Overview

The Bank has been expecting for some time that inflation will increase gradually over the period ahead, to be above 2 per cent. Recent data have been consistent with this expectation. Headline inflation in the March quarter was a little above 2 per cent and is now expected to be between 2 and 3 per cent throughout the forecast period. Underlying inflation increased in the March quarter, to around 1¾ per cent. It is expected to increase further, to be around 2 per cent in early 2018. These forecasts are little changed from the previous *Statement on Monetary Policy*.

A number of other factors have afforded increased confidence in the central forecast that inflation will increase gradually. The December quarter national accounts confirmed that the period of weakness in the middle of 2016 was only temporary. The stronger near-term global outlook now seems fairly well in train and the terms of trade have held up for a bit longer than earlier expected, which will provide a boost to national incomes.

The expected increase in underlying inflation over the next year or two is still quite gradual, because a number of forces are continuing to hold inflation down. In particular, wage growth is low. Although it seems unlikely that wage growth will slow much further, wage pressures are expected to pick up only gradually, as the effects of structural adjustment after the mining investment boom – which have weighed on wage growth – continue to wane. The forecast for the unemployment rate implies ongoing spare capacity in the labour market; this is likely to constrain wage outcomes in the period ahead. In addition, wage outcomes have been weaker than would be suggested by a straightforward assessment of spare capacity based on the unemployment rate. The underemployment rate has been higher than its past relationship with the unemployment rate would imply, and might be exerting further downward pressure on wage growth.

Other forces on inflation are working in opposing directions. Heightened competitive pressures in the retail sector appear to have been keeping retail inflation low. Growth in rents is around its lowest rate in over 20 years. The appreciation of the exchange rate over the past year is also likely to have added some downward pressure on prices recently, though this follows a larger depreciation over the previous couple of years. Against this, the cost of new dwelling construction, which is a large component of the consumer price index, picked up noticeably in the March quarter, as did tobacco and utilities prices. Tobacco and utilities price inflation are expected to remain high in the period ahead.

The forecasts for the Australian economy have not substantively changed since the previous *Statement*, but the recent run of both domestic and international data has provided some assurance about the domestic outlook. The Australian economy grew by 2½ per cent over 2016; growth is expected to pick up to 2¾–3¾ per cent by early 2018. The period of adjustment that has followed the end of the mining investment boom now appears to be well advanced. The drag from the fall in mining investment, and the negative spillover effects on non-mining

investment and other aspects of non-mining activity, continues to ease. Consistent with this, further signs are emerging that the slowdowns in the Queensland and Western Australian economies are coming to an end.

The expansion in liquefied natural gas (LNG) exports is expected to contribute about ½ percentage point to growth in each of 2017 and 2018. As has been noted previously, LNG production requires little employment, which means that spare capacity in the labour market will be absorbed more slowly than the forecast for GDP growth would typically imply.

Consumption growth picked up a little late last year. Given low wage growth, household income growth is likely to remain quite weak, though not as weak as the December quarter national accounts data would suggest. This makes it hard to be certain about the future pace of consumption growth, particularly in the context of ongoing high levels of household debt. Recent indicators suggest that consumption growth might have eased again in the March quarter, but the expectation is that consumption growth will broadly track income growth in the period ahead.

It is difficult to know if and when a stronger and durable recovery in non-mining business investment might take hold. Non-mining business investment has shown some signs of recovery in New South Wales and Victoria but has been relatively weak in Queensland and Western Australia. Some forward-looking indicators suggest non-mining business investment is unlikely to pick up substantially in the near term, though these indicators do not capture all industries. The level of residential investment is likely to remain high, because of low interest rates and the large pipeline of construction projects to be worked off. However, it will contribute less to growth in the period ahead than it did in the recent past.

Conditions in the established housing market have been mixed. Housing price inflation and other indicators have remained strong in Sydney and Melbourne, but weak in Perth. Increases in apartment supply in Brisbane, and to a lesser extent in Melbourne, have led to noticeable differences in the growth rates of apartment prices and prices of detached houses in those cities. Greater supply has also weighed on rental growth in these cities; falling rents in Perth instead reflect weaker economic conditions and slower population growth.

The Board has continued to monitor risks posed to household balance sheets, given the context of high and rising household debt. In the past couple of months, both the Australian Prudential Regulation Authority and the Australian Securities and Investments Commission have announced further measures to reinforce sound lending practices that are appropriate to borrowers' circumstances. These measures can be expected to mitigate risks that have been building in household balance sheets. Along with the recent increases in interest rates for some types of housing loans, including those announced in March and April, these measures are likely to lead to some slowing in housing credit growth. Increases in interest rates late last year that were focused on investor lending are likely to have dampened demand for credit, after growth in investor credit picked up in the second half of 2016. Housing credit growth overall has been relatively steady over the past few months.

The Board has also been monitoring the labour market closely. Although the unemployment rate increased in the past couple of months, a gradual decline from here remains the most likely outcome. Employment growth strengthened a little in recent months; this is consistent with the signal from forward-looking indicators, which have been pointing to moderate employment growth for a while.

There have been some minor changes in the near-term outlook for GDP growth to account for the effects of Cyclone Debbie. Coking coal exports are expected to be lower, while coking coal prices will be temporarily higher. Beyond the next couple of quarters, prices of bulk commodities are expected to decline, unwinding much of the recent increase in the terms of trade; prices are nonetheless expected to remain above the lows of early 2016. Consistent with previous forecasts, iron ore prices have already fallen significantly in the past few weeks. At this stage, higher commodity prices are not expected to add materially to domestic demand, given their temporary nature and because some of the income accrues to foreign shareholders. But if commodity prices do not fall as far as currently anticipated, the impact on growth and employment could be greater than currently assumed in the forecasts.

Strong Chinese demand for steel has helped support iron ore and coal prices, although the sustainability of this demand is uncertain. Conditions in China improved during 2016, largely because of domestic factors; economic growth in China appears to have retained its momentum in early 2017. Property construction and government spending on infrastructure have been significant drivers of growth; how conditions in the property market evolve will help determine how much of this momentum will be sustained. The Chinese authorities continue to use a range of policies to achieve their economic targets. While financial conditions remain accommodative, they have tightened slightly, consistent with actions by the authorities to address high and rising leverage. It remains to be seen how the authorities will balance their objectives for economic growth and financial stability.

More broadly, the outlook for major trading partner growth was revised up late last year, and recent data have generally confirmed the stronger outlook. The improvement appears to have begun in the second half of 2016; it was first evident in commodity prices and various measures of business and consumer confidence but subsequently became apparent in a broad-based pick-up in global merchandise trade late last year, as well as industrial production. More recently, there have been signs of stronger business investment in a selection of countries. The pick-up in global trade has been particularly important for the more trade-dependent economies in the Asian region. Outside Australia's major trading partners, the growth outlook for some larger emerging economies has recovered somewhat after a period of declining output.

The major advanced economies are all expanding at rates that are fast enough to continue absorbing spare capacity. Unemployment rates have declined and in the United States, Japan and Germany they have reached low levels. Although weak growth in consumption detracted from growth in the United States in the March quarter, business investment appears to be picking up. The US administration is yet to announce detailed tax reform proposals, but any fiscal stimulus will add to demand; given that the economy is already close to full employment, this would add to inflationary pressures. Growth is also expected to continue to exceed potential growth rates in the euro area and Japan in 2017. Core inflation in the major advanced economies generally remains low, however, and headline inflation rates are starting to decline, as the earlier effects of higher oil prices diminish. Nonetheless, underlying inflationary pressures should pick up gradually over coming quarters as spare capacity continues to decline.

International financial markets have been relatively quiet in recent months. The main source of volatility has been market reactions to various political risks and events, and even these

reactions have been relatively small. Volatility and bond spreads in some euro area markets have fallen back since the first round of the French presidential election. Funding conditions globally remain very accommodative. Consistent with the generally stronger tone in economic indicators and the inflation outlook in some economies, market participants are pricing in further tightening in monetary policy in the United States and are also no longer expecting further monetary easing in other major advanced economies. Developments in domestic financial markets have broadly mirrored those in markets overseas. Domestic funding conditions remain accommodative.

Overall, developments over the past three months have tended to be consistent with the forecasts published in the previous *Statement*, in which inflation and output growth were both expected to increase gradually. Taking account of the available information and having eased monetary policy in 2016, the Board has judged that holding the stance of policy unchanged at recent meetings would be consistent with sustainable growth in the economy and achieving the medium-term inflation target.