prices have responded particularly strongly to recent supply disruptions as well as the policy changes that have led to fluctuations in China's domestic production.

Consumer spending and the housing market

Households' consumption decisions depend on their expectations about growth in their incomes and wealth, and any liquidity or credit constraints that they might face. The recent increase in total hours worked and the rise in award wages have led to some upward revision to the forecast for household income growth. A continuation of recent strong employment growth, which would imply stronger growth than is currently embodied in the employment forecasts, could provide a boost to consumption growth relative to current forecasts. However, ongoing expectations for low real wage growth remain a key downside risk for household spending. The recent sharp increase in the relative price of utilities poses a further downside risk to the non-energy part of household consumption to the extent that households find it hard to reduce their energy consumption; this is likely to have a larger effect on the consumption decisions of lower-income households.

Household spending has grown by more in New South Wales and Victoria, where housing prices continue to grow briskly despite some tentative signs of slowing growth recently. Large unexpected rises (or falls) in housing prices could lead to changes in the outlook for consumption growth, at least in the short term. Elevated debt levels are likely to amplify any risks to consumption; if indebted households become less confident about their future prospects, they could choose to pay down debt faster, in which case consumption growth could be lower than forecast.

There are a number of uncertainties that could affect housing prices, particularly in the eastern states. The risk of more weakness in apartment prices in some locations where a large amount of supply is coming online remains. This could mean that buildings approved but not commenced do not go ahead, in which case dwelling investment and related household spending would be weaker than expected. Declining housing prices could also cause difficulties for some apartment developers. Recent state and federal budget measures intended to restrain foreign investment have not yet had time to have had their full effects, which are uncertain; however, the effects are likely to be largest in housing markets where foreign buyers have been most active, particularly inner-city apartments.

Business investment

Non-mining business investment growth has been relatively modest in recent years. This is despite many of the conditions being in place that would normally encourage stronger investment, such as low interest rates, tax incentives for small business and high capacity utilisation rates. This investment cycle has been unusual compared with previous episodes because investment typically picks up quite sharply after a period of weakness. International experience suggests that, as time goes on and the momentum in domestic demand picks up, the probability of a more rapid recovery in business investment increases. There are some signs that this may already be occurring in the major advanced economies; however, it is difficult to forecast exactly when it might happen in Australia. The forecasts have built in a relatively gradual increase in non-mining business investment growth and, as such, there is a risk that investment will pick up by much more than is forecast at some point. If a turning point in non-mining business investment becomes apparent, there could be a substantial upward revision to the forecast profile. On the other hand, a recovery in non-mining investment has been forecast for some time and, given the subdued signals from some leading indicators, it remains possible that a substantial pick-up is still some way off.

Australian dollar exchange rate

The exchange rate is another source of uncertainty for the forecasts. The Australian dollar has appreciated by 5 per cent on a trade-weighted basis since the May *Statement*, and by 7 per cent against the US dollar. This has been incorporated into the current forecasts.

It is possible that the Australian dollar could appreciate further, which if sustained, would be expected to result in a slower pick-up in economic activity and inflation than currently forecast. Based on historical relationships, a 10 per cent appreciation of the trade-weighted exchange rate (that is not associated with higher commodity prices) would be expected to lower year-ended inflation by a little less than ½ percentage point over each of the following two years or so. Output would be expect to be lower by ½–1 per cent in around two years' time.

Spare capacity and inflation

As discussed in previous *Statements*, there is some uncertainty about how much slack there is in the labour market currently and how quickly it will decline over the forecast period as growth in the economy picks up. There is also uncertainty about how employment-intensive future GDP growth will be. This is because the sizeable contribution to growth from LNG production is not expected to add to employment growth. However, growth in public infrastructure activity or service industries such as health could be more employment-intensive than assumed.

Another key risk to the forecast profile is how much wage inflation picks up as spare capacity in the labour market declines. It may be the case that, after a period of low wage growth, workers may seek 'catch-up' or much stronger wage growth, which would see wage pressures emerge more quickly than forecast. On the other hand, an increased perception of competition among workers, as a result of globalisation and/or technological change, may make workers reluctant to seek higher wage outcomes. Lower productivity growth appears to have constrained the pick-up in wage growth in some advanced economies, although this is less of a factor in Australia than elsewhere.

Core inflation has not picked up by as much as expected in many economies that are close to full employment, even though unit labour cost growth has increased. This raises the possibility that low inflation may turn out to be more persistent, both domestically and globally, than forecast, given estimates of spare capacity.