

Overview

As has been the case for some years now, growth of Australia's major trading partners remains close to its long-run average, notwithstanding a slight easing in the June quarter. Growth of global industrial production has moderated over the past year or so, which has contributed to lower commodity prices, although the strength of commodity supply has also been a significant factor. In most of Australia's trading partners, core inflation has been stable in year-ended terms over recent months at rates below central bank targets. Globally, monetary conditions remain very accommodative and finance remains readily available to creditworthy borrowers.

In China, GDP growth picked up in the June quarter, remaining at 7 per cent in year-ended terms, which is the government's target for this year. However, a range of indicators suggest that growth of consumption and industrial production, including steel production, moderated in the first half of 2015. Low inflation has given the authorities scope to adopt more accommodative monetary and fiscal policy settings. Conditions in residential property markets have improved in some respects, although this has yet to translate into a pick-up in residential property investment outside the largest cities. The recent volatility in Chinese equity markets is unlikely to have a significant direct effect on consumption, given the relatively limited exposure of households to equities. Growth in the rest of east Asia (excluding Japan) was a little below average in the first half of 2015, owing to some weakness in domestic and external demand. Meanwhile, output in advanced economies has generally been increasing at a moderate pace and labour market

conditions have been improving, supported by expansionary monetary policy. In Japan, the relatively tight labour market conditions have resulted in wage growth being higher than it was a year ago. The US economy returned to moderate growth in the June quarter, following temporary weakness earlier in the year. Although the Federal Reserve is widely expected to start raising interest rates later this year, monetary conditions will remain very accommodative for some time.

The growth of Australia's major trading partners is expected to remain around its long-run average over the next two years, although there has been a slight downward revision to growth in 2015 since the previous *Statement*, reflecting weaker-than-expected growth for east Asia in the first half of 2015. The forecast for Australia's terms of trade has been revised down by 4 per cent since May. This follows the recent declines in a number of commodity prices and the expected effects of a more subdued outlook for Chinese steel demand on iron ore prices.

Domestically, financial conditions have generally eased since May. Interest rates for borrowers were reduced broadly in line with the reduction in the cash rate in May. More recently, this reduction has been partially offset by lenders raising mortgage rates for investor housing loans. Over recent months, the Australian dollar has depreciated noticeably against the US dollar and on a trade-weighted basis, although it has generally moved in line with the currencies of other commodity-exporting countries. Over the past year the Australian dollar has depreciated by about 15 per cent on a trade-weighted basis.

In the face of significant structural change, the Australian economy has continued to grow at a moderate pace over the past year. Following strong growth in the March quarter, the available data indicate that output growth slowed in the June quarter, largely reflecting some reversal of the substantial rise in exports earlier in the year. At the same time, however, a number of indicators of economic conditions have been more positive over recent months. In particular, labour force data have shown signs of improvement and measures of business conditions in the non-mining sector are clearly above average.

Consumption growth has picked up since 2013 – supported by low interest rates and accompanied by a fall in the household saving ratio. Low interest rates are also providing support to housing market conditions, which remain strong overall. However, there is a noticeable divergence in conditions across the country. House price inflation has been high in Sydney and Melbourne, whereas housing price growth has been weak in the rest of the country and prices in some cases have declined. Housing credit growth has been little changed over recent months. The Australian Prudential Regulation Authority has implemented a suite of measures to address risks related to lending in the housing market and a number of banks have announced tighter lending conditions and increased mortgage rates for investor housing loans.

Survey measures of business conditions have increased over recent months to be clearly above their long-run average levels and profits in the non-mining business sector have grown noticeably. Notwithstanding those improvements, non-mining business investment has continued to fall and the available data on investment intentions do not indicate that there is likely to be a significant pick-up in non-mining business investment over the next year or so. Liaison suggests that businesses are waiting to see a sustained increase in demand before committing to major new investment projects. Mining investment continues to decline, as more projects

reach completion, but few new projects commence. Newly completed projects are underpinning further strong growth in resource exports. Net service exports are also making a strong contribution to GDP growth, supported by the depreciation of the exchange rate.

Labour market conditions are generally better than had been expected a few months ago, although spare capacity still remains. The unemployment rate over recent months was around the levels that have been recorded over much of the past year. There has been a pick-up in labour demand, which has led to a noticeable rise in the employment-to-population ratio. The signs of improvement in labour market conditions have occurred despite GDP growth remaining below average. Some factors that can help explain this include very low wage growth and lower-than-expected population growth. The ABS measure of firms' job vacancies is consistent with the unemployment rate remaining around levels of recent months or even declining a little in the months ahead. Other indicators point to modest employment growth in coming months.

Inflation in the June quarter was broadly as expected and inflationary pressures remain contained. Consumer price inflation has been affected by movements in fuel prices, which are around 10 per cent lower than they were a year earlier. Looking through the effects of such temporary factors, various measures suggest that underlying inflation was around $\frac{1}{2}$ per cent in the quarter and $\frac{2}{4}$ per cent over the year. Domestic inflationary pressures remain well contained, consistent with spare capacity in the labour market and the low growth of labour costs. In contrast, inflation in the cost of new dwellings has been elevated, driven by strength in Sydney. Although the prices of tradable items (excluding volatile items and tobacco) declined modestly over the year to June, further gradual pass-through of higher import prices as a result of the depreciation of the exchange rate is expected to place upward pressure on the final prices of tradable items over the next few years.

Growth in the Australian economy is expected to pick up gradually to be over 3 per cent by 2017. The key forces shaping the outlook for growth are much as they have been for some time. Further large falls in mining investment are expected to be offset by strong growth of resource exports. Growth of household consumption is expected to be supported by very low interest rates, and leading indicators suggest that dwelling investment is likely to remain strong for some time. Rising household expenditure and the response of net exports to the exchange rate depreciation are expected, in time, to support a rise in non-mining business investment. Fiscal consolidation at state and federal levels is anticipated to weigh on output growth over the next few years.

The unemployment rate is forecast to be lower than previously anticipated. In part, this reflects the generally better-than-expected labour market conditions of late. Moreover, the unemployment rate is expected to remain little changed from the levels of recent months. This is despite the change to the forecast for aggregate demand, which is likely to be broadly matched by lower growth of the economy's productive capacity, owing to lower population growth. Accordingly, the unemployment rate is now forecast to remain little changed over the next 18 months or so from a level that is a bit lower than had earlier been forecast, before declining over 2017 as demand growth picks up.

The inflation forecast has been revised up a little since the previous *Statement*, primarily because the Australian dollar has depreciated further, implying additional growth in the prices of tradable items over the next few years. Domestic cost pressures are likely to remain well contained and underlying inflation is expected to be around 2½ per cent over the forecast period.

The risks to the outlook for global growth appear broadly balanced. The risks in China, however, remain somewhat tilted to the downside. There continues to be uncertainty surrounding the trajectory for growth and macroeconomic policy in China, and

the implications for commodity demand. The recent volatility in the Chinese equity market and the government's policy response have both increased the general level of uncertainty regarding the economic outlook. Downside risks stemming from the weak property market and constraints on local government funding for infrastructure investment persist but have receded at the margin, partly in response to policy measures designed to address these risks. As always, there are also uncertainties associated with how global financial markets will respond to significant economic events. Concerns about spillovers from developments in Greece have abated and the focus has shifted more towards how financial markets will react when the Federal Reserve starts raising its policy rate. This is expected to occur before the end of the year and is likely to be associated with an increase in global financial market volatility. There is also a reasonable chance that the Australian dollar will depreciate further once that tightening commences.

Domestically, as always, there are uncertainties around the balance between the growth of demand and supply. Recently, labour market developments have suggested that there is a little less spare capacity in the labour market than had been expected, although measures of demand and supply are subject to error and revision.

As has been the case for some time, there is uncertainty about the outlook for consumption growth. Given the low growth of wages, the anticipated increase in consumption growth is likely to be associated with a further gradual decline in the household saving ratio. However, households may behave differently from what is assumed and it is possible that consumption growth could be stronger and the saving ratio lower than forecast, or vice versa.

There is significant uncertainty around the forecast for business investment. Indicators of non-mining business investment intentions provide little evidence of a pick-up in non-mining business investment in the near term, and actually suggest

that it could fall over 2015/16. However, these indicators cover only part of the non-mining business sector's investment and measures of business conditions paint a much more positive picture. Moreover, there are increasing signs that the depreciation of the exchange rate is providing additional support to demand for domestically produced goods and services, which should in time lead to more investment.

The Reserve Bank Board reduced the cash rate by 25 basis points at its February meeting and then again at its May meeting. The effects of these reductions are still working their way through the economy. Data on the domestic economy over the past few months have generally been positive. Survey measures of business conditions are clearly above average, businesses have been hiring more labour and the unemployment rate is slightly lower than had earlier been expected. The further depreciation of the exchange rate will provide some assistance with the adjustment of the economy to the lower terms of trade. Nevertheless, the economy

is still facing some headwinds and it is likely to be operating with a degree of spare capacity for some time yet. Recent information confirms that domestic inflationary pressures have been contained. Given that this is likely to be the case for some time, inflation is forecast to remain consistent with the target, even with a lower exchange rate. Meanwhile, conditions in housing markets remain somewhat divergent across the country, with Sydney and Melbourne house prices rising rapidly, but housing price inflation declining across much of the rest of the country. Growth of housing credit is little changed. The Bank is continuing to work with other regulators to assess and contain risks that may arise from the housing market.

Since the *May Statement*, the Board has judged that an accommodative stance of monetary policy remains appropriate. The Board will continue to assess the outlook and adjust policy as needed to foster sustainable growth in demand and inflation outcomes consistent with the inflation target over time. ✎