Overview

Economic conditions in Australia's major trading partners generally appear to have eased a little of late. Growth in China moderated further in the March quarter. Subdued investment growth in the manufacturing sector was partly offset by rising public infrastructure investment and a return to growth in real estate investment. The latter was consistent with a strengthening in the property market in recent months in response to a range of earlier measures to stimulate demand. The moderation of Chinese growth has affected Asian economies and emerging economies in other regions that have strong trade links with China. Economic activity remained weak in Japan, while growth eased in the United States but continued at an above-trend rate in the euro area. Meanwhile, there have been further improvements in labour market conditions across all three economies. Despite that, inflation in the major advanced economies remains below central banks' targets and inflation expectations have declined. This has been an important concern for central banks and contributed to the European Central Bank's decision to ease monetary policy further in March. Monetary policy settings remain very accommodative in Japan and the United States (where markets expect no further increase in the policy rate before late 2016).

Changes in expectations about the course of the monetary policies of the major central banks have been reflected in exchange rates and financial market prices more generally. Sentiment in global financial markets has improved since late February. The outlook for growth in Australia's major trading partners in 2016 has been revised a little lower since the February *Statement on Monetary Policy* to incorporate generally weaker-than-expected growth in the March quarter and a reassessment of growth momentum, particularly in Asia. Despite the moderation in Chinese growth in the March quarter, the outlook there is much as it was earlier forecast, based on the expectation of further support being provided by more stimulatory policy settings. The Chinese authorities appear, at present, to be giving greater priority to short-term growth objectives than to the longer-term goals of deleveraging and achieving growth that is less reliant on investment and heavy industry. The outlook for the Chinese economy continues to be a key source of uncertainty for the forecasts. One risk is that the pursuit of the authorities' near-term growth targets is likely to increase already elevated levels of debt and could potentially delay addressing the problem of excess capacity in the manufacturing and resources sectors.

While commodity prices are significantly lower than the peaks of a few years ago, the expectation of more policy stimulus in China has been accompanied by a sizeable increase in commodity prices over recent months. Iron ore and coking coal prices are around 60 per cent and 30 per cent above their low points in late 2015, respectively. This amounts to a rise in Australia's terms of trade in the near term. However, it is assumed that the prices of bulk commodities are not sustained at current levels. Chinese steel demand is still expected to decline over the next couple of years and a substantial amount of new, low-cost iron ore supply is likely to enter the market over that period. Meanwhile, liquefied natural gas (LNG) prices are expected to be higher than previously forecast, which will tend to increase the terms of trade. The net result of these various movements is that the terms of trade are expected to be around recent levels by the end of the forecast period.

Growth in the Australian economy over 2015 was a bit stronger than earlier anticipated, and a little above estimates of potential growth. Growth was moderate in the December quarter, however, and appears to have continued at about this pace into 2016, much as was forecast at the time of the February *Statement*. Consistent with this, employment growth has slowed from the strong pace of last year and leading indicators of employment have been somewhat mixed of late. Nevertheless, labour market conditions remain much better than a year ago. The unemployment rate has been around 5¾ per cent in recent months, having been as high as 6¼ per cent last year.

There has been no material change to the forecast for GDP growth or the unemployment rate. GDP growth is expected to strengthen gradually to an above-trend rate, reflecting the effects of low interest rates and the depreciation of the exchange rate since early 2013. Both have been helping activity to rebalance towards the non-resource sectors of the economy. As before, the unemployment rate is forecast to remain around current levels for the next year or so and then gradually decline as growth in economic activity strengthens. The outlook for the unemployment rate is consistent with spare capacity remaining in the labour market throughout the forecast period.

Growth in household consumption picked up in the second half of last year and is expected to be sustained at around that rate in the period ahead. The pace of growth in retail sales volumes was maintained in early 2016. And while surveys suggest that households' perceptions of their own finances have eased, they were around long-run average levels in April. Growth in consumption is forecast to be maintained at a pace that is a bit above average, despite only modest growth in wages. This implies a further gradual decline in the household saving ratio over the forecast period.

The amount of residential construction work still in the pipeline is substantial and has continued to increase. This points to further strong growth in dwelling investment, albeit at a gradually declining rate consistent with the decline in building approvals since last year. In established housing markets, conditions have stabilised over the past six months or so. Housing prices have grown moderately over 2016 to date, following a small decline at the end of 2015. Housing credit growth has eased a little over recent months to be around 7 per cent in six-month-ended annualised terms in early 2016. This follows increases in mortgage rates and the strengthening of banks' non-price lending terms in response to supervisory actions.

Surveyed conditions in the business sector remain above average and business credit growth has picked up over the past year or so. Nevertheless, indicators of investment intentions suggest that non-mining business investment is likely to remain subdued for a time, although it is expected to gradually pick up later in the forecast period as overall demand strengthens. Mining investment is expected to continue to fall as projects are progressively completed, although the magnitude of the falls should diminish over the next couple of years, consistent with the forecasts presented in the February *Statement*. Project completions will support further growth in resource exports. Net service exports are expected to continue to make a noticeable contribution to growth.

Inflation was lower than expected in the March quarter. The various measures suggest that underlying inflation declined to a little less than ¼ per cent in the quarter (compared with about ½ per cent in the December quarter), to be about 1½ per cent over the year. Headline inflation was lower still, partly reflecting some temporary factors. Nonetheless, the CPI data indicate that there has been broad-based weakness in domestic cost pressures. This is evident in the further decline in non-tradables inflation in the March quarter. In part, this reflects lower-than-expected growth in labour costs, with unit labour costs being little changed for four or more years now. In addition, there has been heightened retail competition, a moderation in conditions in housing rental and construction markets, and declines in the cost of some business inputs, such as fuel and utilities. A number of these factors are also likely to have mitigated some of the upward pressure on the prices of tradable items arising from increasing import prices following the depreciation of the exchange rate since early 2013.

The forecast for underlying inflation has been revised lower, reflecting the lower-than-expected outcome for inflation in the March quarter and an expectation that domestic cost pressures, including labour costs, will pick up more gradually than anticipated at the time of the February *Statement*. The outlook for domestic cost pressures is a key source of uncertainty. Despite above-trend growth in economic activity and improvements in labour market conditions over the past year, it is possible that domestic cost pressures may weaken further, and so inflation may not pick up as expected. However, it may be that the strengthening in the labour market embodied in the forecasts is associated with growth of labour costs picking up sooner or by more than is currently forecast.

The substantial exchange rate depreciation over recent years is expected to continue to place some upward pressure on inflation for a time. While the exchange rate is assumed to remain around current levels over the forecast period, it may respond to a number of influences, including any unanticipated changes to the outlook for growth in China, commodity prices or the monetary policy decisions of the major central banks. It therefore represents a significant source of uncertainty for the forecasts of inflation, as well as for the outlook for growth in activity.

For some time, the Reserve Bank Board had noted that the inflation outlook provided scope for a further easing in monetary policy. After taking account of developments over recent months, the Board's assessment at its May meeting was that the outlook for economic activity and the unemployment rate was little changed, but that the inflation outlook was lower than earlier anticipated. At the same time, the Board took careful account of developments in the housing market, noting the effects of supervisory measures to strengthen lending standards, the recent easing in housing credit growth and the abatement of strong price pressures. Taking all of these considerations into account, the Board judged that the prospects for sustainable growth in the economy, with inflation returning to target over time, would be improved by further easing of monetary policy. Accordingly, the cash rate was reduced by 25 basis points. The Board will continue to assess the outlook and adjust policy as needed to foster sustainable growth in demand and inflation outcomes consistent with the inflation target over time.