# Overview

Growth of Australia's major trading partners looks to have moderated a little in the March quarter, but indicators are consistent with the pace of growth remaining around average this year. There are some signs that the recent slowing in China may be temporary and the Chinese authorities have indicated a willingness to support investment growth, if needed, to achieve their target for output growth. In Japan, economic activity appears to have picked up as expected in the March quarter, ahead of the increase in the consumption tax in April, and this has been followed by a decline in some measures of activity. It remains to be seen whether the planned fiscal stimulus measures will be sufficient to offset the anticipated decline in household expenditure. Other east Asian economies appear to have been growing at around their decade-average pace. The US economy is showing signs of moderate growth, notwithstanding a slowdown in the early part of the year attributable, in large part, to adverse weather. Global inflation remains low, particularly in the advanced economies, while monetary policy is highly accommodative in most economies.

The outlook for Australia's trading partner growth is little changed since the February *Statement*. With the moderation in trading partner growth in the first quarter expected to be temporary, growth of Australia's trading partners in year-average terms is forecast to be around its long-run average in 2014 and 2015.

Commodity prices overall have declined over the past three months. Notable falls in the prices of iron ore and coal reflect a moderation in the demand for steel in China, some tightening of credit affecting the steel sector there, and continued expansion of the global supply of bulk commodities. Commodity prices, and hence the terms of trade, are expected to be a bit lower over coming years owing to the increased supply of bulk commodities following the significant investment in capacity. However, the demand for bulk commodities is expected to remain strong and bulk commodity prices are generally expected to remain well above their levels of recent decades.

Conditions in financial markets have been remarkably stable in the past few months, with historically low volatility evident in many asset classes. The US Federal Reserve has further pared back its program of asset purchases. The Bank of Japan has continued its pace of asset purchases, while the European Central Bank has expressed a preparedness to use additional measures if the medium-term outlook for inflation softens or financial conditions tighten. There has been an increase in investors' appetite for risk with global equity prices reversing the falls recorded in January, demand for corporate bonds remaining strong and yields on sovereign bonds of several euro area periphery economies declining to multi-year lows. Conditions in many emerging markets have also improved, with their bond yields generally declining, equity markets rising and their currencies appreciating, reversing much of the movements seen in the second half of last year. Australian financial markets have followed the lead of international markets over recent months. Equity prices have increased, while bond yields and spreads have declined or remained at relatively low levels. Domestic financing conditions remain very accommodative, with ongoing expansion in market-based financing, while growth in business credit has picked up and housing credit growth has stabilised at a rate that is a little faster than income growth.

The Australian dollar has appreciated by around 4 per cent since the February *Statement*, supported in part by domestic economic data being a little stronger than markets had expected. This has taken the exchange rate back to levels seen late last year, though it is still about 10 per cent lower than the peak seen earlier in 2013.

In Australia, overall economic activity picked up over the past six months with the economy looking like it grew at close to its long-run average pace over this period. Much of this improvement was accounted for by a surge in resource exports, although there are also some signs of better conditions in parts of the non-mining economy. Still, non-mining investment remains subdued, as businesses are reluctant to take on significant new projects. Also, mining investment will decline substantially over the coming years, and growth in public demand is expected to be subdued owing to planned fiscal consolidation at state and federal levels.

The still high level of mining investment has added to capacity in the resources sector and helped to underpin the particularly strong growth of resource exports over the past two quarters. Further capacity for bulk commodities is still coming on line, although this will likely be at a slower rate than of late. Meanwhile, mining investment will decline substantially over the coming years as more resource projects reach completion and few new projects commence construction in the near term. This decline will subtract significantly from economic activity, although it will also see a substantial reduction in capital imports.

Non-mining investment is estimated to have declined in the December quarter and remains low as a share of GDP. While this was consistent with survey measures of business conditions being below average through much of 2013, a number of those surveys suggest that conditions have lifted to around their average levels since mid last year. Nevertheless, firms continue to report through the Bank's liaison program that they are waiting to see a sustained pick-up in demand before committing to increasing capital expenditure.

Household consumption growth picked up through 2013 as households became more optimistic about their finances, helped by low interest rates and the strength in the housing market. Over the past year, income growth was slower than that of consumption, with the saving rate declining a little. A moderate pace of growth in consumption appears to have been sustained into early 2014.

The strength in the established housing market, with rapid price growth over 2013 and rising housing turnover, not only provided an impetus to consumption but has also provided the backdrop for a much anticipated pick-up in dwelling investment. Dwelling approvals remain at high levels, and recent data on commencements point to strong growth in dwelling construction in the first half of 2014. Nationwide housing price inflation has moderated a little in recent months from the earlier rapid pace, auction clearance rates have also declined from recent high rates and loan approvals have been stable for a few months. It remains to be seen whether these signs of a tempering of conditions represent a shift to a more sustainable growth rate for housing prices. At the same time, indicators of demand for new housing remain strong, including first home owner grants and loan approvals for new dwellings.

Labour market conditions have shown some signs of improvement over recent months, consistent with the earlier improvement in economic activity. Employment growth picked up in the early months of 2014, following subdued growth over 2013. The unemployment rate has not increased over the past few months in contrast to the gradual upward trend of the previous year and a half. The participation rate also appears to have stabilised. Despite the improvement in conditions, there remains a fair degree of spare capacity in the labour market. This has seen the growth of wages remain low, with most measures of wages recording their slowest pace of growth for a decade or more. The combination of slow wage growth and productivity growth a little above the average of the past decade resulted in very little growth in unit labour costs over 2013.

The slow growth of wages is now more clearly evident in lower rates of inflation for a range of consumer prices. This is especially so in the prices of market services, which tend to be relatively responsive to changes in labour costs. Inflation in the prices of those non-tradable items for which prices are regulated or the government is a significant provider have been running at a faster pace. Historically the prices of these items have been less sensitive to changes in domestic labour costs. Overall though, non-tradables inflation has slowed over the past year to around 3 per cent, well below the average rate of nearly 4 per cent over the past decade. Inflation in the prices of tradable items, in contrast, has been running at a faster pace over the past year than in the preceding few years, consistent with the depreciation of the exchange rate since early 2013.

The various measures suggest that underlying inflation was ½ per cent in the March quarter, noticeably lower than the December quarter's reading. These data appear to overstate the change in inflationary pressures in recent quarters and in this regard it is likely that the past two quarters of inflation data have reflected an element of noise. Abstracting from this volatility by looking at the various measures in year-ended terms suggests that underlying inflation is running at a pace of around 2½ to 2¾ per cent. CPI inflation was a little higher than this, in part reflecting the rise in the tobacco excise in December.

The outlook for the domestic economy is little changed from that presented in the February *Statement*. Growth is expected to be a bit below trend pace over the next year or so, reflecting the decline in mining investment and weak public demand, offset to some extent by the support being provided to domestic demand by very low interest rates. This support is already evident in the recent strength in indicators of dwelling investment, as well as some pick-up in the pace of consumption growth. As household demand picks up, businesses are expected to increase their investment given growth in the non-mining capital stock in recent years has been well below average. The depreciation of the exchange rate over the past year is also expected to make a contribution to a pick-up in activity in the traded sector, albeit to a slightly lesser extent than was anticipated in February given the appreciation of the exchange rate since then. The combination of these forces is expected to see growth increase gradually to an above-trend pace over 2015/16.

The unemployment rate is unlikely to decline consistently for some time. Forward-looking indicators of labour demand have improved recently, but they are still at low levels, consistent with relatively moderate growth of employment in coming months. With GDP growth forecast to be at a below-trend pace for the next year or so, the unemployment rate is not expected to begin to decline in a sustained fashion until after this, and then only slowly.

Inflation is forecast to remain consistent with the inflation target. The outlook for inflation reflects the influence of two opposing forces. There is expected to continue to be a fair degree of spare capacity in both product and labour markets, which is likely to contain profit margins and lead to moderate growth of labour costs. Working in the other direction is the impetus to tradables prices coming from the depreciation of the exchange rate since early 2013. Overall, the forecast for inflation is little changed from the previous *Statement*.

For most of Australia's major trading partners, the uncertainty surrounding the forecasts for growth appears broadly balanced. Notably, Chinese growth slowed in the first quarter of 2014, as it did in each of the past two years. But in both of those years growth picked up later in the year, in part because of government actions but potentially also reflecting a changing seasonal pattern. Chinese officials have recently announced an unchanged growth target for this year and emphasised the importance of stable growth to achieve job creation. In Japan, it is uncertain how the disruption to growth from the increase in the consumption tax rate will be balanced by the fiscal stimulus and the current stimulatory stance of monetary policy.

For the domestic economy, the key uncertainties surrounding the outlook relate to the balance of two key forces: the decline in mining investment and the pick-up in activity in the non-mining economy (which is being helped in large part by stimulatory monetary policy). The timing and strength of these remain subject to considerable uncertainty. Consequently, it could be that aggregate demand will be weaker or stronger than expected over the next couple of years, with resulting implications for inflation. The path of the exchange rate also presents a significant source of uncertainty for the forecasts of both economic activity and inflation. With resource prices and therefore the terms of trade expected to decline further, historical relationships suggest that the exchange rate could move lower over time. The decline in capital inflows that have helped to fund mining investment, the increase in income payments to domestic and foreign owners accruing from strong growth in resource exports, as well as the conduct of monetary policy in major countries and associated capital flows, could also affect the exchange rate.

The cash rate has been at its current low level for some time now, resulting in very low levels of household and business borrowing rates. This stimulatory setting of monetary policy is having the expected effect. The housing market has been strong and a significant pick-up in dwelling investment is in prospect. Household consumption has also strengthened as have some measures of business conditions. While there have been signs of improvement in the labour market over recent months, a fair degree of spare capacity remains. Over the next couple of years, growth in activity is expected to pick up gradually but it is likely to be some time before unemployment declines consistently. This should see domestic costs remaining contained, which will be necessary to help offset the ongoing effect on prices of the depreciation of the exchange rate over the past year. The balance of these forces on consumer prices is expected to see inflation remain consistent with the inflation target through the forecast period.

Since last August, when the cash rate reached its current low level of 2.5 per cent, evidence of the effects of the substantial degree of stimulus already imparted has continued to accumulate. At the same time, the economy continues to face some significant headwinds, with the large decline in resources sector capital spending getting underway and fiscal consolidation in prospect. Also, while the exchange rate is noticeably lower than a year ago, it remains high and commodity prices have declined further over recent months. The outlook is uncertain but as currently assessed suggests that a degree of spare capacity will be present for much of the forecast period. Given that assessment, the Board's view is that the current accommodative monetary policy setting is likely to be appropriate for some time yet.