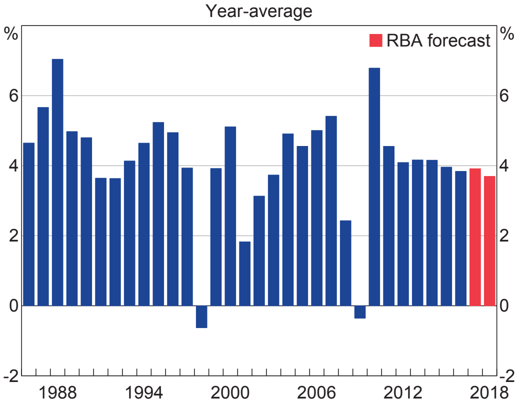
6. Economic Outlook

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 forecast in late 2016 and early 2017. The improvement in global economic conditions last year has been maintained in early 2017, and major trading partner growth is forecast to be around its long-run average this year before easing slightly in 2018 (Graph 6.1). Global growth – which includes economies that do not have a significant trade relationship with Australia – is expected to pick up over the next couple of years to around its long-run average (Graph 6.2). Since late 2016, most forecasters have revised up their forecasts for global growth.

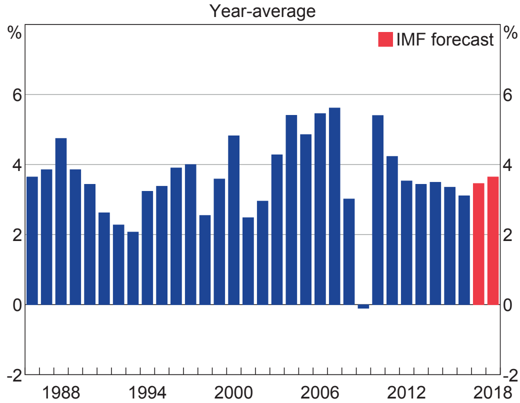
In China, growth in 2017 is forecast to be only a bit lower than last year as the authorities continue to support economic activity to achieve their annual GDP growth target. Growth in China

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



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

Graph 6.2
World GDP Growth*
Year-average



* PPP-weighted; forecasts from April 2017
Source: IMF

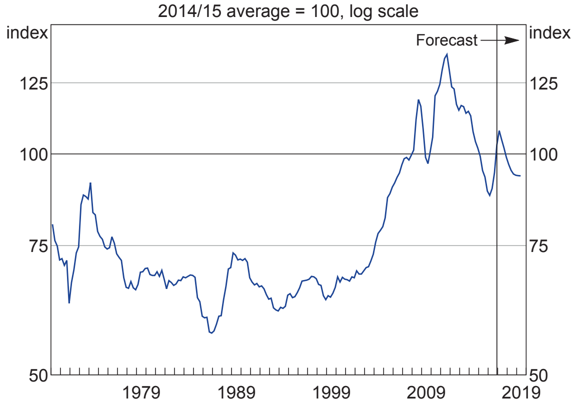
is then expected to continue to ease gradually because of longer-run factors, including the decline in the working-age population and lower productivity growth. The east Asian economies (other than China and Japan) are expected to grow at around potential over the forecast period, supported by accommodative monetary and fiscal policies and the improvement in the global economy since last year. GDP growth in the major advanced economies is likely to be above potential over the next couple of years, partly because monetary policies are expected to remain accommodative and US fiscal policy is expected to be expansionary. Potential growth rates in these economies are lower than their long-term average growth rates owing to lower growth in the working-age population, the capital stock and productivity.

Considerable uncertainty remains about the economic policies of the US administration, which recently announced a proposal for tax reform involving substantial cuts in personal and corporate taxes. The proposal faces significant hurdles in passing through Congress, and so the magnitude and timing of any policy changes is uncertain. Changes in fiscal policy are expected to increase growth in the United States at a time when there is limited spare capacity in the US labour market, thereby increasing inflationary pressures. This could have spillovers to higher growth and inflation in other economies, depending on how exchange rates respond. However, there is a risk that more restrictive and protectionist trade and immigration policies in the United States could harm global growth prospects.

The increase in the prices of oil and other commodities in 2016 contributed to a pick-up in global headline inflation; these effects will diminish unless commodity prices rise further. Measures of wage growth in some economies have picked up, following a period of subdued growth. In the major advanced economies, wage pressures are expected to continue to increase as spare capacity in labour and product markets declines further; in the United States and Japan, growth in unit labour costs is already above average. A number of major advanced economies look to be around full employment, although this is a source of uncertainty. If there is less spare capacity than assumed, inflation could rise more quickly than currently forecast, which could lead to tighter monetary policy in some advanced economies and a depreciation of the Australian dollar.

Australia's terms of trade are estimated to have increased further in the March quarter, but are still expected to decline over the forecast period because of falls in commodity prices (Graph 6.3). The near-term forecast for the terms of trade has been revised slightly higher since the previous

Graph 6.3
Terms of Trade
2014/15 average = 100, log scale



Sources: ABS; RBA

Statement, largely because of the sharp increases in coking coal prices after Cyclone Debbie damaged key railway networks and shut down coal shipping ports in the Bowen Basin region in late March. The rail lines reopened at reduced capacity in late April. Thermal coal prices are also a little higher because of the effects of Cyclone Debbie and changes in Chinese government policies to further reduce overcapacity in the Chinese coal industry. The recent decline in the spot price of iron ore has been broadly in line with expectations. Further out, the forecast for the terms of trade is little changed from the previous *Statement*; the terms of trade are expected to decline, but to remain above the trough in early 2016.

Domestic Activity

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 (trade-weighted index (TWI) at 64 and A$ = US$0.74), which is slightly lower than the assumption underlying the forecasts in the February *Statement*. The forecasts are also based on the price of Brent crude oil being US$51 per barrel over the forecast period, which is 9 per cent lower than the assumption used in February and in line with futures pricing in the near term. The population aged over 15 years is still assumed to grow by 1.6 per cent over both 2017/18 and 2018/19. This assumption draws on projections from the Department of Immigration and Border Protection.

Economic activity rebounded in the December quarter by more than had been expected, confirming that the weak outcome in the September quarter largely reflected temporary factors. The strength in the December quarter, which included a surprise increase in mining investment, is not expected to be sustained in the near term. Overall, GDP growth over 2016 was slightly below central estimates of potential output growth, consistent with subdued labour market outcomes and low inflation.

The forecasts for domestic output growth are little changed from those presented in the February *Statement*. Year-ended GDP growth is expected to pick up as the drag from mining investment comes to an end and the ramp-up in resource exports continues. GDP is forecast to increase by 2½–3½ per cent over 2017, with growth expected to remain a bit above potential throughout the rest of the forecast period (Table 6.1).

Mining activity increased strongly in the December quarter, following the weak September outcome which was affected by a number of temporary supply disruptions. In the near term, the forecast for coal exports has been revised lower because of the damage to rail infrastructure caused by Cyclone Debbie. The ramp-up in liquefied natural gas (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, contributing around ½ percentage point to GDP growth in each of 2017 and 2018. Iron ore export volumes are likely to be supported by increased production from Australia's low-cost producers.

The increase in commodity prices since late 2015 has boosted the profitability of firms in the mining sector. However, this has not led to a material increase in investment in production capacity, partly because prices are expected to decline over the forecast period. Mining investment is still expected to fall further over the forecast period, as large resource-related

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

	Year-ended					
	Dec 2016	Jun 2017	Dec 2017	Jun 2018	Dec 2018	Jun 2019
GDP growth	2.4	1½–2½	2½–3½	2¾–3¾	2¾–3¾	2¾–3¾
Unemployment rate[(b)]	5.7	5¾	5–6	5–6	5–6	5–6
CPI inflation	1.5	2	1½–2½	1½–2½	1½–2½	2–3
Underlying inflation	1½	1¾	1½–2½	1½–2½	1½–2½	2–3
	Year-average					
	2016	2016/17	2017	2017/18	2018	2018/19
GDP growth	2.5	1½–2½	2–3	2½–3½	2¾–3¾	2¾–3¾

(a) Technical assumptions include A$ at US$0.74, TWI at 64 and Brent crude oil price at US$51 per barrel; shaded regions are historical data
(b) Rate at end of period
Sources: ABS; RBA

projects are completed and few new projects are expected to commence. However, the drag on overall domestic activity from falling investment in the resources sector is expected to be limited, as most of the remaining decline is related to LNG projects, which are import intensive and use relatively little labour.

Growth in household spending in the December quarter picked up by more than had been expected. Indicators such as retail sales and consumer sentiment point to a moderation in household consumption growth in early 2017. For the remainder of the forecast period, household consumption is forecast to grow at a bit above its average since the financial crisis, as had been expected at the time of the February *Statement*. Household income is expected to grow at a similar rate to consumption, implying little change in the household saving ratio.

Dwelling investment is expected to continue to contribute to GDP growth over the next year or so, particularly given the large volume of new apartment construction in the pipeline, although the contribution to growth is likely to diminish over time. In the March quarter, growth in dwelling investment may have been affected by rain-related disruptions to construction in Sydney.

Non-mining business investment has risen modestly since mid 2015, supported by low interest rates and the earlier depreciation of the exchange rate. However, non-mining business investment as a share of GDP remains low relative to its history. The outlook over the next year or so is subdued, consistent with the Australian Bureau of Statistics (ABS) capital expenditure survey of firms' investment intentions and the downward trend in non-residential building work yet to be done. Growth in non-mining business investment is expected to pick up later in the forecast period as the spillover effects from falling mining investment dissipate and aggregate demand growth increases.

Employment growth has picked up a little since late last year, as had been expected, following below-average growth over much of 2016. Leading indicators of labour demand, such as job advertisements and vacancies, point to moderate employment growth over the next six months. Further out, employment growth is expected to be fairly steady at around its long-run average. Even though overall GDP growth is forecast to be above potential, the boost to GDP from higher LNG production is not expected to generate significant employment growth. This is because LNG production is very capital intensive and requires relatively few employees, a sizeable portion of LNG profits will flow to foreign investors and tax revenue will be constrained by deductions (such as depreciation).

Labour force participation has been a little stronger recently than expected and the unemployment rate is currently a little higher than was forecast at the time of the February *Statement*. From this higher starting point, the unemployment rate is expected to edge slightly lower over the forecast period. This suggests that spare capacity in the labour market will remain over the next few years. The participation rate is assumed to remain at around current levels over the forecast period.

Wage growth is expected to remain at around its current rate over the next year, which is consistent with information from the Bank's liaison program and a survey of union wage expectations. Wage growth is then expected to pick up gradually over 2018 and 2019, although at a slightly slower pace than had been forecast in February. The level of *real* wages is forecast to increase, having been fairly flat over the past couple of years. Spare capacity in the labour market is expected to continue to weigh on wage growth over the next few years. However, some of the other factors that have been putting downward pressure on wage growth over recent years are expected to dissipate gradually. For example, the declines in wage growth in mining-exposed states and industries are likely to be less pronounced over the next few years as the drag on economic activity from falling mining investment and the earlier decline in the terms of trade fades. Higher headline inflation should also contribute to wage pressures.

Inflation

The March quarter inflation outcome was consistent with expectations at the time of the February *Statement*. Measures of underlying inflation are expected to pick up a little further to be around 2 per cent in early 2018. Headline inflation was just above 2 per cent over the year to the March quarter; it was higher than underlying inflation because of increases in tobacco and fuel prices. Headline inflation is expected to be between 2 and 3 per cent throughout the forecast period, partly because of further tobacco excise increases and utilities price inflation. These forecasts are little changed from the previous *Statement*.

Wage growth is expected to pick up gradually over the forecast period and labour productivity growth is expected to remain around its current rate. This implies that there will be a modest pick-up in unit labour costs over the forecast period, which will tend to push up inflation, particularly for non-tradable goods and services. Prices of tradable items (excluding volatiles) have been flat or falling for most of the past five years, despite the boost from the depreciation of the exchange rate during that period. This is because heightened retail competition and low wage growth have had a disinflationary effect on prices in supermarkets and for clothing & footwear. There is some evidence that these competitive forces may have started to spread to other retail items, such as furniture. Furthermore, the entry of new foreign retailers into the Australian market over the next few years could constrain retail price inflation.

There are a number of other forces affecting inflation. Large additions to housing supply, both over recent years and over the next year or so, are expected to increase vacancy rates and keep rent inflation low over the next few years; rents have a weight of around 7 per cent in the CPI. On the other hand, new dwelling cost inflation is not expected to ease significantly and the legislated tobacco excise increases are expected to add a bit more than ¼ percentage point to headline inflation in each of the next couple of years. Following a sizeable increase in electricity and gas prices in the March quarter, utilities inflation is expected to continue to pick up in the period ahead, which will have both direct and indirect effects on inflation.

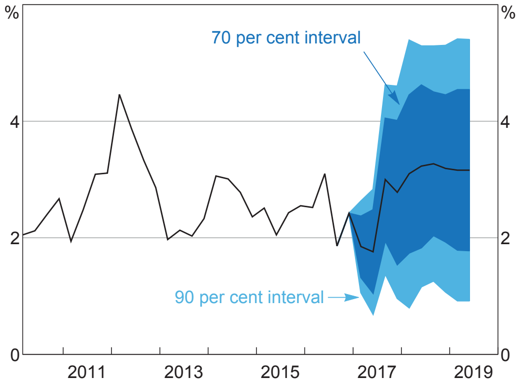
Key Uncertainties

The forecasts are based on a range of assumptions about the evolution of some variables, such as the exchange rate and the cash rate, and judgements about how developments in one part of the economy will affect others. One way of demonstrating the uncertainty surrounding the central forecasts is to present confidence intervals based on historical forecast errors (Graph 6.4; Graph 6.5; Graph 6.6). It is also worth considering the implications of different assumptions and judgements for the forecasts and the possibility of events occurring that are not part of the central forecast.

Momentum in the global economy

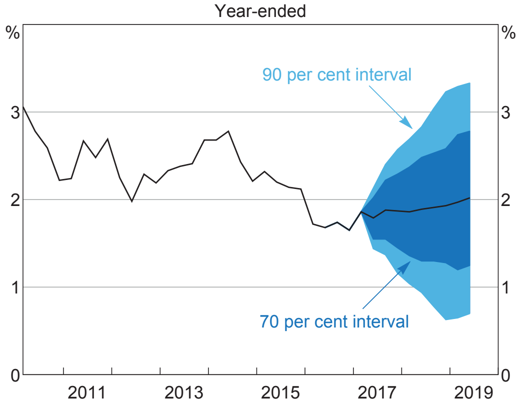
The improvement in global growth since late 2016 has been quite broad based geographically. However, it remains possible that the upswing could be derailed by geopolitical events.

Graph 6.4
GDP Growth Forecast*
Year-ended



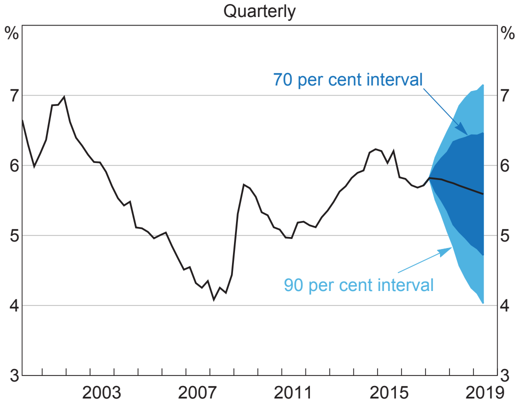
* Confidence intervals reflect RBA forecast errors since 1993
Sources: ABS; RBA

Graph 6.5
Trimmed Mean Inflation Forecast*
Year-ended



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

Graph 6.6
Unemployment Rate Forecast*
Quarterly



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

Increased trade protectionism would also lower global growth prospects. There is still considerable uncertainty about trade policy in the United States and how authorities in other economies might respond to any changes to existing arrangements. On the other hand, there is some chance that the upswing could turn into a self-sustaining expansion that is stronger than expected. The pick-up in global economic conditions since last year was more pronounced than had been anticipated, and follows a sustained period of subdued growth in global trade and investment.

The Chinese economy and commodity prices

The outlook for the Chinese economy remains an important source of uncertainty for commodity prices and Australia's exports. Conditions in the Chinese housing market have been stronger than expected, despite the sharp slowing in housing price growth in cities where tightening measures have been introduced. Continued efforts to lower price growth and reduce speculative activity in the housing market could dampen residential investment. If conditions in the Chinese housing market ease by more than expected, growth in demand for steel, and therefore iron ore and coking coal, could be lower than expected.

There is also uncertainty about how the authorities will respond to the continued rise in leverage in the Chinese economy, including in the large and somewhat opaque 'shadow banking' sector. The authorities face a difficult trade-off between supporting GDP growth to meet their short-term economic targets and preventing a further build-up of financial risks. While Chinese financial conditions overall have remained accommodative this year, conditions in money markets and the corporate bond market have tightened somewhat. Moreover, the lower target for growth in total social financing in 2017 could indicate an intention by the authorities to tighten monetary conditions modestly this year, and the authorities have also signalled that they will take a stricter regulatory approach to managing financial risks, both of which could weigh on GDP growth.

Spare capacity in the labour market

Spare capacity in the labour market over recent years has put downward pressure on wage growth and inflation. While the central forecast is for the unemployment rate to edge slightly lower over the forecast period, there is uncertainty about how much spare capacity there will be over the next few years. For example, the recent pick-up in national income from the higher terms of trade could flow through to stronger growth in economic activity and employment than assumed. The composition of GDP growth might also be associated with more employment growth than forecast. In both cases, it is likely that the unemployment rate would fall by more than expected currently.

The amount of spare capacity in the labour market can also be affected by firms adjusting the hours worked by their existing employees (rather than changing the number of employees). In 2016, firms reduced the average hours worked by their employees, which may have prevented an increase in the unemployment rate. Growth in part-time employment was relatively strong over 2016, and around one-quarter of all part-time workers indicate that they want to work additional hours. As a result, the *underemployment* rate has edged higher. It is likely that these underemployed workers have put some downward pressure on wage growth, given that they would like to work more hours, although it is uncertain how much influence they have on wage outcomes compared with the unemployed. It is possible that growth in firms' demand for labour could be met by increasing the hours of these part-time workers, which would reduce underemployment without necessarily reducing the unemployment rate.

Consumption and housing

Household consumption is influenced by households' expectations about growth in their incomes and wealth, as well as any constraints that they might face in accessing finances. On the one hand, if the terms of trade fall later or by less than anticipated, this could lead to stronger growth in household income and wealth than currently expected (via dividends and superannuation, and possibly wages in some industries). This, in turn, could generate more spending than currently envisaged. The pick-up in global economic conditions since last year might also improve households' expectations about future income growth. On the other hand, elevated levels of household debt mean that households are likely to be more sensitive to any deterioration in expected income growth. For example, if indebted households believe that their prospects for income growth have weakened, they could choose to pay down debt faster and consumption growth could be lower than forecast.

Housing prices have grown briskly in Sydney and Melbourne over the past year. In the short term, this could see more household spending and renovation activity than is currently anticipated, but a continuation of these trends would raise medium-term risks. The recent tightening in prudential standards and higher interest rates on some mortgage products are likely to weigh on credit growth, particularly for investors. Investor activity is currently strong in Sydney and Melbourne, but history shows that sentiment can turn quickly, especially if prices start to fall. A substantially weaker housing market could have broader implications, including slower growth in consumption and dwelling investment than expected. Consumer price inflation could also be lower than forecast because of weaker growth in economic activity and lower housing cost inflation.

Inflation

As has been the case for some time, there is considerable uncertainty around the timing and extent to which domestic cost pressures will rise over the next few years. As wages are the largest component of business costs, the outlook for wage growth is particularly important for the inflation outlook. The recovery in wage growth could be stronger than anticipated if conditions in the labour market tighten by more than assumed, or if employees demand wage increases to compensate for the sustained period of low real wage growth. However, it could be the case that some of the factors currently weighing on wage growth, such as underemployment in the labour market or structural forces such as technological change, are more persistent or pervasive than assumed. The path of inflation will also depend on whether the heightened competitive pressures in the retail sector continue to constrain inflation. On the other hand, the earlier increases in global commodity prices and increases in domestic utilities prices could flow through to domestic inflation (through higher business costs) by more than assumed.

Another factor affecting the outlook for CPI inflation is that the weight assigned to each expenditure class in the CPI will be updated in the December quarter 2017 CPI release. Measured CPI inflation is known to be upwardly biased because the weight assigned to each expenditure class is fixed for a number of years. This means that 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, although it is hard to predict by how much because the effects of past re-weightings have varied significantly and are not necessarily a good guide to future episodes. The ABS plans to re-weight the CPI annually in future, which will reduce substitution bias on an ongoing basis.