# 5. Economic Outlook

Economic growth in Australia was weaker over 2018 than expected at the time of the February *Statement*. New information received over the past three months has led to some further downward revisions to the outlook for GDP growth and inflation. In summary, GDP growth is expected to be around 2¾ per cent over 2019 and 2020. Underlying inflation is expected to pick up to 2 per cent by early 2020, and to increase a little further by mid 2021.

As discussed in the chapter on 'The International Environment', growth in Australia's major trading partners eased in the second half of 2018, and growth is expected to have continued at this more moderate rate into 2019. Recent data have led to some small downward revisions to the global growth outlook, mainly because of lower growth in parts of Asia. Growth in Australia's major trading partners is expected to be around 3¾ per cent in 2019 and 2020. Global inflation is expected to be a little lower over the forecast period than was expected at the time of the February *Statement*.

There are a number of global and domestic uncertainties for the forecasts. Risks around trade policies remain and could weigh on global growth more than currently expected. In contrast, the risks around the global impetus from Chinese demand are more balanced in light of emerging signs that policy stimulus is supporting growth in China. Global financial conditions have become more accommodative since the turn of the year and could lead to stronger growth than forecast. However, there are events that could lead to both tighter financial conditions and lower global growth. Domestically, the outlook for consumption remains a key source of uncertainty. In addition, there continues to be uncertainty about how the unemployment rate will evolve and how quickly any tightening in labour market conditions might feed into wage pressures and so inflation.

## Domestic growth has been revised lower for 2019

Over 2018, Australian GDP growth was weaker than previously anticipated (Table 5.1). Some of the drivers of the slowdown in growth in the domestic economy over the second half of 2018, particularly mining activity, are expected to have been transitory. But other drivers, such as consumption and dwelling investment, are expected to remain soft over coming quarters. Recent partial indicators point to moderate GDP growth in the March quarter.

Year-ended GDP growth is expected to be around 2¾ per cent over 2019 and 2020, supported by accommodative monetary policy and an increase in household disposable income growth (Graph 5.1). The outlook for household consumption growth continues to be an important source of uncertainty for the domestic growth forecasts, particularly given uncertainties around the outlook for income growth and how developments in housing markets will affect household decision-making. Public demand and business investment are expected to continue supporting growth over

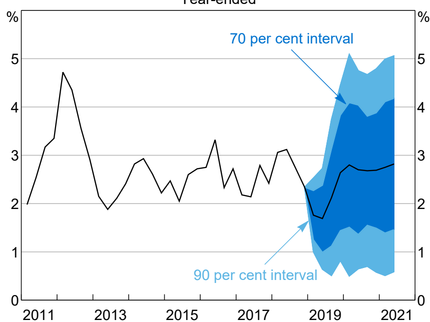
the forecast period. The gradual increase in gross national expenditure growth over the next few years is expected to be complemented by steady export growth.

The domestic forecasts are conditioned on the technical assumption that the cash rate moves in line with market pricing, which implies two 25 basis point cuts to the cash rate. The exchange rate is assumed to be around 2 per cent below where it was at the time of the February *Statement*. The oil price is assumed to remain 8 per cent higher than at the time of the February *Statement*. The working-age population is assumed to grow by 1.7 per cent per annum over the forecast period, which is a little stronger than previously assumed.

## Consumption growth has been revised lower

Consumption growth was weak in the second half of 2018, despite the ongoing improvement in the labour market. Consumption is expected to remain soft over coming quarters because of weak household disposable income growth over the past few years and weak housing market conditions. Growth in consumption is expected to be 2 per cent over 2019, and is then forecast to increase to be 2¾ per cent by mid 2021, supported by stronger growth in disposable income and the absence of a drag from housing market conditions.

Graph 5.1



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

Growth in nominal household disposable income was 2 per cent over 2018 because moderate growth in labour income and subdued growth in non-labour income was partly offset by strong growth in tax payments. Household disposable income growth is expected to increase over 2019, supported by employment growth, a gradual pick-up in wages growth and more typical growth in tax payments. Expectations that growth in tax payments will be lower partly reflect the introduction of the low- and middle-income tax offset. The forecast incorporates the increase in the offset announced in the 2019/20 budget. The total benefit to households from the offset is around 0.6 per cent of disposable income each year over the forecast period. Most of the benefit will be concentrated in the September and December quarters when those eligible receive their tax refunds.

Over coming years, household disposable income growth is also expected to be supported by lower net interest payable owing to the lower cash rate assumption. By contrast, the contribution from unincorporated business income has been revised lower in the near term, reflecting downward revisions to activity in the farm and residential construction sectors. With household disposable income forecast to grow at about the same rate as consumption over the forecast period, the household saving ratio is expected to remain around its current level.

## Dwelling investment will decline over the forecast period …

Dwelling investment is expected to decline substantially over coming years. The pipeline of work to be done on higher-density housing remains very large, which should continue to support activity in the near term. This is

**Table 5.1: Output Growth and Inflation Forecasts[(a)]**

Per cent

| | Year-ended | | | | | |
|---|---|---|---|---|---|---|
| | Dec 2018 | June 2019 | Dec 2019 | June 2020 | Dec 2020 | June 2021 |
| GDP growth | 2.3 | 1¾ | 2¾ | 2¾ | 2¾ | 2¾ |
| (previous) | (2¾) | (2½) | (3) | (2¾) | (2¾) | (2¾) |
| Unemployment rate[(b)] | 5.0 | 5 | 5 | 5 | 5 | 4¾ |
| (previous) | | (5) | (5) | (5) | (4¾) | (4¾) |
| CPI inflation | 1.8 | 1¾ | 2 | 2 | 2 | 2 |
| (previous) | | (1¼) | (1¾) | (2) | (2¼) | (2¼) |
| Trimmed mean inflation | 1.8 | 1½ | 1¾ | 2 | 2 | 2 |
| (previous) | | (1¾) | (2) | (2) | (2¼) | (2¼) |
| | **Year-average** | | | | | |
| | 2018 | 2018/19 | 2019 | 2019/20 | 2020 | 2020/21 |
| GDP growth | 2.8 | 2¼ | 2 | 2½ | 2¾ | 2¾ |
| (previous) | (3) | (2½) | (2¾) | (2¾) | (2¾) | (2¾) |

(a) Technical assumptions include the cash rate moving in line with market pricing, TWI at 60, A$ at US$0.70 and Brent crude oil price at US$68 per barrel; shaded regions are historical data; figures in parentheses show the corresponding forecasts in the February 2019 *Statement*

(b) Average rate in the quarter

Sources: ABS; RBA

consistent with messages from construction firms and developers in the Bank's liaison program. However, building approvals have been trending lower for more than a year, and building commencements have declined sharply more recently. Further, information from the liaison program points to a significant slowdown in activity in the early stages of residential development. Pre-sales of new houses and apartments have been steady at a low level in recent months, after sales slowed sharply over the second half of 2018. Liaison with developers suggests that financing conditions remain tight.

## … but business investment is expected to support growth …

Business investment growth is expected to continue supporting the economy over the forecast period. Non-mining business investment was stronger than expected in the December quarter and is expected to remain at a higher level over the next year or so, although growth is expected to moderate somewhat, consistent with the recent softening in some partial indicators. However, there is still a solid pipeline of private infrastructure (particularly transport and electricity projects) and building work that should support business investment over the forecast period.

Mining investment declined in the December quarter as construction on the remaining liquefied natural gas (LNG) projects neared completion. The ABS Capital Expenditure Survey and information from business liaison suggest that mining investment is close to its trough. Mining investment should gradually pick up over the next year or two as investment to sustain production continues. Growth is expected to increase further from mid 2020 as

construction on a number of new mining projects commences. The total amount of expenditure is substantial, but is expected to be much smaller than was seen in the recent mining investment boom.

## … along with public demand

Growth in public demand was much stronger than expected over 2018. Public demand is expected to continue to provide support to economic growth, although its rate of growth is expected to ease over the forecast period. Public investment is expected to remain strong over coming years, supported by the large pipeline of infrastructure projects. Growth in public consumption is being supported by the rollout of the National Disability Insurance Scheme, which is due to be completed by mid 2020.

## Exports have been revised higher over the forecast period

There have been some changes to the expected timing and volume of resource exports over the forecast period. Iron ore and coal exports are expected to pick up gradually over 2019 as they recover from various disruptions that have affected volumes in recent quarters. Because of delays experienced at some LNG projects, LNG exports look likely to reach production targets over the second half of 2020 rather than in late 2019 as was previously expected. The outlook for resource exports has also been lifted by some modest increases to smaller-resource exports, including non-ferrous metals and condensate associated with LNG production.

Manufacturing exports are expected to grow steadily over the forecast period, supported by the lower exchange rate. Service exports are expected to continue to be supported by student and visitor arrivals. Rural exports are expected to decline over the next year as the effects of unfavourable weather conditions weigh on cereal and meat production. Further out, the outlook is highly contingent on weather outcomes and is based on the assumption that seasonal conditions gradually return to their long-run average over the next couple of years.

Imports are expected to grow a little more slowly than at the time of the previous *Statement*, reflecting slower domestic demand and the recent small exchange rate depreciation.

## Commodity price movements have lifted the terms of trade

The terms of trade forecasts have been revised higher, but are still expected to moderate over the forecast period (Graph 5.2). Iron ore prices have risen considerably following mine closures in Brazil, as well as some supply disruptions in Australia. As a result, iron ore prices have been revised higher throughout the forecast period, but are still expected to decline over time as supply gradually comes back online and Chinese demand moderates; Chinese steel production forecasts are unchanged compared with the previous *Statement*.

Coking coal prices have evolved broadly in line with expectations at the time of the previous *Statement*, and the outlook for a gradual decline is unchanged. Thermal coal prices are expected to increase a little in coming months, reflecting seasonal demand in Asia. Further out, prices are forecast to moderate, partly due to the gradual transition away from coal-fired power generation and an increase in seaborne supply. LNG prices are expected to strengthen over 2019, owing to recent increases in oil prices as well as the assumption that the oil price remains at its current higher level.

## The unemployment rate is expected to remain unchanged for a while

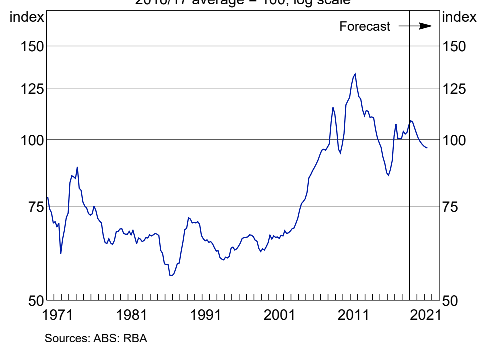
Labour market conditions remained strong in the March quarter. However, the signal from near-term leading indicators of labour demand has softened since the February *Statement*. There continues to be some divergence in these indicators; the decline in job advertisements points to a much weaker outcome for employment in the near term than the leading indicators from business surveys. Further out, the small downward revision to the employment growth forecast is a result of the lower GDP growth profile. Employment is now expected to grow at around the same rate as the working-age population over the next six months, but then to pick up a little as GDP growth increases. The participation rate is expected to remain around its current high level.

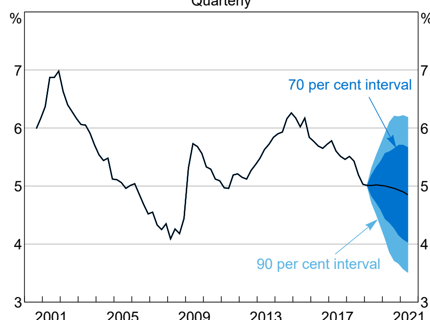
The unemployment rate is expected to remain around 5 per cent for some time, before edging lower to 4¾ per cent by mid 2021 (Graph 5.3). This suggests that there will continue to be some spare capacity in the labour market over the next few years, although there is ongoing uncertainty around its extent.

## Wages growth is expected to pick up gradually

The moderate increase in wages growth forecast over the next year is consistent with information from the Bank's liaison program, the recent pick-up in wages growth in new enterprise bargaining agreements and a cessation of wage freezes for some workers. The central forecast assumes that some of the factors that have weighed on wages growth over recent years, including low productivity growth and changes in competitive dynamics such as globalisation, will continue to put downward pressure on wages growth for some time yet. There has been a small downward revision to the wages growth profile since February, in line with the revision to the outlook for the labour market.

Average earnings from the national accounts, which is a broader measure of labour costs, is expected to grow at a slightly faster pace than the Wage Price Index (WPI) over the next few years. This assumes that whatever compositional or other changes have been holding average earnings growth below WPI growth in recent years will gradually dissipate. The extent to which this pick-up in wages growth will translate into inflationary pressures



will depend on whether there is an accompanying increase in productivity growth.

## Inflation has been revised lower

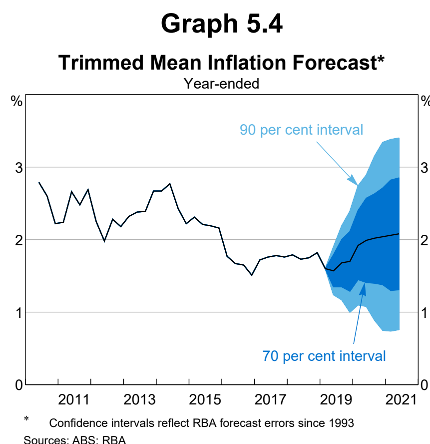
The March quarter outcome for underlying inflation was lower than expected and domestic price pressures are more subdued than previously thought. In particular, the weakness observed in the March quarter in the large housing components, which account for one-sixth of the Consumer Price Index (CPI) basket, is expected to continue as housing activity slows. The lower GDP growth profile has also contributed to a small downward revision. Nevertheless, a gradual increase in inflation is still expected to occur, reflecting the increase in wages growth, the modest depreciation of the exchange rate and some drought-related increases to food prices. Trimmed mean inflation is now expected to increase to 2 per cent by early 2020 and be a little above 2 per cent by early 2021 (Graph 5.4).

The partial rebound in oil prices in recent months has led to an upward revision to the forecast for headline inflation in the June quarter. The 12 per cent increase in fuel prices in the June quarter to date is expected to add around 0.4 percentage points to headline inflation in the quarter. Headline inflation is expected to reach 2 per cent in the second half of 2019 and increase modestly after that.

Inflation is expected to remain low across the components of the CPI. Leading indicators suggest that growth in rents will remain low in some capital cities for some time. The downturn in dwelling investment and an increased level of competition among builders is expected to keep new dwelling inflation subdued. Policy developments suggest that inflation in utilities and administered prices will remain below average in 2019. For example, health insurance premiums will increase at their slowest pace since 2001 in the June quarter. Though the modest depreciation of the exchange rate will place some upward pressure on consumer durable prices over the year ahead, there is no clear evidence yet of an easing in retail competition. The recent increase in grocery food inflation related to the drought is likely to be temporary.

## There are a number of global and domestic uncertainties for the forecasts

Over the past three months, the global growth outlook has been revised slightly lower and the risks remain tilted to the downside. The outlook for China continues to be an important source of uncertainty for the external environment facing Australia's economy. The Chinese authorities face significant policy trade-offs and it is unclear how various policy changes will play out. The outlook for trade policy remains uncertain and negative developments could harm global growth. Global financial conditions have become more accommodative since the turn of the year and could lead to stronger growth than forecast. However, there are events that could lead to both tighter financial conditions and lower global growth.



There are also a number of domestically sourced uncertainties for the growth and inflation outlook. As has been the case for some time, uncertainty about the outlook for consumption growth is a key risk that is closely related to uncertainty about the outlook for household disposable income and the labour market. The potential for household net wealth to affect consumption decisions has increased as housing prices have fallen. Declining housing market activity could also have larger knock-on effects on other parts of the economy than assumed in the forecasts.

The increase in the terms of trade has been larger and more persistent than had been anticipated and is expected to provide a significant boost to national income over the forecast period. Although it is difficult to pinpoint how this will flow through the economy, it does represent an upside risk to domestic demand growth and inflation, particularly if commodity prices remain elevated. Recent labour market conditions suggest that economic activity may have been stronger than the GDP data have signalled. Relatedly, there continues to be uncertainty about how the unemployment rate will evolve and how quickly any tightening in labour market conditions might feed into wage pressures and so inflation. In the near term, the outlook for inflation also depends on the extent to which housing, utilities and administered price changes continue to put downward pressure on inflation.

## It is uncertain how the policy mix in China will evolve

The Chinese authorities face policy trade-offs that are important to the outlook for the Chinese economy, demand for bulk commodities and Australia's terms of trade. Recent policy actions appear to have contributed to a stabilisation of growth in activity in recent months. However, the authorities are seeking to strike a delicate balance, aiming to keep growth stable without exacerbating leverage. It is possible that recent easing measures could amount to a larger stimulus than authorities intend, resulting in further increases in debt and higher GDP growth than currently projected. Additionally, recent reforms to household registration policies may spur an increase in rural-urban and intercity migration, which would pose upside risks to activity in the property sector. On the other hand, if the current mix of policy-easing measures proves less effective or durable than anticipated, Chinese growth could be weaker than forecast; in that event, weaker growth in nominal incomes could make it harder to inflate away the existing stock of debt.

The emerging configuration of policies towards China's property markets, infrastructure spending and environmental controls will be important for the growth trajectory and, in particular, the outlook for Chinese steel demand. Trade frictions with the United States remain and other aspects of the economic relationship between the two nations could affect bilateral investment and induce some production to relocate out of China. This could weigh on China's manufacturing export sector in the longer term.

## The evolution of trade tensions and other political risks could lead to tighter financial conditions

Bilateral trade negotiations between the United States and China are continuing. While there had been reports of progress in recent months, the US administration has recently threatened additional tariffs in the near term. There is also a risk that the US administration increases automotive import tariffs. This would have a

significant effect on economies with large automotive exports to the United States, and economies that are connected to automotive supply chains. More broadly, the consequences for global growth, investment and trade of any negative developments on trade policy could be significant.

Issues such as the United Kingdom's expected exit from the European Union and sovereign indebtedness in some euro area economies continue to pose risks to growth in the United Kingdom and euro area. These issues remain unresolved and any negative developments could have significant spillovers to other economies through trade, investment and confidence.

Global financial conditions have become more accommodative since the start of the year. As a result, global growth could strengthen by more than is currently forecast. However, global financial conditions could tighten if one or more of the trade and other political risks were to materialise. In particular, an unexpected further slowdown in global growth could increase financial market volatility and widen risk premiums, setting off a feedback loop between lower growth expectations and tighter financial conditions at a time when expectations for central bank policy rates are already low. Alternatively, the tight labour market could see US inflation pick up by more than expected, leading the Federal Reserve to raise its policy rate sooner than is currently projected, which could in turn increase bond yields and financial market volatility more generally.

## Domestically, the outlook for consumption remains a key source of uncertainty

As has been the case for some time, the outlook for consumption is a key source of uncertainty for the forecasts. Household consumption accounts for close to three-fifths of GDP, so if consumption growth were to be materially higher or lower than currently forecast, there would be implications for the forecasts for overall GDP growth, employment growth and inflation.

Uncertainty about expected household income growth continues to be important for the outlook for consumption. Should households conclude that low income growth will be more persistent than previously expected, households may adjust their spending by more than currently projected and consumption growth could remain weak for a longer period. Real disposable income growth is expected to pick up over the forecast period, supported by a tightening in labour market conditions and income tax offsets. However, it remains uncertain how fast spare capacity in the labour market will be absorbed and translate into wage pressures. The rate of growth in non-labour sources of income is another source of uncertainty. For example, weak residential construction activity may depress profits of unincorporated businesses by more than expected, which would weigh on household income growth if the owners of these businesses are unable to find opportunities in other sectors of the economy. By contrast, growth in consumption may be stronger than expected in the second half of 2019 if households decide to spend a greater share of the tax offset payments than is currently assumed.

Developments in housing markets are also important for understanding the risks to the consumption outlook. The deterioration in housing market conditions is expected to continue to weigh on consumption in coming quarters. However, the recent falls in housing prices have followed several years of very strong growth. If households take a longer-term perspective of their wealth, they may partly look

through the recent declines. By contrast, if there are further sizeable falls in housing prices, this would be expected to result in more persistent weakness in some types of consumption, such as household appliances and furnishings.

The high level of household debt also remains a key consideration for household consumption. In general, households that are more indebted are likely to be more sensitive to changes in their expected income growth and household wealth; consumption growth may be weaker for a time if households are concerned about their debt levels and choose to pay down debt more quickly. It is also possible that households that are highly indebted or credit-constrained will be more sensitive to falling housing prices than to rising prices.

## Labour market conditions could improve by more than expected

As flagged above, the outlook for the labour market is one of the key uncertainties for the household income and consumption forecasts. Labour market conditions over the past year could imply that economic activity has been stronger than the GDP data have signalled. If this is the case, the forecasts for labour market activity may have incorporated too much signal from the recent weakness in GDP growth. To the extent that some of that weakness was temporary, the labour market could be more resilient than forecast. Stronger labour demand would be expected to lower the unemployment rate, though it could also be met to a greater extent than usual by existing workers or those who are currently outside the labour force.

If the labour market improves by more than forecast, wages growth and labour income growth may increase by more than expected. However, wages growth may also be slower to pick up than forecast. Recent international evidence indicates that it can take longer for significant wage pressures to build than previous experience suggests. Much of the increase to date in domestic wages growth reflects a decline in the prevalence of wage freezes, rather than an increase in the typical size of wage increases when they are delivered.

## Weaker housing construction and prices could have pervasive economic effects

Developments in housing markets can affect economic activity through a number of channels other than consumption. The decline in housing prices will have a direct effect on dwelling investment, but the timing and magnitude of the effect is uncertain, particularly when the outlook for housing prices is unclear. The pipeline of work to be done is large and is expected to provide support to dwelling investment over coming quarters, but there is a risk that dwelling investment declines by more than currently forecast in the near term. This would have flow-on effects to the outlooks for employment and household income. In addition, very weak conditions in the earlier stages of residential development identified in business liaison point to downside risk to dwelling investment in 2020 and 2021. If there is a period in which additions to the dwelling stock do not keep pace with growth in the underlying demand for dwellings coming from population growth, there would eventually be upward pressure on housing prices until property developers respond; past experience has demonstrated that the lags in these responses can be considerable.

There are also a number of indirect channels through which a decline in housing prices could affect the economy. Lower housing prices limit how much small businesses can borrow when using housing as collateral. The decline in housing market turnover associated with the decline in housing prices has implications for

business and household services, such as real estate and legal services. Changes in housing prices and turnover can also affect public demand through state government stamp duty revenue.

## A number of other factors could lead to lower inflation than forecast

The gradual increase in inflation that is forecast over the next two years is underpinned by a forecast for a gradual pick-up in wages growth that is subject to its own uncertainties, as discussed above. There is also a risk that developments in some CPI components will lower inflation by more than assumed. The March quarter inflation data suggested that previous forecasts have underestimated the degree to which the forecast decline in housing activity will put downward pressure on new dwelling inflation, and the degree to which the increase in housing supply over recent years will lower growth in rents.

As flagged for some time, government initiatives to reduce cost-of-living pressures have put downward pressure on administered price inflation in recent quarters and this may continue. Relatedly, electricity prices are likely to increase at a below-average pace over the forecast period, and may decline. Wholesale costs are expected to decline on the back of a large increase in renewable energy generation capacity, while recent regulatory determinations suggest that network costs will increase only modestly over the forecast period. On 1 July, standing offer electricity prices will decline considerably in several states due to the introduction of the Default Market Offer and the Victorian Default Offer. These offers will supersede all existing standard offers.

Measures of longer-term inflation expectations have declined, but remain consistent with the Bank's medium-term inflation target. However, an extended period of inflation below the target range could lead to a further decline in inflation expectations, potentially affecting wage- and price-setting norms. ✠