Overview

The Australian economy has been navigating a period of slow growth, with subdued growth in household income weighing on consumption spending. In contrast, employment growth has been strong. The response of labour supply has been even stronger, taking the participation rate to a record level. Despite the strong employment growth, the unemployment rate has increased to 5.2 per cent, where it has remained for three months. Domestic inflation pressures remain subdued. Housing-related inflation has been particularly soft lately, compounding the ongoing effects of spare capacity in the labour market and the resulting slow growth in labour costs.

GDP growth is likely to have troughed around the middle of this year and is expected to reach about 2½ per cent over 2019. It is expected to pick up gradually to 2¾ per cent over 2020, and around 3 per cent over 2021, which is a little higher than previously forecast. Growth is expected to be supported by a number of factors, including lower interest rates and recent tax measures. The established housing markets in some cities are showing signs of a turnaround, which should support spending. The mining sector is also likely to support output growth; in the near term, resource exports are recovering from recent supply disruptions, while a pick-up in mining investment will boost growth further out.

Given the slower output growth over recent quarters, the unemployment rate is expected to remain around its current level for a time, before declining to around 5 per cent in 2021. Wages growth is therefore likely to remain low and to increase more gradually than earlier expected. As a result, inflation is likely to take longer to rise to 2 per cent. Trimmed mean inflation is forecast to remain around 1½ per cent for the rest of this year, before increasing to be a little under 2 per cent over 2020 and a little above 2 per cent over 2021. Headline inflation is expected to follow a similar trajectory.

Global growth remains reasonable, but the risks have become more clearly tilted to the downside. Global trade has declined noticeably in the context of continuing trade and technology disputes. There is considerable uncertainty about possible future tariff measures and the potential for global technological standards to become fragmented. This uncertainty has weighed on investment and investment intentions in a number of economies, and poses a significant risk to the global outlook.

In China, growth slowed further in the June quarter. Additional policy measures have been announced to support growth in the face of the negative effects of tariff measures. Some of these policy measures have been focused on enabling infrastructure spending, which has been a positive for steel production – and thus demand for some bulk commodities – even as conditions in the industrial sector more broadly have remained weak. This has benefited the Australian economy.

These trade-related developments have particularly affected the economies in east Asia that are most exposed to Chinese domestic demand and are most integrated into global manufacturing supply chains. Growth in investment has also turned down in some of these economies. By contrast, growth has been more resilient in economies such as Indonesia, where manufacturing for export is a smaller share of activity.

Growth in the major advanced economies has slowed over the past year, driven by slower external demand and business investment. Consumption growth is still reasonable, however, and labour markets in these economies remain tight. Faster wages growth is supporting consumption, but is yet to translate into materially higher inflation in these economies. Inflation generally remains below central bank targets, though it is around target in several advanced economies.

In response to the weaker growth outlook and ongoing low inflation, a number of central banks have lowered policy interest rates in recent months. This has added to already accommodative financial conditions. Sovereign bond yields have declined further – in many cases to historical lows – and credit spreads remain narrower than a year ago. Equity market valuations have generally been supported by the effect of accommodative monetary policies on risk-free yields and positive expectations for earnings growth, though prices have declined recently in response to heightened concern about the trade and technology disputes. These expansionary financial conditions have also benefited emerging markets, although risks surrounding global trade developments remain.

Domestic financial conditions have also eased. The reductions to the cash rate in June and July have largely been passed through to deposit and lending rates. Australian government bond yields have reached a new historical low. Bank funding costs have also declined to historically low levels. Equity prices declined in response to the global trade tensions, but are still noticeably higher over the year to date. Credit growth has continued to slow, but there was an increase in housing loan approvals in the month of June, in line with better conditions in housing markets more generally. Some lenders have announced changes to their lending criteria in response to the Australian Prudential Regulation Authority revising its guidelines, which have boosted borrowing capacity for some customers.

The Australian dollar has depreciated over recent months and is at its lowest level of recent times. The depreciation over the past year is consistent with the decline in Australian bond yields relative to those in other major markets over that period.

There have been some large movements in commodity prices in recent months. Iron ore prices had increased in response to restricted seaborne supply and strong Chinese demand, but have fallen more recently, along with oil prices, following the recent escalation in trade tensions. Coal prices have also declined because demand has weakened somewhat at a time when seaborne supply has been ample. Taken together, though, prices of Australia's commodity exports remain at high levels. The terms of trade are therefore higher than previously expected. This represents a boost to Australia's national income, as a portion of the higher profits of mining companies are distributed to domestic shareholders and via government revenues.

GDP growth was a touch slower in the March quarter than expected at the time of the May *Statement on Monetary Policy*. Early indications for the June quarter are for reasonable growth. Some of the temporary factors that weighed on growth in recent quarters, including supply disruptions to resource exports, have been resolved. However, consumption growth remains slow, consistent with ongoing weakness in household incomes and the effects of recent falls in housing prices. The adjustment in housing markets is also evident in declining dwelling investment and low turnover rates for existing homes.

Following a period where labour market data were stronger than other data on economic activity implied, labour market conditions were more mixed in the June quarter. Employment growth continues to run well above growth in the working-age population, taking the employment-to-population ratio close to its historical peak. The participation rate reached its highest level on record, driven by strong rises in participation by older workers and women aged between 25 and 54. However, the unemployment rate also picked up a little and has remained at 5.2 per cent for a few months. Leading indicators point to a moderation in employment growth in the period ahead.

With increasing demand for labour being met by an expansion in labour supply, spare capacity remains in the labour market. This has weighed on wages growth. Wages growth has picked up a little in the private sector over the past year, but remains stable in the public sector, consistent with government wages policies. Labour income growth has therefore been underpinned more by the strong employment growth of recent times than by rising wages. Growth in non-labour income has been weak, partly because unincorporated business income has been held down by declining housing construction and sales turnover, as well as drought-related weakness in farm incomes. Household disposable income growth has also been lowered by the unusually fast growth in household tax payments over 2018.

Slow growth in household incomes has dampened consumption spending for some time. This is likely to have continued into the June quarter; the volume of retail sales increased only a little in the quarter. Household incomes will receive a boost in the second half of 2019 from the low- and middle-income tax offset. The outlook for consumption more broadly continues to be the main uncertainty facing the domestic economy, especially in the context of ongoing high levels of household debt.

A more positive signal for future consumption is that established housing markets appear to have stabilised. Prices in Sydney and Melbourne have stopped falling and, although prices are still falling in some other markets, the pace of decline has eased. The rate of sales turnover also appears to have troughed and auction clearance rates have risen. Rental vacancies remain low in most cities, except in Sydney, where the vacancy rate has increased as new apartments continue to be added to the rental stock.

Similarly, the mining sector is also expected to support growth over the next few years, after a long period during which declining mining investment was a drag on growth. Mining investment is forecast to increase moderately in coming years as firms invest to sustain and expand production. Resource exports had experienced some weakness earlier in the year, related to supply disruptions, but have increased in recent months because these disruptions have been resolved and production at recently completed liquefied natural gas facilities continues to ramp up.

The investment outlook in Australia more generally is broadly positive. Non-mining business investment continues to expand at a moderate pace, supported by a solid pipeline of non-residential building work and infrastructure projects (particularly transport and renewable energy). Infrastructure projects have also been an important element of public demand's ongoing support to growth.

Inflation remains low. Trimmed mean inflation increased a little to 0.4 per cent in the June quarter, but remained at 1.6 per cent over the year. Measures of underlying inflation have now been below 2 per cent for around three years. Housing-related inflation, including both rents and prices of newly built dwellings, has been a significant contributor to the low inflation outcomes. The prices of some administered items have also risen at a below-average pace lately. This has been only partly offset by higher prices for some retail goods affected by the drought or the pass-through of exchange rate depreciation.

Headline inflation was affected by higher petrol prices and increased to 0.7 per cent in the June quarter and 1.6 per cent over the year. Oil prices have fallen more recently, suggesting that some of this effect will reverse in the September quarter. Further out, inflation is still expected to drift up gradually. However, this is now forecast to take place over a more extended period than previously envisaged, because there appears to be more spare capacity remaining in the labour market than had been thought.

Together, the recent data on wages, prices, output and unemployment suggest that there was more spare capacity in the economy than had previously been recognised. They also suggest that, like a number of other countries, Australia can sustain lower rates of unemployment and underemployment without running inflation risks.

In response to this accumulation of evidence, the Reserve Bank Board lowered the cash rate at both its June and July meetings, to a new low of 1 per cent. While the stance of policy had already been accommodative for some time, the Board judged that additional monetary stimulus would assist with faster progress in reducing unemployment, and help create the conditions for more assured progress towards the inflation target. Given the current environment, it is reasonable to expect that an extended period of low rates will be needed to achieve the Board's employment and inflation objectives. The Board will continue to monitor developments in the labour market closely and is prepared to ease monetary policy further if needed to support sustainable growth in the economy and the achievement of the inflation target over time.