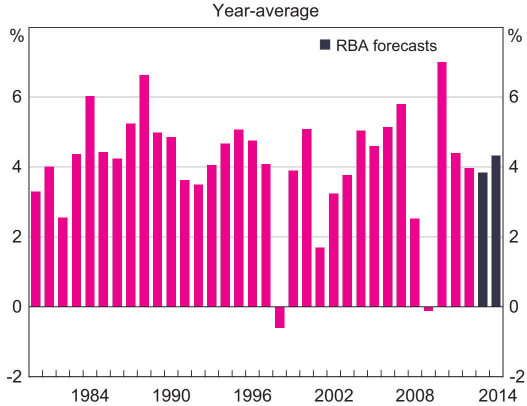
6. Economic Outlook

The International Economy

Growth of Australia's major trading partners in 2013 is expected to be a bit below its decade average of around 4 per cent, before picking up to 4¼ per cent in 2014 (Graph 6.1). For both 2013 and 2014, this outlook is a little weaker than that in the May *Statement*, although there are differences across countries in the forecast revisions. These forecasts are broadly similar to those published by other forecasters.

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



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

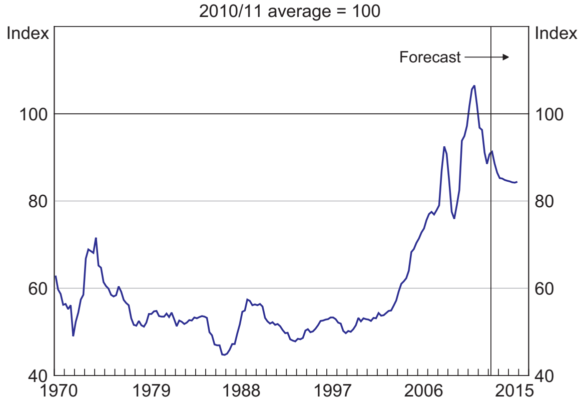
For most countries, the outlook for growth has been revised down, with the exception of Japan where growth is now expected to be stronger in 2013 as a result of policy actions. Growth in China is anticipated to continue at around recent rates, having slowed over the past year. This is somewhat less than previously expected, reflecting a weaker contribution from external demand and diminished prospects for an upswing in domestic demand. This assessment reflects recent statements and actions taken by the Chinese authorities indicating that they are increasingly focused on achieving a more sustainable pace of growth that could be close to, or even slightly below, the official growth target of 7.5 per cent. In the rest of east Asia, growth forecasts for 2013 have been revised down a little, owing to weaker-than-expected data for the March quarter and more subdued prospects for external demand. Growth is still expected to pick up gradually in the United States, supported by improvements in the labour market, an easing in the pace of fiscal tightening and rising household wealth. Conditions in the euro area are expected to remain weak throughout 2013.

The terms of trade are estimated to have been little changed in the June quarter, after an increase in the March quarter owing to an earlier rise in the price of iron ore (Graph 6.2). The terms of trade are forecast to decline gradually over the next couple of years as the global supply of bulk commodities increases. The profile for the terms of trade is a little lower than in the May *Statement*. In the near term, subdued coking coal and gold prices weigh on the forecast for the terms of trade.

Graph 6.2

Terms of Trade

2010/11 average = 100



Sources: ABS; RBA

Domestic Activity

In preparing the domestic forecasts, a number of technical assumptions have been employed, as usual. The exchange rate is assumed to remain at its current level over the forecast period (A$ at US$0.90 and the TWI at 69, which is around 10 per cent lower than was assumed in the May *Statement*). The forecasts are based on the price for Brent oil remaining at US$104 per barrel, similar to the assumption in May. The cash rate is assumed to be unchanged over the forecast period at 2.50 per cent. This profile is slightly higher than market expectations, which currently imply a further 25 basis point reduction in the cash rate by the end of the year. Given the low level of the cash rate, variable borrowing rates are currently around their 2009 lows. The forecasts assume that annual growth in the working-age population will be 1.8 per cent over the forecast horizon, reflecting forecasts by the Department of Immigration and Citizenship. Finally, the forecasts are based on the most recent federal and state budgets, and do not take into account proposed government policy changes since then, which as noted in the 'Domestic Economic Conditions' chapter, would have a somewhat sharper fiscal consolidation at the end of the forecast horizon.

The Australian economy expanded at a little below-trend pace over the year to the March quarter, with strong growth in exports offset by subdued demand in the domestic economy. The available indicators point to growth remaining below trend in the June quarter. Retail sales data and the Bank's business liaison suggest that consumption growth has remained weak over recent months and measures of consumer sentiment have fallen back towards average levels. Labour market indicators also point to ongoing softness in activity, while business surveys suggest that conditions remain below average. Consistent with this, non-mining investment is expected to grow only modestly in the near term, while the completion of a number of mining investment projects is expected to see mining investment decline.

In contrast, residential building approvals increased in the June quarter, suggesting that the recovery in dwelling investment will persist. Recent imports data have been weaker than expected, while export growth has remained strong. Given the depreciation of the exchange rate since the May *Statement*, this trend of export strength and below-average growth in imports is expected to continue.

GDP growth is expected to remain a little below trend at close to 2½ per cent through to mid 2014, before picking up to above-trend growth by the end of the forecast horizon as the global economy experiences above-trend growth and the stimulatory effects of the recent exchange rate depreciation and current low level of interest rates lead to an improvement in business conditions and so investment (Table 6.1). In the near term, the outlook is a little weaker than that presented in the May *Statement*, but at the aggregate level it is little changed over 2014. The softer outlook over the next few quarters reflects the somewhat weaker data received since May, for household consumption and business investment in particular. The depreciation since May is expected to bolster growth, working to boost activity in the trade-exposed sector. At the same time though, the profile for mining investment has been revised down. Overall, the change in the forecasts reflects the balance of the boost to activity from the recent

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

Per cent

	Year-ended					
	June 2013	Dec 2013	June 2014	Dec 2014	Jun 2015	Dec 2015
GDP growth	2½	2¼	2½	2½–3½	2¾–3¾	2¾ –4¼
Non-farm GDP growth	2½	2¼	2½	2½–3½	2¾–3¾	2¾ –4¼
CPI inflation	2.4	2	2½	2–3	2–3	1¾–2¾
Underlying inflation	2½	2¼	2¼	2–3	2–3	2–3
	Year-average					
	2012/13	2013	2013/14	2014	2014/15	2015
GDP growth	2¾	2¼	2½	2¼–3¼	2½–3½	2¾–3¾

(a) Technical assumptions include A$ at US$0.90, TWI at 69 and Brent crude oil price at US$104 per barrel
Sources: ABS; RBA

depreciation, the recent run of data, and a downward revision to the forecast path of mining investment.

The forecast for consumption spending has been revised lower since the May *Statement*, with the available partial data pointing to near-term weakness. Retail sales were unchanged in the June quarter, while consumer sentiment has fallen back towards average levels after rising earlier in the year. Slower growth of wages and somewhat subdued employment growth are also expected to continue to restrain growth in labour income. In contrast, conditions and confidence in the established housing market have improved, helping to support growth in household wealth. Overall, growth of consumption spending is expected to be below trend over 2013, before gradually rising to around trend by 2015. The forecasts embody the household saving ratio remaining around the 10–11 per cent range where it has now been for several years.

The forecast for dwelling investment is little changed in the near term and has been increased slightly in 2015. The environment for investment remains favourable with low interest rates, high rental yields, support for first home buyers that favours new dwellings, and the improvement in conditions in the established housing market. Forward-looking indicators such as building approvals, loan approvals and first home owner grants for new construction also remain consistent with a modest recovery in dwelling activity.

The outlook for mining investment has been revised lower reflecting several considerations. The ABS' March quarter capital expenditure (Capex) survey recorded a significant decline in mining investment and growth of capital imports remained weak through the June quarter. While the expectations component of the Capex survey remains strong, this is inconsistent with information from the Bank's liaison, few new commitments to mining projects and a lack of current expenditure on the development and planning work that would typically precede new projects. This is especially noticeable in the coal industry where lower prices of late have led to a significant curtailment of this type of expenditure. Given this, the expectation is that mining investment will decline somewhat over the next year or so before falling away more noticeably thereafter. The impact on GDP will be smaller in magnitude than the decline in mining investment suggests because around half of this investment spending is estimated to be on imported capital goods.

Overall, non-mining investment is expected to remain subdued in the near term. Surveys of firms' investment intentions and the Bank's liaison with firms suggest that there will be only modest growth over the next year or so. Also, office vacancy rates have increased and measures of capacity utilisation remain a little below average. Non-residential construction is, however, expected to be supported by the large stock of work to be done, predominantly in the healthcare sector. Further out in the forecast horizon, non-mining investment is expected to experience a stronger pick-up. This reflects the recent depreciation, low interest rates and strong population growth and the fact that for some time investment has been adding to the capital stock at well below the historical norm.

The outlook for export volumes remains strong with exports expected to make a significant contribution to GDP growth in the coming years. Given the significant investment that has occurred to date, and is currently underway, bulk commodity exports are expected to increase strongly over the next few years. More broadly, activity in the traded sector is expected to be a little stronger in light of the recent depreciation of the Australian dollar.

In aggregate, federal and state governments are planning to undertake fiscal consolidation over the next few years, and so growth in public demand is expected to be low relative to its historical average. The forecasts are based on the state and federal budgets, with a small reduction in the consolidated budget deficit in 2013/14 and larger reductions in the following two years.

Labour market conditions have remained somewhat subdued in recent months, with modest employment growth. Indicators of labour demand have declined and reports from liaison indicate that firms remain cautious about hiring staff. Reflecting the revision to GDP growth forecasts, the outlook for employment growth is slightly lower than at the time of the May *Statement*. The unemployment rate is expected to continue its recent upward trend over the next few quarters, but stabilise and then start to decline toward the end of the forecast horizon as GDP growth picks up to above-trend rates.

The somewhat subdued labour market conditions are expected to keep labour costs well contained over the forecast horizon. Growth in wages has moderated recently in line with increased spare capacity in the labour market, a sense of job insecurity among workers, lower inflation expectations, efforts to contain costs by firms in some industries and fiscal restraint. Overall, growth in wages is expected to remain at around 3 per cent over most of the forecast horizon.

Inflation

The inflation forecast is broadly unchanged from the May *Statement* reflecting the net effect of two offsetting influences. The slower outlook for wages growth, and the economy in general, will tend to push down inflation. Working in the other direction is the recent depreciation of the exchange rate, which is expected to lead to higher prices for tradable items. In the near term, these effects are expected to largely balance one another and year-ended underlying inflation is likely to remain close to the low end of the inflation target before moving back toward the centre of the target range around the middle of next year. The higher price of automotive fuel since the May *Statement* will contribute to somewhat higher CPI inflation in the near term.

Largely as expected, the quarterly pace of inflation picked up slightly in the June quarter. The various measures suggest that underlying inflation was a touch above ½ per cent in the quarter and remained a bit below 2½ per cent over the year. The pick-up in underlying inflation in the quarter reflected a small increase in the prices of tradable items following significant declines in recent quarters, while non-tradables inflation eased somewhat.

The recent depreciation of the exchange rate is unlikely to have affected underlying inflation in the June quarter, but it is expected to exert upward pressure on the prices of tradable items over the next few years. While some consumer prices, such as automotive fuel, tend to respond quickly to higher import prices, in general it usually takes some time before the effect of the depreciation on underlying inflation becomes apparent. In part, this is because importers have a significant degree of exchange rate hedging and some prices are subject to pre-existing contracts. The forecasts anticipate that the recent depreciation will begin to exert an upward influence on underlying inflation from around the end of this year.

Meanwhile, the ongoing subdued conditions in the labour market and continued productivity growth are expected to exert some downward pressure on inflation. Unit labour cost growth has slowed significantly over the past year or so, and growth is expected to remain contained over the forecast horizon. Accordingly, domestically generated inflationary pressures are likely to remain moderate, contributing to lower inflation in non-tradable items in particular.

Inflation will also depend on the price of carbon. The forecasts incorporate a move from a fixed to floating price for carbon on 1 July 2015 as per current legislation. The move to a floating scheme is widely expected to see the carbon price fall, to be similar to the price of European permits, which has been at low levels for several years. The Bank's forecasts for the floating carbon price and its effects on inflation use earlier modelling by Treasury. In line with projections in the Australian Government's budget, the forecasts encompass a floating price of around $12 in 2015/16, down from the fixed price of around $25 in 2014/15. This change is expected to subtract under ½ per cent from CPI inflation in 2015. Around half of this effect is expected to directly reflect lower energy prices. The rest reflects the indirect effects of lower energy costs as an input to other goods and services, and so would subtract from underlying inflation. The government has recently proposed bringing forward the move to a floating carbon price to 1 July 2014. This change could be expected to reduce the forecasts of CPI inflation by around ½ percentage point over the year to June 2015, with inflation in the subsequent period being correspondingly higher than the current forecast. Underlying inflation would again respond by less than this, with the forecasts less than ¼ percentage point lower in the corresponding period. The government has also proposed staged increases in tobacco excise over the next four years. These would be expected to add a little less than ¼ percentage point to the forecasts for headline inflation over each year and leave underlying inflation unchanged.

Risks

While the forecasts for global growth have been downgraded since the May *Statement*, the risks surrounding the forecasts appear to remain balanced for most economies. The notable exception is Europe, where the risks continue to be tilted to the downside given the weak economy and ongoing need for balance sheet repair.

It is possible that the continuing recovery in the US economy could accelerate given the improvement in the housing sector as well as the potential for greater confidence and the strong state of corporate balance sheets to lead to increased risk-taking and investment by businesses. As a result of the improvement in the US economy, more attention is now being paid to the timing and nature of the pullback from exceptionally expansionary monetary policy. As has already been seen to an extent, expectations for changes in US monetary policy have the potential to unsettle financial markets. That could hamper the ongoing economic recovery, though longer-term rates remain unusually low in the United States. The challenge for authorities in the United States will, as usual, be to time the shift in policy so as to not impede the recovery, but equally to avoid the risks inherent in policy remaining too stimulatory for too long.

In China, policymakers face challenges in progressing economic reform. While reforms may well slow growth in the near term, if successful they should reduce the risks of financial instability and improve the growth prospects for the economy over the longer term. Notably, the authorities' recent efforts to slow the pace of borrowing have demonstrated a resolve to contain the build-up of risk in the financial system, although these reform efforts will need to be carefully calibrated to ensure that they do not lead to financial instability. In any event, the financial reform efforts will be likely to reduce access to financing in the near term and could slow the expansion of sectors that have been strong drivers of growth, such as property development. Working in the other direction, while in this episode the recent strength of housing demand has not led to stronger growth in other parts of the economy, ongoing strength in housing demand could well lead to stronger growth in aggregate activity, as it has done in the past.

The outlook for the Japanese economy has improved markedly since late last year as a result of monetary and fiscal policy initiatives. The depreciation of the yen has been a key factor in promoting external demand and increasing prices. However, if these developments are not accompanied by an increase in domestic demand and higher inflation expectations, a stabilisation of the yen could see the incipient recovery stall. Few details are available about the proposed structural reforms in Japan and so it remains uncertain as to whether they will be able to boost the potential growth rate of the economy. With significant monetary expansion currently underway in large developed economies, and the potential for that to be wound back in the United States, exchange rate developments in east Asia, and the possible policy responses to those movements, will be important in influencing the growth outlook in that region.

The forecast for Australian GDP continues to embody a transition in the drivers of growth from mining investment to other parts of domestic demand, and to exports. There remains considerable uncertainty about how this transition will proceed. In particular, the forecast for mining investment remains uncertain reflecting the timing of investment work on large projects and the possibility of cost overruns. Also, there are still several proposed large projects slated for later in the forecast horizon and there is considerable uncertainty about their prospects. With little planning and development for other new projects underway, mining investment could fall away faster than anticipated. However, with commodity prices projected to only decline modestly, lower domestic costs in foreign currency terms (as a result of exchange rate depreciation and reduced demand for labour inputs from the current big projects) could lead to new projects being slated beyond the next few years.

The forecasts of non-mining business investment have a more muted recovery, at least initially, than in past cyclical upturns. In the near term, this seems likely given current conditions and leading indicators. However, the freeing up of labour from mining investment projects and the depreciation of the exchange rate could see a faster pick-up in non-mining investment in later years than is forecast. An additional consideration here is that investment has been at a low level in recent years and so spare capacity is lower than otherwise.

In the household sector, a key risk is that households become more cautious in the face of the anticipated slower wage growth, resulting in weaker consumption growth; this risk would be accentuated were the labour market to soften by more than currently expected. On the other hand, if established housing prices rise more quickly than expected, spurred in part by low interest rates, then the associated boost to wealth and sentiment may generate stronger-than-expected consumption growth. If this were accompanied by a return to increasing household leverage, it would raise concerns from a financial stability perspective.

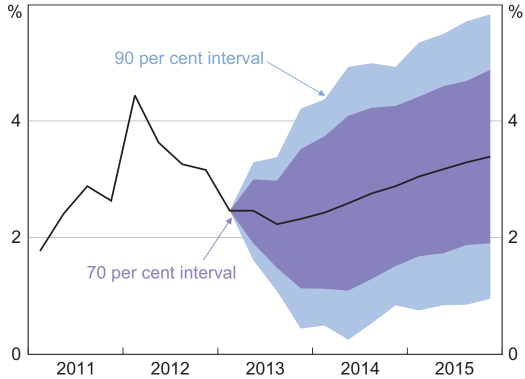
The path of the exchange rate is an important source of uncertainty for the forecasts. As the terms of trade decline and mining investment falls back from its high level, the exchange rate could depreciate further. This would help to assist with the required rebalancing of growth in the domestic economy, a role the exchange rate has frequently played over the past three decades and in particular during the boom in mining investment over recent years. A significant depreciation can have a substantial impact on aggregate economic activity. There is a wide range of empirical estimates of such effects, which in part depend on whether the depreciation is accompanied by a decline in the terms of trade. Central estimates from this range suggest that a 10 per cent depreciation of the exchange rate stimulates GDP growth by ½–1 percentage point over a period of two years or so. Further depreciation of a similar magnitude to that already experienced to date could, for example, deliver above-trend growth sooner than currently forecast.

The current forecasts, incorporating the impact of the depreciation to date, have inflation returning to around the middle of the target range by mid next year. A further depreciation could see inflation around the top of the target. A range of estimates suggest that, other things equal, a 10 per cent depreciation might be expected to increase the year-ended rate of inflation by around ¼–½ percentage point over each of the following two years or so.

If the transition to non-mining led growth were to progress less smoothly than anticipated, then the labour market could weaken by more than is anticipated, leading to lower inflation outcomes. Weaker domestic demand might also see less pass-through of the exchange rate depreciation to inflation than expected.

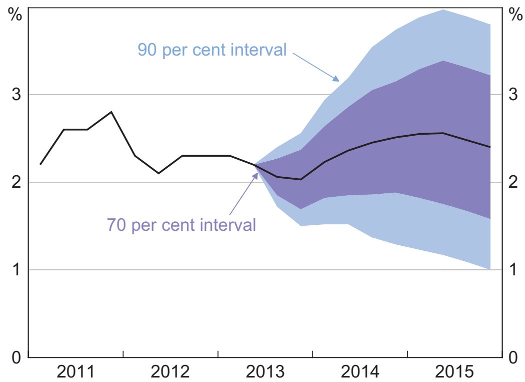
These identified risks, and other potential shocks, mean that the path for GDP and inflation may well differ from the forecasts presented. One way of demonstrating the uncertainty surrounding the GDP and inflation forecasts is to present confidence intervals based on historical forecast errors (Graph 6.3 and Graph 6.4).[1]

Graph 6.3
GDP Growth Forecast*
Year-ended



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

Graph 6.4
Trimmed Mean Inflation Forecast*
Year-ended



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

1 This is based on Bank research; see Tulip P and S Wallace (2012), 'Estimates of Uncertainty around the RBA's Forecasts', RBA Research Discussion Paper No 2012-07 and RBA (2013), 'Box E: Forecast Confidence Intervals', *Statement on Monetary Policy*, February, p 68, for further details.