Overview

The global economy entered 2017 with more momentum than earlier expected. Along with various survey indicators pointing to improved sentiment, growth in global industrial production and merchandise trade have picked up. Partly reflecting the run of recent data, the outlook for GDP growth in Australia's major trading partners has improved. GDP growth in China has been stronger than earlier anticipated, supported by accommodative macroeconomic policies, although growth is still expected to slow over coming years and the credit-based financing of some of the expansion poses risks. The largely policy-induced rebound in residential investment in China has spurred stronger demand for construction-related materials, such as steel, which in turn has boosted demand for iron ore and coal. High and rising debt, combined with excess capacity in some sectors, remains a risk to the medium-term outlook for growth in China. Growth in the major advanced economies is expected to be above potential, although there is significant uncertainty around policy in the United States and its effect on global growth and prices.

Global inflationary pressures are somewhat stronger than they have been for some time, because of accommodative policy settings, the recent increases in commodity prices and limited spare capacity in a number of advanced economies. Reflecting this, sovereign bond yields have risen (though only back to levels of a year ago), the Federal Open Market Committee raised the federal funds rate, and there is no longer an expectation of further monetary easing in the other major advanced economies. The adjustments in global financial market prices have been orderly and measures of market volatility remain low.

The prices of bulk commodities increased significantly over the past year. Australia's terms of trade have consequently risen by more than 15 per cent since mid 2016, following the large falls over the previous few years. These higher price levels are unlikely to be sustained. Coal prices have already fallen from very elevated levels, partly because some earlier supply disruptions have been resolved. Also, additional low-cost iron ore production from Australia and Brazil is expected to come on line over the period ahead. The forecasts accordingly assume that much of the recent increase in the terms of trade and commodity prices will be unwound over the next couple of years, although the terms of trade are expected to remain above the lows of a year ago.

The higher commodity price levels are boosting the profits of resource firms. At this stage, this is not expected to translate into materially higher investment or employment in the resources sector, because the recent increases in prices are widely expected to be temporary. Some of the additional income is likely to accrue to foreign shareholders of resource firms; the proportions received by domestic shareholders and governments are unlikely to add much to domestic demand. However, if commodity prices do not fall by as much as anticipated, the boost to Australia's domestic income growth and economic activity could be more material. The recent increases in the terms of trade have been associated with an appreciation of the Australian dollar. The depreciation of the Australian dollar since 2013 has contributed to the ongoing adjustment of the domestic economy to the end of the mining investment boom; an appreciating exchange rate could complicate that process.

Real GDP declined in the September quarter, a significantly weaker outcome than was anticipated. Some of the decline can be attributed to disruptions to coal supply and bad weather affecting construction activity. This weakness is not expected to continue and real GDP looks to have increased in the December quarter. Beyond that, the outlook for the domestic economy is little changed from three months ago and the ongoing adjustment to the end of the mining investment boom is expected to continue. GDP growth is expected to pick up over 2017 to 2½–3½ per cent, supported by low interest rates, the diminishing drag on growth from falling resource investment and rising resource exports. In particular, liquefied natural gas exports are projected to add around ½ percentage point to GDP growth in each of 2017 and 2018. However, overall growth is not expected to be sufficient to generate much of a decline in the unemployment rate over the forecast period.

Non-mining business investment has remained at relatively subdued levels for some years, although it expanded moderately over the year to the September quarter. Over the past few years, it has grown relatively strongly in New South Wales and Victoria, the states that have been least affected by the declines in the terms of trade and the end of the mining investment boom. In contrast, non-mining investment has been weak in Queensland and Western Australia. Some pick-up in non-mining investment is expected over the period ahead, although the timing of this upswing remains uncertain. Complementing this expected increase is a sizeable pipeline of public infrastructure projects.

Consumption growth moderated in mid 2016, although it looks to have picked up more recently. Growth in retail sales volumes increased in the December quarter; households' perceptions of their personal finances are around average; and expectations of unemployment are at relatively low levels. However, subdued growth in household income is likely to continue to constrain consumption growth over the period ahead. The forecast for consumption growth has been scaled back a little to reflect recent data and a view that consumption is unlikely to grow materially faster than income over the next couple of years.

Private dwelling investment declined unexpectedly in the September quarter, largely because poor weather disrupted construction. Dwelling investment nonetheless continued to grow at an above-average rate over the year, supported by low interest rates. The large amount of work in the pipeline suggests that dwelling investment will remain at high levels over the next year or so. However, if investors were to reassess expected returns to property investment, some projects currently in the pipeline could be at risk of not going ahead.

Overall conditions in the established housing market have strengthened further, although there is significant variation across the country. Housing prices continue to rise briskly in Sydney and Melbourne, while housing prices have fallen further in Perth. The recent increases in housing loan approvals have been driven largely by investors and have resulted in housing credit growth picking up a little. At the same time, conditions in most apartment markets appear to be softening. A further considerable flow of new apartments is coming onto the market over the next year or so, primarily in the eastern capital cities. Past increases in supply are weighing on rents in most cities, especially in Perth and

Brisbane, where economic conditions have been weaker and apartment prices are falling.

The unemployment rate increased slightly in late 2016 to 5.8 per cent, which is around its level of a year earlier. Employment rose modestly in the December quarter. All of the increase was in the full-time component, reversing the pattern of the previous few quarters. The divergence in labour market conditions across states continued: employment in Queensland and Western Australia declined over the year, in contrast to the growth recorded in New South Wales and Victoria. Forward-looking indicators point to a pick-up in employment growth over the period ahead.

The current rate of unemployment suggests that there is still a degree of spare capacity in the labour market, which has contributed to subdued wage pressures. Low wage growth might also have partly reflected businesses' responses to increased competitive pressures. More recently, there has been some evidence from surveys and liaison with firms suggesting that wage growth is unlikely to ease further.

Inflation remains quite low. Headline inflation was 0.5 per cent in the December quarter and 1.5 per cent over the year, as had been expected. Underlying inflation was little changed at 1½ per cent over 2016. Prices of most tradable items have been declining, especially for consumer durables, reflecting among other things heightened competitive pressures on retailers. The effects of the earlier depreciation of the exchange rate are thought to be no longer putting upward pressure on prices. Domestic cost pressures remain subdued, largely because growth in labour costs has been slow. However, non-tradable inflation looks to have stabilised over recent quarters.

Inflation is expected to increase as the effects of some factors that have been weighing on domestic cost pressures dissipate, including the earlier decline in the terms of trade and falling employment in mining-related industries. Wage growth is forecast to increase only gradually. Headline inflation is expected to pick up to 2 per cent in early 2017. The increase in underlying inflation is likely to be gradual. These forecasts are little changed from those published in the November *Statement on Monetary Policy*.

Taking account of the available information, and having eased monetary policy in 2016, the Board judged that holding the stance of policy unchanged at recent meetings would be consistent with sustainable growth in the economy and achieving the inflation target over time.