Overview

Overall, global economic growth appears to have been close to average in recent months, having been a bit below average earlier in the year. The Chinese economy has been growing at around the same pace as seen earlier in the year, which on an annualised basis is a bit below the authorities' stated target of 7.5 per cent. Growth of total financing in China, which was very strong earlier in the year, looks to have slowed amid authorities' concerns about the strength of non-bank financing. In Japan, the adoption of more expansionary monetary and fiscal policies has seen the exchange rate depreciate significantly since the end of last year and has supported strong growth of the economy this year. In the rest of east Asia, weaker external demand is weighing on growth but domestic demand has remained relatively resilient. The US economic recovery is proceeding at a moderate pace, notwithstanding the effects of fiscal consolidation. In contrast, economic activity remains weak in the euro area. Globally, inflation pressures have eased over the past year and monetary policy has remained highly accommodative in most economies.

The outlook for the global economy is a little softer than at the time of the May *Statement*. World GDP growth is expected to remain close to average over the rest of this year, but with annual average growth around 3 per cent for 2013 reflecting weaker growth around the turn of the year. Growth is then expected to pick up, to be slightly above average in 2014. Economic growth is expected to be stronger for Australia's major trading partners than for the world as a whole. The slightly weaker outlook than a few months ago reflects, among other things, the assessment that growth in China is now unlikely to pick up much, if at all, in coming quarters. Rather, it is expected to remain at a pace that is close to the official target.

Prices of most commodities have declined over the past few months, although spot prices for iron ore remain little changed. While commodity prices overall remain at historically high levels, the prices of those commodities for which there has been significant investment in capacity in Australia and globally are projected to decline gradually over the coming years. Accordingly, the terms of trade are expected to decline over the medium term.

Movements in financial markets have been driven by a reassessment of the future path of US monetary policy. In late May, the Federal Reserve communicated that it may begin to wind down its asset purchase program later this year, leading to expectations being brought forward for when the central bank would begin to tighten monetary policy. As a result, yields for sovereigns and corporations moved markedly higher, although they still remain very low relative to historical norms. Yields on emerging market government bonds have also moved higher. A number of emerging market central banks have tightened policy and/or intervened in currency markets, owing to concerns about sharp reversals of capital inflows received over the past few years. Changes in expectations about US monetary policy have also led to a broad-based appreciation of the US dollar over recent months.

These changes have contributed to a significant depreciation of the Australian dollar. In trade-weighted terms it is around 15 per cent lower than the high reached in April. This follows a period when the currency had been relatively stable despite the decline in the terms of trade and a narrowing of interest differentials.

This depreciation of the exchange rate will be helpful in rebalancing growth given the transition that the Australian economy is facing. Business investment as a share of GDP has risen to record high levels, with mining investment rising substantially on the back of very high levels of the terms of trade. Though they remain high, the terms of trade have declined over the past two years and mining investment is expected to decline over the course of the next few years. Other sources of demand, which have been relatively subdued, including because of the high level of the exchange rate, are expected to contribute more to growth in time.

As the economy enters this period of transition, growth has been below trend over the first half of this year. Indicators of business conditions have remained below average levels and business investment, though still high as a share of economic activity, declined in the March quarter, with estimates of mining and non-mining investment lower. Capital imports have declined over the year to date and the Bank's liaison and business surveys indicate that firms are reluctant to take on new risks. Even so, the latest ABS capital expenditure survey implies a small increase in non-mining investment in 2013/14. These data also suggest that mining investment could increase over the same period, although this survey tends to be a less reliable guide for the mining sector. The Bank's liaison and public statements by mining companies suggest that mining investment is likely to decline noticeably over the next few years from its current very high level, although the exact profile of the decline remains difficult to predict.

Over the past year, household consumption growth has slowed, in line with softer growth of incomes. Retail sales data and the Bank's liaison point to weak growth of consumption over recent months. Measures of consumer sentiment are around average levels after being above average earlier in the year.

In contrast, conditions in the housing market continue to improve. Dwelling prices increased further in recent months and auction clearance rates remain high. This has been accompanied by an increase in housing loan approvals in response to low interest rates. These factors, along with strong population growth and the relatively low level of dwelling investment for some years now, point to a continued rise in dwelling investment in the period ahead. Indeed, residential building approvals, especially for detached housing, increased in the June quarter and it seems likely that this will continue.

Exports also grew in the June quarter. Strong growth in resources exports is expected in coming quarters as more productive capacity comes on line on the back of the high level of investment in the mining sector. The depreciation of the Australian dollar is also expected, over time, to help export volumes more broadly.

Consistent with the below-trend growth in economic output over recent quarters, conditions in the labour market remain somewhat subdued. The unemployment rate has continued to drift higher this year as employment growth has been slower than the above-average growth in the population. Employment growth has eased in mining areas, but growth in employment has remained stronger in some service sectors and in the larger south-eastern states. Job vacancies and advertisements have declined of late and are consistent with modest growth of employment in the near term. The Bank's liaison also suggests that firms remain cautious about hiring staff.

Softer conditions in the labour market have seen the pace of growth in wages decline to around its lowest rate in a decade. Combined with relatively strong growth of productivity, this has contributed to low growth of unit labour costs.

Consumer price inflation has been moderate this year, with tradables prices lower and some easing in the inflation rate for non-tradable goods and services in line with the slower growth of wages over recent quarters. In the June quarter, the rate of inflation picked up slightly from the low rate in March. There was a small pick-up in the prices of tradable items following significant declines over previous quarters. While the exchange rate has depreciated in recent months, for most tradable items historically it takes some time for this to be reflected in the prices facing consumers; a notable exception is the price of petrol, which has increased over the past few months and is likely to make a noticeable contribution to inflation in the September quarter.

The various measures suggest that underlying inflation was a touch above ½ per cent in the June quarter. In year-ended terms, underlying inflation was a little under 2½ per cent. Year-ended rates of inflation continue to be affected by the introduction of the carbon price in July 2012. Abstracting from this effect, underlying inflation appears to be close to the lower end of the inflation target range.

The outlook for the domestic economy is a little weaker in the near term than it was in the May *Statement*. This reflects the recent run of data on domestic demand and a lowering of the forecast profile for mining investment over the next few years. At the same time, however, the recent exchange rate depreciation is expected to add to activity in trade-exposed sectors over the next two years or so. The combination of these different influences means that GDP growth is now expected to remain below trend through to around the middle of next year, before picking up to be above trend in 2015. Mining investment is expected to decline more noticeably towards the end of the forecast period as the large projects in liquefied natural gas reach completion. However, in time other sources of demand are likely to contribute more to growth. That expectation is based on the forecast pick-up of global growth, stimulatory effects of low interest rates, strong population growth and the need to add to the capital stock after a long period of below-average investment outside the mining sector. These conditions are expected to lead businesses to become increasingly willing to pursue new investment opportunities in the latter part of the forecast period.

Employment growth is expected to be only modest over the next few quarters, consistent with the below-trend growth of the economy. This will see the unemployment rate increase gradually for a year or so. Subsequently, as growth moves closer to trend and eventually above trend, employment growth should pick up, and the unemployment rate should level out and then start to decline.

The forecast for inflation incorporates some opposing influences. A slightly weaker outlook for the labour market and the economy more generally is expected to put mild downward pressure on inflation. In contrast, the significant depreciation of the exchange rate is likely to boost the prices of tradable items over the next few years. In the near term, these effects are largely expected to balance one another. In year-ended terms, underlying inflation is expected to remain close to the lower end of the inflation target this year, before picking up to around the middle of the target range in the first half of 2014 and staying close to that level thereafter. Overall, the forecast for inflation is broadly unchanged from that in the May *Statement*.

With the global growth forecasts a little lower than those in the May *Statement*, the risks around the forecasts appear to be balanced for most economies. The notable exception is Europe, where the risks continue to be tilted somewhat to the downside. In the United States, growth could be stronger than forecast given the ongoing recovery in the housing market and very stimulatory monetary policy setting, although the scaling back of highly stimulatory monetary policy could lead to unsettled financial markets globally. In China, the authorities face challenges associated with the process of reform, which could well slow growth in the near term but also contribute to more sustainable growth further out. In Japan, a credible package of structural reforms could see stronger growth than is currently forecast, but failure to implement such reforms could see growth disappoint.

On the domestic front, there are risks to both the downside and upside for economic activity and inflation. In particular, there remains considerable uncertainty about the process of economic growth rebalancing away from mining investment towards other sources of domestic demand and to exports. It is possible that mining investment could decline more rapidly than expected or that confidence will remain subdued and other domestic sources of demand pick up by less than expected. However, it may also be that the current aversion of both mining and non-mining businesses to take on new risks could dissipate, particularly if growth in the advanced economies picks up sooner or by more than expected. While an ongoing recovery in dwelling investment remains in prospect, the strength of that recovery remains uncertain.

Another factor that has an important bearing on the economy is the exchange rate. It has depreciated noticeably over recent months, although it remains at a high level. The depreciation seen to date is expected to add to economic activity and to prices of tradable items, although by how much and over what period cannot be precisely estimated. It may be that the effect could be slower than in the past if businesses wait to see if the exchange rate is sustained at a lower level for some time before responding. It is also possible that just as the high terms of trade and high level of investment led to a higher exchange rate over recent years, a lower terms of trade and lower investment could lead to a further depreciation of the exchange rate. If this were to occur, it could help with the rebalancing of the economy by bolstering activity in the trade-exposed sector and raising the profile for overall economic activity. It would also push up tradable prices further, temporarily adding to inflation.

In May, the Board reduced the cash rate by 25 basis points, taking the cumulative reduction since late 2011 to 200 basis points and bringing borrowing rates to around their previous lows. There are signs that the low level of interest rates is supporting interest-sensitive spending and asset values – particularly in the housing market – and further effects are expected over time. While the pace of borrowing overall has remained fairly subdued, there are recent indications of an increase in the demand for new loans by households.

Since the May decision, the Australian dollar has depreciated noticeably, though it remains at a high level. The depreciation should assist with the rebalancing of growth in the economy. It will also add a little to tradable prices and so raise inflation for a time. Nevertheless, at its recent meetings the Board had noted that the inflation outlook would afford some scope to ease policy further, if needed to support demand. The recent price and wage data do not suggest any lessening of that scope from an inflation point of view, and the expectation is for inflation to be consistent with the target even with the effect of the depreciation. At the same time, indicators of demand have generally been a little soft of late, and the outlook for activity has been lowered, with growth expected to remain below trend for a time. At its August meeting the Board judged that a further reduction in the cash rate was appropriate to help support growth in the economy, and would be consistent with achieving the inflation target.

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.