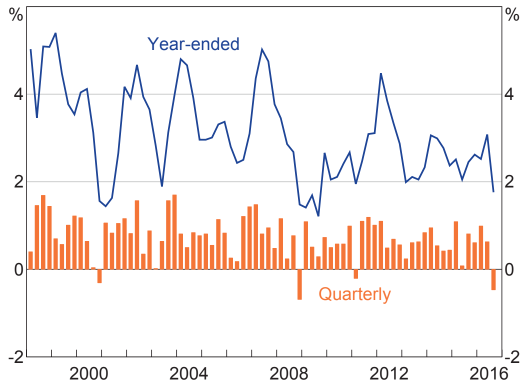
3. Domestic Economic Conditions

Year-ended growth in the Australian economy has slowed (Graph 3.1; Table 3.1). GDP fell in the September quarter, reflecting some temporary factors. Consumption growth was subdued in mid 2016; it is expected to recover but remain below its historical average. This is consistent with relatively weak growth in household income and a gradual improvement in labour market conditions.

Overall, GDP growth has slowed to be below the economy's potential growth rate. This is consistent with developments in the labour market including moderate employment growth

Graph 3.1
GDP Growth



Source: ABS

Table 3.1: Demand and Output Growth
Per cent

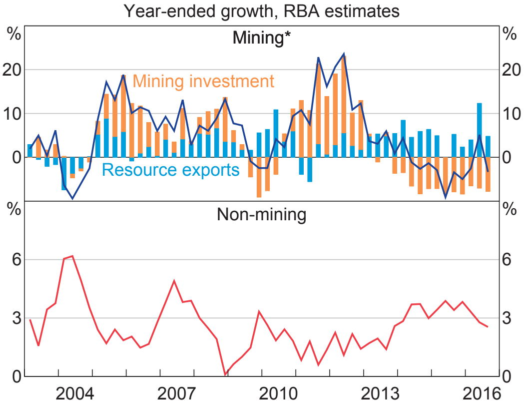
	September quarter 2016	June quarter 2016	Year to September quarter 2016
GDP	–0.5	0.6	1.8
Domestic final demand	–0.5	0.8	1.5
– Consumption	0.4	0.5	2.5
– Dwelling investment	–1.4	2.6	7.2
– Mining investment	–10.6	–15.0	–32.9
– Non-mining investment	–0.2	5.3	5.1
– Public demand	–0.7	2.9	4.8
Change in inventories[(a)]	0.1	0.2	0.3
Exports	0.3	2.1	6.0
Imports	1.3	2.9	2.3
Mining activity[(b)]	–2.3	–0.2	–3.3
Non-mining activity[(b)]	–0.2	0.8	2.5
Nominal GDP	0.5	1.4	3.0
Real gross domestic income	0.4	1.0	2.0
Terms of trade	4.4	2.3	1.4

(a) Contribution to GDP growth
(b) RBA estimates
Sources: ABS; RBA

and low wage growth. The transition from the mining investment boom is still in progress, but is now well advanced; the drag on growth from falling mining investment should wane. Low interest rates and the depreciation of the Australian dollar over recent years also remain supportive of growth. The recent increase in the terms of trade should boost nominal income, but is expected to have less flow-on to real activity than it did during the earlier terms of trade boom.

Mining activity has subtracted from growth in recent years, but is expected to contribute to growth in coming quarters as the drag from mining investment dissipates and exports of liquefied natural gas (LNG) continue to ramp up (Graph 3.2). Non-mining activity eased in mid 2016, partly reflecting the moderation in household consumption growth. Both public demand and dwelling investment grew strongly over the year to September and are expected to continue to support growth in non-mining activity in coming quarters. Non-mining business investment has remained subdued.

Graph 3.2
Mining and Non-mining Activity
Year-ended growth, RBA estimates



* Net of mining-related imports; components are contributions to year-ended mining activity growth; contribution from changes in inventories not shown

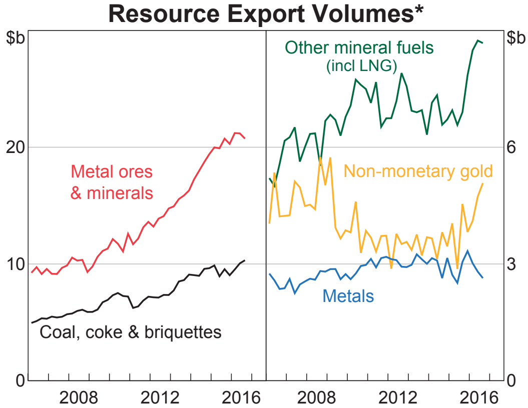
Sources: ABS; RBA

Mining Activity

Mining activity (net of mining-related imports) declined in the September quarter as resource exports were little changed, while mining investment continued to fall. Mining investment has declined sharply from its peak in 2012/13. Recent falls have corresponded with the completion of a number of major projects and further falls are expected as work on LNG facilities reaches completion and few new projects are expected to commence. However, the largest subtraction of net mining investment from GDP growth looks to have already occurred; the Australian Bureau of Statistics (ABS) capital expenditure (Capex) survey of investment intentions and Bank liaison point to a smaller subtraction in 2016/17. The recent increases in commodity prices are expected to boost the profitability of mining firms, but are unlikely to lead to much new mining investment over the next few years.

Resource export volumes have increased strongly over the past year (Graph 3.3). The ramp-up in LNG production has been underway for the past year or so and LNG exports are expected to continue to grow strongly over the next few years. Looking ahead, iron ore export volumes

Graph 3.3
Resource Export Volumes*



* Reference year is 2014/15

Source: ABS

should be supported by increased production from Australia's low-cost producers, while coal production is also expected to increase in the coming quarters as recent supply disruptions have been largely resolved.

Despite the recent pick-up in commodity prices, economic conditions still remain relatively weak in the resource-rich states – Western Australia and Queensland – that have been most directly affected by declining mining investment and the earlier falls in the terms of trade.

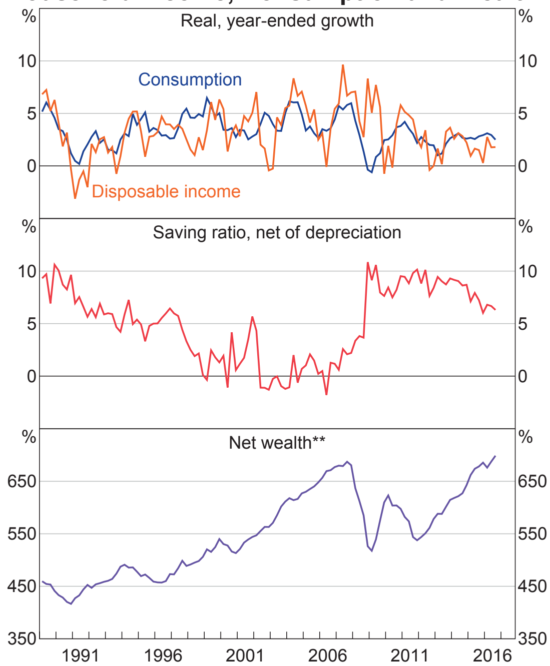
Household Sector

Household consumption growth moderated over the year to September 2016 (Graph 3.4). Goods consumption recorded a decline for the second consecutive quarter, while services consumption grew at around its average pace. The modest pace of real household disposable income growth over the past year has weighed on consumption growth, although low interest rates and rising household wealth have generally supported household spending. The saving ratio has broadly moved sideways over the past year, having declined from its post-crisis peak.

More timely indicators suggest that goods consumption strengthened somewhat in late 2016, following the weak September quarter outcome; growth in retail sales volumes picked up in the December quarter (Graph 3.5). Households' perceptions of their personal finances are around average and their unemployment expectations are at low levels relative to recent years.

Private dwelling investment continued to grow at an above-average rate over the year, but fell unexpectedly in the September quarter, largely because poor weather disrupted construction. Residential building approvals, especially higher-density dwelling approvals, have fallen in recent months (Graph 3.6). Nevertheless, the large amount of work in the pipeline should continue

Graph 3.4
Household Income, Consumption and Wealth*

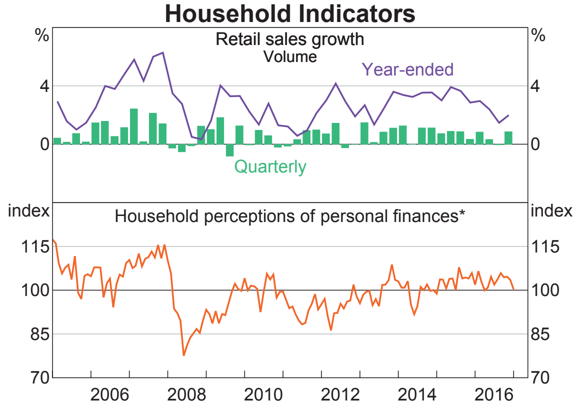


* Household sector includes unincorporated enterprises; disposable income is after tax and interest payments, and has been smoothed between March quarter 2000 and March quarter 2002

** Per cent of annual household disposable income, before the deduction of interest payments

Sources: ABS; RBA

Graph 3.5
Household Indicators

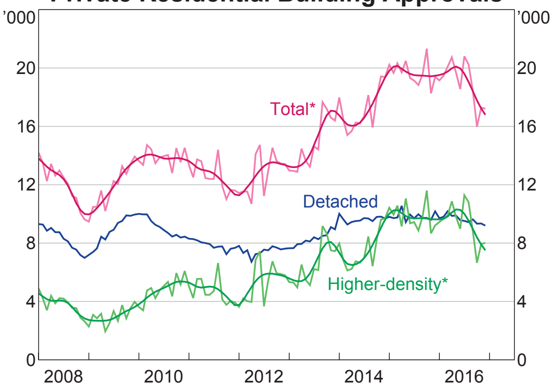


* Average of the ANZ-Roy Morgan and Westpac-Melbourne Institute consumer sentiment measures of respondents' perceptions of their personal finances relative to the previous year; average since 1980 = 100

Sources: ABS; ANZ-Roy Morgan; RBA; Westpac and Melbourne Institute

to support a high level of dwelling investment for the foreseeable future (See 'Box A: The Pipeline of Residential Dwelling Work').

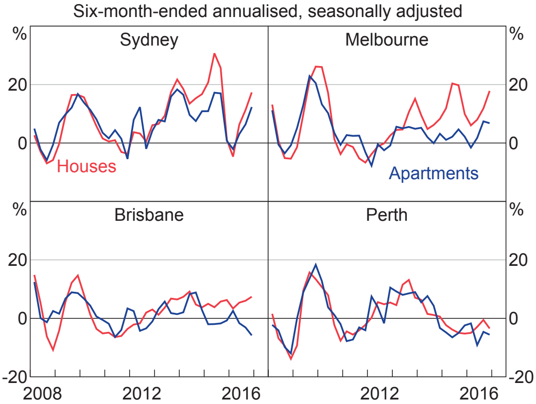
Graph 3.6
Private Residential Building Approvals



* Smoothed lines are 13-period Henderson trends
Sources: ABS; RBA

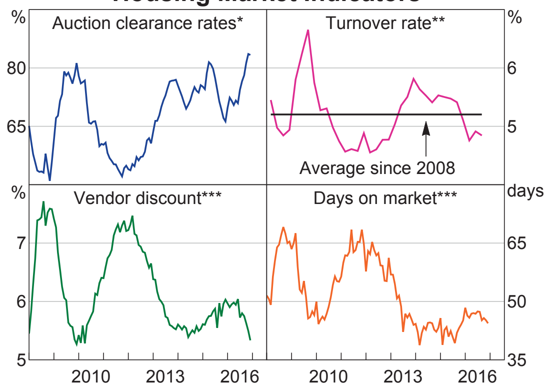
Conditions in the established housing market differ significantly across the country (Graph 3.7; Graph 3.8). Conditions in the housing market in Sydney and Melbourne strengthened over the second half of 2016, but they have remained relatively subdued elsewhere. In the private treaty market, the average discount on vendor asking prices has decreased, but the average number of days that a property is on the market has increased from the lows of 2015, mainly reflecting developments outside Sydney and Melbourne.

Graph 3.7
Housing Price Growth by Dwelling Type
Six-month-ended annualised, seasonally adjusted



Sources: APM; RBA

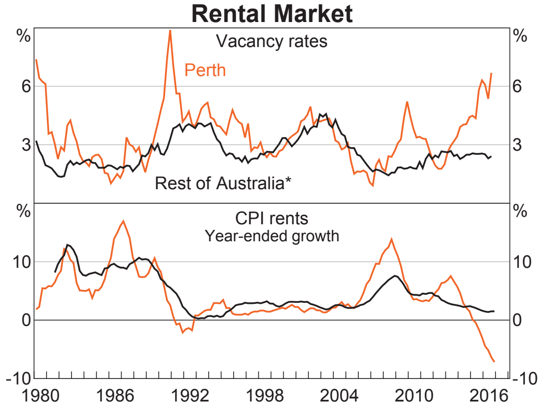
Graph 3.8
Housing Market Indicators



* Average of Melbourne and Sydney
** Share of dwelling stock, annualised
*** Capital city dwelling stock weighted median for private treaty sales only
Sources: ABS; APM; CoreLogic; RBA; Real Estate Institute of Victoria

In general, price growth for detached houses has been stronger than for apartments, particularly in the capital cities where the supply of new apartments has increased the most. For example, in the second half of 2016, apartment prices declined noticeably in Brisbane while growth in prices for detached houses increased. Conditions in Perth remain particularly weak; prices and rents have continued to decline and the vacancy rate has increased further (Graph 3.9). Rental growth in the rest of the country remains subdued and vacancy rates have been steady near their long-run average for some time.

Graph 3.9
Rental Market



* Capital cities only; excludes Adelaide from March quarter 2015
Sources: ABS; RBA; REIA

Low interest rates are providing ongoing support to housing demand. Over recent months, loan approvals have picked up, largely reflecting stronger demand from investors (see 'Domestic Financial Markets' chapter for further details on the developments in housing finance). Bank lending standards have been tightened over the past couple of years, which is a positive development given the already high levels of debt.

Non-mining Business Sector

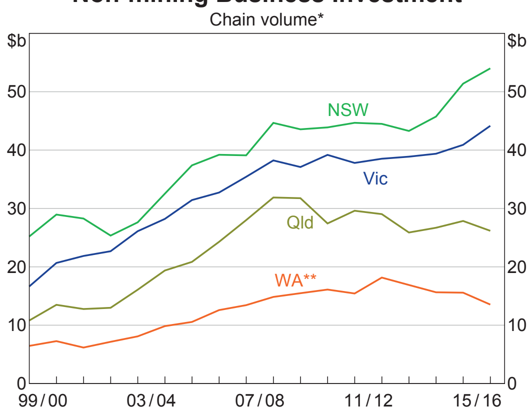
The level of non-mining business investment has been subdued for some time, although it increased by around 5 per cent over the past year. Recent state-level data published by the ABS indicate that non-mining investment has grown in New South Wales and Victoria over the past few years, led by the household and business services sectors (Graph 3.10). In contrast, non-mining investment has been declining in the resource-rich states of Western Australia and Queensland where the effects of the falling terms of trade have been most pronounced.

The share of non-mining business investment relative to GDP remains low relative to history. Indicators such as the Capex survey suggest that non-mining business investment is likely to remain subdued in 2016/17. However, the Capex survey only covers about half of the non-mining business investment captured by the more comprehensive national accounts measure; it does not cover certain industries, such as some service industries that have seen relatively strong investment over recent years. Non-residential building approvals increased over 2016, partly reflecting some very large projects in the retail, entertainment and short-term accommodation sectors.

Survey measures of business conditions have been above average for some time, although they have eased over the past six months or so (Graph 3.11). Business credit growth has picked up in the past three months; however, this is partly due to a number of large privatisations being financed by business credit. Survey measures of profitability have been at above-average levels, while non-mining company profits have been little changed as a share of nominal GDP for some time.

The depreciation of the exchange rate over the past couple of years has supported non-mining exports (Graph 3.12). Net service exports, including tourism, education and business services, have made a significant contribution to GDP growth

Graph 3.10
Non-mining Business Investment

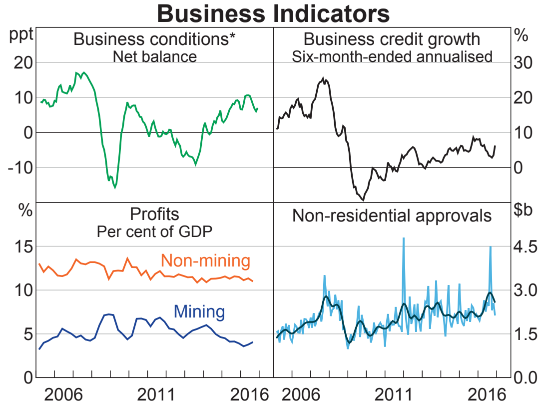


* Reference year is 2014/15

** From 2011/12, includes second-hand asset transfers of buildings and structures

Sources: ABS; RBA

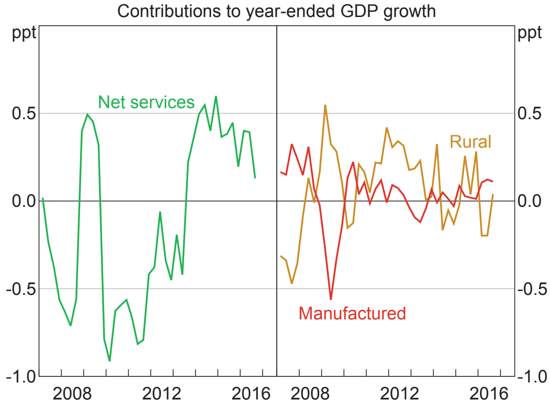
Graph 3.11
Business Indicators



* Deviation from long-run average; three-month moving average

Sources: ABS; APRA; NAB; RBA

Graph 3.12
Non-mining Exports
Contributions to year-ended GDP growth



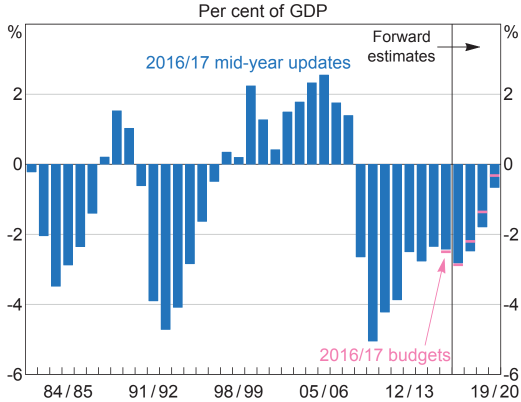
Sources: ABS; RBA

over this period. Manufactured exports have increased over the year to the September quarter, following several years of little change. Rural exports have been largely unchanged over the past year as increased grain and other rural exports have offset declining meat exports as farmers have opted to rebuild their herds.

Government Sector

Public demand contributed strongly to economic growth over the year, despite a weak outcome in the September quarter. Federal and state budget updates resulted in little change to the forecasts of the consolidated deficit in 2016/17 of around 3 per cent of GDP and implies a modest stimulus to growth (Graph 3.13). Lower expected revenues and higher state infrastructure spending in the budget updates imply slightly larger deficits in subsequent years than previously forecast, although the projections continue to expect the consolidated deficit to decline gradually over time.

Graph 3.13
Consolidated Budget Balance*
Per cent of GDP



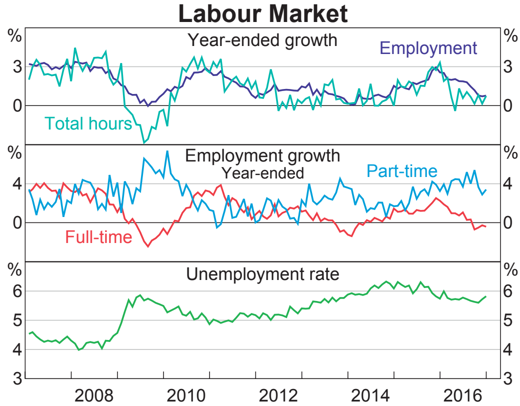
* Federal, state and territory governments based on 2016/17 budgets and mid-year updates; excludes effect of the federal grant to the RBA in 2013/14

Sources: ABS; Australian Treasury; RBA; State and Territory Treasuries

Labour Market

Following strong growth in 2015, employment growth moderated over 2016, consistent with the slowing in domestic activity (Graph 3.14). The net increase in employment in 2016 was entirely in part-time employment, although full-time employment increased in the December quarter. The composition of employment growth over the year reflects a strong contribution to growth from the household services sector, which has a high share of part-time workers. It may also reflect firms being hesitant to hire full-time workers until they see further evidence that demand for their output is likely to be sustained.[1] Average hours worked declined over the year in line with the shift towards part-time

Graph 3.14
Labour Market



Source: ABS

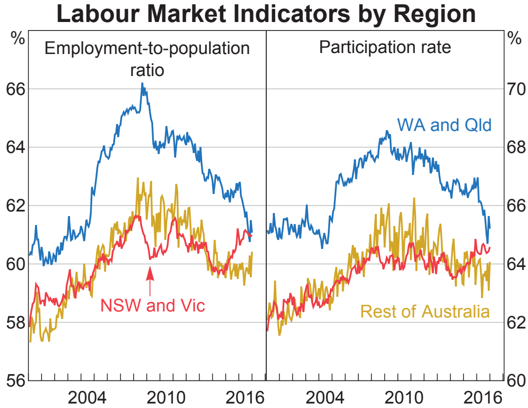
1 See RBA (2016), 'Box B: Trends in Part-time and Full-time Employment', *Statement on Monetary Policy*, November, pp 36–38 for a discussion of this issue.

employment, and growth in total hours worked has been subdued.

The unemployment rate in December was 5.8 per cent, around its level a year earlier. However, the participation rate declined by around ½ percentage point over the year, led by a decline in the participation rate of 15–24 year olds. Furthermore, the youth unemployment rate rose over 2016, although it remains lower than its peak in 2014. The unemployment rate for workers aged 25–64 years fell slightly over the past year and their participation rate was little changed.

There has been a large divergence in labour market conditions across states, reflecting variation in activity. In the resource-rich states of Western Australia and Queensland, employment has declined over 2016 and the participation rate is now back to around where it was prior to the mining investment boom (Graph 3.15). Labour market outcomes have been strongest in Victoria, which has experienced solid growth in employment and a rising participation rate; this may partly reflect strong growth in labour supply from both interstate and overseas migration. The unemployment rate remains lowest in trend terms in New South Wales, though employment growth recorded a noticeable slowing over the second half of 2016.

Graph 3.15
Labour Market Indicators by Region



Sources: ABS; RBA

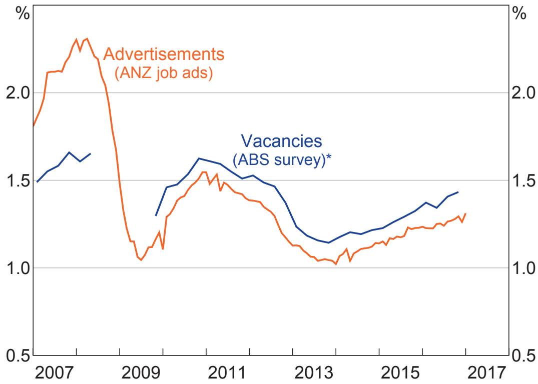
By sector, employment growth in trend terms remains strongest in household service industries, where the share of part-time employment has been increasing, with the exception of education. In the December quarter, tertiary education employment continued to make a noticeable contribution to growth, consistent with forecasts of further growth in international student arrivals by the Department of Immigration and Border Protection.

Mining industry employment appears to have stabilised and construction employment remains elevated. Estimates suggest that residential construction accounts for around three-quarters of total construction industry employment and should be supported by the pipeline of residential construction activity. Employment in the retail, agricultural and finance & insurance industries declined in trend terms over the year.

ABS job vacancies and ANZ job advertisements increased further in the December quarter, suggesting that there could be some pick-up in employment growth over the next six months (Graph 3.16). However, employment growth over the past year has been weaker than suggested by its historical relationship with these leading indicators of labour demand.

There are various ways to measure the degree of spare capacity in the labour market. The Bank estimates that the unemployment rate is roughly half a percentage point above the level consistent with stable inflation (often referred to as the non-accelerating inflation rate of unemployment or NAIRU). Another way to gauge the degree of slack is to assess broader measures of underutilisation in the labour force. The number of people in work desiring additional hours (the underemployed) remains elevated, and has diverged from the unemployment rate over the past two years. However, the nature of underemployment suggests that developments

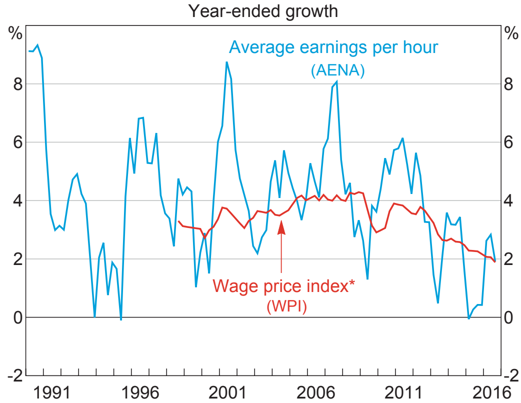
Graph 3.16
Job Vacancies and Advertisements
Per cent of labour force



* This survey was suspended between May 2008 and November 2009

Sources: ABS; ANZ

Graph 3.17
Labour Costs
Year-ended growth



* Total pay excluding bonuses

Sources: ABS; RBA

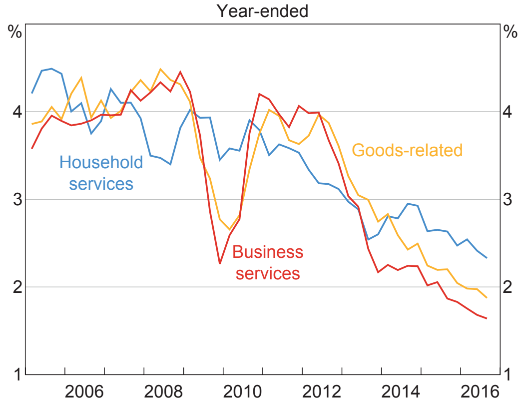
in the unemployment rate have been a generally reliable indicator of changes in labour market spare capacity. (See 'Box B: Underemployment and Labour Market Spare Capacity').

Labour Costs

Wage growth was slightly slower than expected in the September quarter. Growth in the wage price index (WPI) over the year was 1.9 per cent, which is the lowest growth in the index since the series began in the late 1990s (Graph 3.17). Part of the decline in the quarter can be attributed to the Fair Work Commission's annual minimum award wage increase, which was slightly smaller than the corresponding increase in 2015, taking effect. Growth in average earnings in the national accounts (AENA) also remains subdued.

The decline in wage growth since 2012 has been broad based across industry and states (Graph 3.18). Wage growth in business service industries has been relatively weak over the past two years, in part the result of slower wage growth for jobs in mining-related business services. Wage growth in household service industries recorded a faster pace than in other industries, which is likely to be because of the

Graph 3.18
Wage Price Index Growth
Year-ended



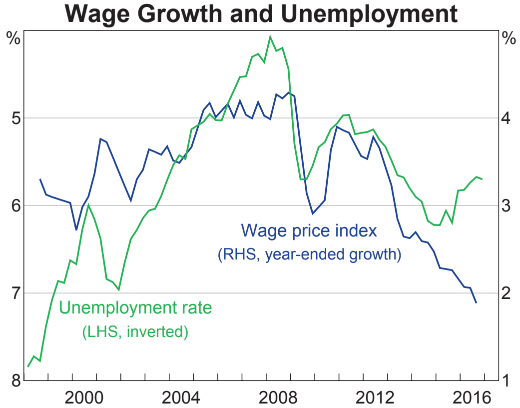
Sources: ABS; RBA

stronger employment outcomes during this time and may also reflect the importance of wage-setting methods that link to the minimum wage (which has seen higher wage increases than average WPI outcomes in recent years). Wage growth in goods-related industries has also slowed in recent years and in the September quarter. Construction wage growth picked up in the latest quarter, due to an increase in Victorian construction wages. This is consistent with liaison information pointing to high labour demand in residential construction and micro-level WPI data that show that 20 per cent of construction jobs experienced a wage increase larger than 4 per cent over the past year. It is likely that construction wage growth will continue to pick up, given that new construction enterprise bargaining agreements reached in the September quarter contained annualised wage increases averaging 6 per cent.

The slowing in wage growth in recent years has occurred alongside the decline in the unemployment rate (Graph 3.19). This could suggest that there are other structural or cyclical factors weighing on wage growth. One possibility is that the lower wage growth could be part of businesses' responses to increased competitive pressure arising from globalisation and technological progress. This may have resulted in workers feeling their bargaining power has been reduced and/or firms being less willing to offer larger wage increases. Another possibility is that the significant increase in underemployment over the past year has had a dampening effect on wage growth (see 'Box B: Underemployment and Labour Market Spare Capacity' for a discussion of these issues). How long these factors persist could affect the pace of wage growth as labour market conditions improve.

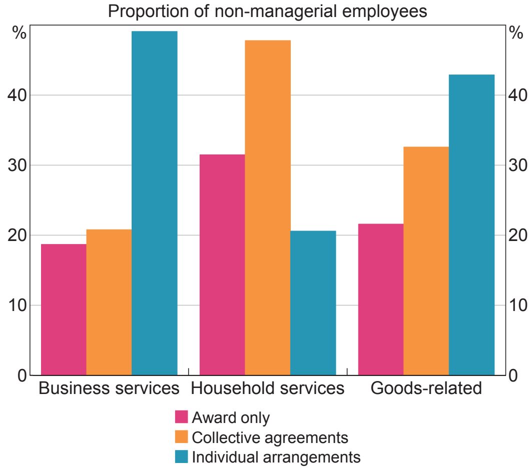
A recently released ABS survey of firms provides information on wage-setting methods, which vary significantly across industries. In May 2016, a little over 20 per cent of employees had their pay based on awards, which are mostly determined by the Fair Work Commission. The highest share of award-based jobs was in household service industries, which also had the highest share of part-time and casual jobs (Graph 3.20). Awards also indirectly affect a significant proportion of employees covered by collective or enterprise agreements and individual agreements; these agreements each cover over 35 per cent of employees.

Graph 3.19
Wage Growth and Unemployment



Sources: ABS; RBA

Graph 3.20
Wage-setting Methods
Proportion of non-managerial employees



Sources: ABS; RBA