

## 5. Economic Outlook

Domestic economic growth in the first half of the year was a little lower than expected at the time of the *May Statement*. As a result, the forecast for GDP growth over 2019 has been revised down. Further out, expectations for growth are marginally higher. Following the recent data, the unemployment rate is now expected to be a little higher than previously forecast over the next couple of years, and forecasts for inflation have been revised lower. In summary, year-ended GDP growth is expected to be 2½ per cent over 2019, 2¾ per cent over 2020 and around 3 per cent over 2021. The unemployment rate is expected to remain around 5¼ per cent for some time, before gradually declining to around 5 per cent as GDP growth picks up. Underlying inflation is forecast to pick up to a little above 2 per cent over 2021.

Growth in Australia's major trading partners has eased since mid 2018 but it remains reasonable. The forecast for growth in this group of economies has been revised a little lower since the *May Statement* because of the escalation in the US–China trade and technology dispute and the related weakness in investment indicators in a number of economies. Major trading partners' growth is expected to be around 3¾ per cent over the forecast period, which is noticeably lower than 2017 and 2018.

There are a number of global and domestic uncertainties around the forecasts. The potential for a further escalation in trade and technology tensions has increased the downside risk to the global growth outlook. The Chinese authorities continue to face a number of policy trade-offs

and uncertainties remain about how they will be resolved. Accommodative global financial conditions may support growth more than expected, although potential also exists for a tightening in financial conditions that would lower growth.

Domestically, the near-term risks to growth are more to the downside. Some leading indicators suggest that employment growth could moderate by more than forecast, which could lead to lower than expected growth in household incomes and consumption. Conditions in the earlier stages of residential development remain weak, which raises the risk that dwelling investment will decline by more than currently forecast.

In the medium term, however, there are a number of upside risks that contribute to a more balanced outlook. In particular, the housing market appears to have stabilised sooner than previously expected which, combined with the impact of lower interest rates and tax cuts, raises the possibility that consumption and dwelling investment could contribute more to growth towards the end of the forecast period than previously expected. There are also a number of upside risks to the forecasts for mining activity towards the end of the forecast period.

### Domestic growth is expected to strengthen

Australian GDP growth in the March quarter was a little lower than expected (Table 5.1). Private-sector demand has been weak since the middle

**Table 5.1: Output Growth and Inflation Forecasts<sup>(a)</sup>**

Per cent

	Year-ended					
	June 2019	Dec 2019	June 2020	Dec 2020	June 2021	Dec 2021
GDP growth	1¾	2½	2¾	2¾	3	3
(previous)	(1¾)	(2¾)	(2¾)	(2¾)	(2¾)	(n/a)
Unemployment rate <sup>(b)</sup>	5.2	5¼	5¼	5¼	5	5
(previous)	(5)	(5)	(5)	(5)	(4¾)	(n/a)
CPI inflation	1.6	1¾	1¾	1¾	2	2
(previous)	(1¾)	(2)	(2)	(2)	(2)	(n/a)
Trimmed mean inflation	1.6	1½	1¾	1¾	2	2
(previous)	(1½)	(1¾)	2	2	2	(n/a)
Year-average						
	2018/19	2019	2019/20	2020	2020/21	2021
GDP growth	2¼	2	2½	2¾	3	3
(previous)	(2¼)	(2)	(2½)	(2¾)	(2¾)	(n/a)

(a) Technical assumptions set on 7 August include the cash rate moving in line with market pricing, TWI at 59, A\$ at US\$0.68 and Brent crude oil price at US\$58 per barrel; shaded regions are historical data; figures in parentheses show the corresponding forecasts in the May 2019 Statement

(b) Average rate in the quarter

Sources: ABS; RBA

of 2018, mainly because consumption growth has been weighed down by an extended period of low growth in household income and weak conditions in the housing market. Dwelling investment has also declined. Some of the other contributors to the slow growth in the domestic economy in recent quarters, particularly slower mining activity, were transitory. Partial indicators point to reasonable GDP growth in the June quarter.

Year-ended growth is expected to be 2½ per cent over 2019, 2¾ per cent over 2020 and around 3 per cent over 2021, supported by accommodative monetary policy and some recovery in household income growth, boosted by tax cuts. The outlook for consumption growth continues to be one of the important sources of uncertainty for the domestic growth forecasts, although the risks in the medium term are more balanced than they have been for some time. Growth in consump-

tion is expected to increase gradually alongside an increase in household disposable income growth. The signs of stabilisation in the housing market reduce one possible source of downside risk to consumption growth and could provide some upside risk towards the end of the forecast horizon. Dwelling investment is expected to subtract from GDP growth for several quarters, though the drag on growth is expected to diminish by late 2020. Public demand and non-mining business investment are expected to continue supporting growth over the forecast period, complemented by ongoing export growth. Mining investment is expected to turn around from being a drag on growth to making a material contribution over the latter part of the forecast period.

The domestic forecasts are conditioned on the technical assumption that the cash rate moves in line with market pricing. Current market pricing implies one 25 basis point cut in the cash

rate by the end of this year, to 0.75 per cent, and a further 25 basis point cut in the first half of 2020. This compares with market pricing for an ongoing cash rate at around 1 per cent at the time of the *May Statement*. The exchange rate is assumed to be constant at around 2 per cent below where it was at the time of the *May Statement*. The oil price is assumed to remain at the current level, which is about 15 per cent lower than at the time of the *May Statement*. The population aged 15 years and over is assumed to grow by 1.8 per cent per annum over 2019 and 2020 (up from 1.7 per cent at the *May Statement*) and by 1.7 per cent in 2021, which is unchanged compared with the assumption in May.

### Consumption growth has been revised lower in the near term

Growth in consumption was a little lower than expected in the March quarter and recent partial indicators suggest this softness continued into the June quarter. As a result, year-ended growth in consumption is expected to slow to 1¼ per cent over the year to June 2019. Growth in consumption is expected to pick up in the second half of 2019 because of the boost to income from lower tax payments, including the low- and middle-income tax offset, and lower

net interest payments for the household sector, which is a net borrower in aggregate.

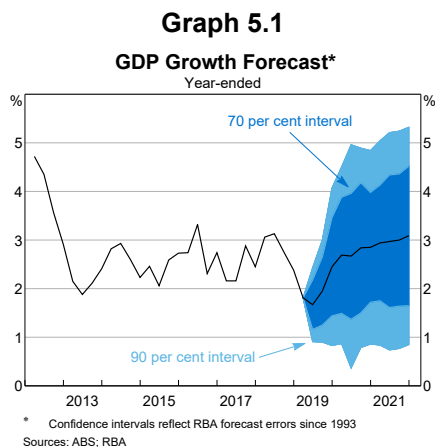
Over coming years, growth in nominal household disposable income is expected to pick up to around 4 per cent annually, supported by growth in employment. However, the expected contribution from labour income has been revised a little lower over 2020 reflecting the downward revision to wages growth. Beyond 2019, growth in consumption is forecast to increase gradually, consistent with the underlying improvement in household disposable income growth and a recovery in housing market conditions. Consumption is forecast to grow by 2¾ per cent over 2021, which is unchanged relative to the *May Statement*. The household saving ratio has increased modestly over recent quarters and is expected to increase a little further over coming quarters.

### Dwelling investment will decline further over coming quarters

Dwelling investment has declined broadly in line with expectations at the *May Statement* to be around 5 per cent below the September quarter 2018 peak. Dwelling investment is expected to continue to decline for several quarters. The near-term outlook for dwelling investment has been revised lower partly because of slightly weaker-than-expected building approvals data over recent months. However, the projected trough in dwelling investment is now expected in late 2020. This is about half a year earlier than previously anticipated because of the earlier-than-expected signs of a turnaround in established housing market conditions and the lower profile assumed for the cash rate.

### Public demand is expected to continue supporting growth ...

The forecast for growth in public demand is unchanged relative to the *May Statement*.



Growth in public consumption is expected to moderate but remain above 3 per cent over much of the forecast period, partly supported by ongoing spending on the National Disability Insurance Scheme (NDIS). Spending on the NDIS is projected to increase as much this financial year as it did last year. The pipeline of infrastructure work to be done is elevated relative to work done, pointing to growth in public investment in the near term. However, growth in public investment is also expected to moderate over coming years because additional investment projects are considered likely to sustain the relatively high level of activity rather than contribute much more to growth.

### ... along with growth in business investment

The outlook for business investment is little changed from the previous *Statement*. Both non-mining and mining investment are expected to contribute to growth throughout the forecast period. In non-mining sectors, the outlook for non-residential construction remains positive; building approvals remain fairly steady, and there is a solid pipeline of private infrastructure projects (particularly transport and electricity). Investment in machinery & equipment and software is also expected to grow throughout the forecast period.

Mining investment declined further in the March quarter as construction on the final liquefied natural gas (LNG) projects continued to wind down. The decline in the quarter, taken together with the ABS Capital Expenditure survey and business liaison information, suggests that mining investment is close to its trough. Mining investment should gradually pick up over the next year or two as sustaining investment continues, along with some expansionary projects. However, there is a fair degree of uncertainty regarding the timing of expenditure for mining investment and some risk that there will be more expenditure on these projects than

is currently incorporated into the outlook. There are also several projects under consideration but not yet approved. The recent strength in iron ore prices is not expected to drive much change in the outlook for iron ore investment, given industry expectations that the recent price increase is largely a response to supply constraints that will be resolved over time.

### Exports continue to contribute to growth

Recent trade data indicate that exports continued to expand in the June quarter; growth in resource exports is expected to have picked up, partly because iron ore exports are recovering from earlier disruptions. The outlook for exports remains broadly unchanged since the previous *Statement*. Resource exports are expected to grow over the remainder of 2019 and into 2020, supported by some growth in iron ore and coking coal production, as well as the continued ramp-up of LNG exports from the final projects. Growth should then slow as this ramp-up finishes. From mid 2021, some decline in LNG exports is expected as existing gas fields are depleted; although some replacement projects are under consideration, lags in construction mean that they are unlikely to commence production during the current forecast period.

Service exports are expected to continue growing steadily, underpinned by overseas student enrolments. Data for the June quarter suggest manufactured exports were stronger than previously expected and the lower exchange rate is expected to continue supporting growth in this category. In addition, the underlying rate of growth in exports of some categories of manufactured goods, including medicinal & pharmaceutical goods and professional & scientific instruments, has increased in recent years as markets for them open up. Rural exports are expected to be modestly higher in the near term, largely

reflecting elevated slaughter rates, but to ease by more than previously forecast further out because dry conditions are expected to persist at least until the end of the year. Rural exports are now expected to trough around the September quarter of 2020 before picking up, assuming a gradual return to average weather conditions supports increased crop production over time.

Imports are expected to grow a little more slowly than at the time of the previous *Statement*, reflecting slower domestic demand growth and the recent exchange rate depreciation, which has increased the relative price of imports.

### Elevated iron ore prices have lifted the terms of trade

The terms of trade have been revised higher, largely driven by higher-than-expected iron ore prices in recent months (Graph 5.2). Iron ore prices rose considerably in the months following the previous *Statement*, reaching their highest level since early 2014. Supportive factors included limited supply in the seaborne market (mainly because of disruptions in Brazil) and more resilient Chinese demand than previously expected. The escalation in trade tensions has led to sharp falls in iron ore prices since the start of August. Iron ore prices are expected to decline further as supply gradually comes back on line and Chinese demand moderates. However, there is considerable uncertainty around the outlook.

Coking coal prices have also been revised a little higher in light of the lift in expected Chinese steel production, but are still expected to decline over the forecast horizon. Thermal coal prices have declined further since the previous *Statement* because seaborne supply has continued to increase while there has been some softening in Asian demand. Further out, rising seaborne supply and a gradual transition

away from coal-fired power generation are expected to weigh on thermal coal prices.

### The unemployment rate is expected to remain higher for longer

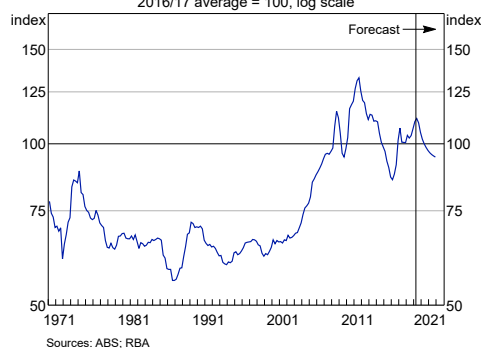
The unemployment rate increased by  $\frac{1}{4}$  percentage point in the June quarter (Graph 5.3). Leading indicators suggest that the unemployment rate is likely to remain around  $5\frac{1}{4}$  per cent for some time. As GDP growth picks up to an above-trend pace, the unemployment rate is expected to edge lower to around 5 per cent. The upward revision to the unemployment rate outlook suggests that there will be more spare capacity in the labour market over the next few years than previously forecast, although there is considerable uncertainty around its extent.

Employment growth has been stronger than expected over the past year, despite the slowing in economic activity. Leading indicators such as job vacancies and firms' hiring intentions point to a slowing in employment growth over the remainder of the year, although growth is expected to remain a little above working-age population growth over the next couple of years. Consistent with solid employment growth, the participation rate is expected to remain around its current record level. However, there is considerable uncertainty around how

**Graph 5.2**

**Terms of Trade**

2016/17 average = 100, log scale



much any increase in labour demand will be met by unemployed workers finding jobs, existing employees working more hours or a further increase in the participation rate.

### Wages growth has been revised a little lower

Wages growth is expected to remain stable over the next year. At the time of the *May Statement*, wages growth was expected to continue to lift modestly over the year ahead. However, there is limited upward pressure stemming from current labour market conditions and the majority of surveyed firms in the liaison program now anticipate little change in wages growth over the next year. The 3 per cent increase in award and minimum wages (which is lower than in previous years) and wage increases in a number of significant enterprise bargaining agreements have been incorporated into the near-term forecasts. Private sector wages growth is expected to increase modestly from 2020 as the unemployment rate declines. Public sector wages growth is expected to remain stable over the next couple of years, consistent with government wage policies in most jurisdictions.

Average earnings from the national accounts, which is a broader measure of labour costs, is expected to be growing at a slightly faster pace than the wage price index (WPI) by 2021. This

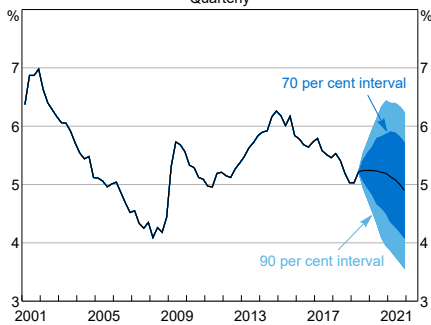
assumes that the compositional changes in the labour market or weakness in non-wage labour costs that have been holding average earnings growth below WPI growth in recent years will have dissipated by then. How far this pick-up in earnings growth translates into inflationary pressures will depend on whether there is an accompanying increase in productivity growth.

### Inflation has been revised lower

The June quarter inflation outcome was largely as expected. However, the forecast for year-ended underlying inflation over the next couple of years has been revised lower by around ¼ percentage point. Underlying inflation is expected to be around 1½ per cent over 2019 and gradually increase to a little above 2 per cent in 2021 (Graph 5.4). Headline inflation is expected to be a little higher than underlying inflation over 2019 as a result of earlier increases in volatile prices.

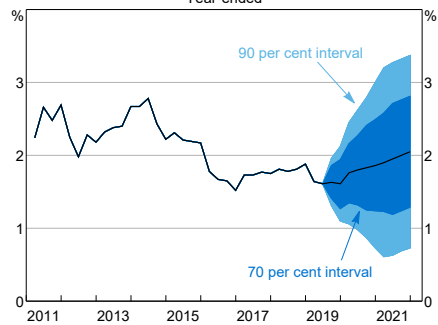
In the near term, there has been a modest downward adjustment to the September quarter forecast for inflation to incorporate some government policy changes that will affect administered and electricity prices, and the recent decline in fuel prices. Further out, the downward adjustment reflects more spare capacity in the labour market than previously

**Graph 5.3**  
Unemployment Rate Forecast\*  
Quarterly



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

**Graph 5.4**  
Trimmed Mean Inflation Forecast\*  
Year-ended



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

forecast and the associated lower wages growth. Nevertheless, a modest increase in underlying inflation is still expected to occur over the next few years alongside the gradual increase in wages growth from 2020 and GDP growth picking up to be above potential.

Inflation is expected to remain low across a range of components of the CPI. Rent growth is expected to remain low in some capital cities for some time; over the longer term, rent growth will depend on the balance between construction activity and population growth. Inflation in the prices of newly built dwellings is expected to remain subdued until dwelling investment begins to pick up again. Retail competition is expected to continue to weigh on prices, but the recent modest exchange rate depreciation will continue to put some upward pressure on the prices of consumer durable goods over the year ahead. The recent increase in grocery food inflation related to the drought is likely to be temporary. A number of commentators also anticipate that wholesale electricity prices will decline over the next couple of years as a large volume of new renewable energy generation comes on line.

### **There are a number of uncertainties around the global growth forecasts**

Over the past three months, the global growth outlook has been revised slightly lower and downside risks have increased because of the re-escalation of US–China trade and technology tensions. In addition to the direct effects of any further escalation of trade tensions on trade, a long period of unresolved trade tensions poses a risk to global growth because the associated uncertainty could depress business investment. Further US–China tariff rate increases or restrictions on technology transfers, trade and investment would have the most significant effects on growth in the United States, China and highly trade-exposed economies in east Asia. 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 Europe. Negative developments on these issues could have significant spillovers to other economies through trade, investment and confidence.

The Chinese authorities continue to face a number of policy trade-offs and uncertainties about how they will be resolved present risks to the outlook for the Chinese economy, demand for bulk commodities and Australia’s terms of trade. To date, policy easing measures have supported Chinese domestic demand and partly offset the effects on overall activity of the trade and technology disputes with the United States. The stimulus to the Chinese domestic economy has benefited Australia and mitigated some of the impact of the trade dispute on the Australian economy. However, the Chinese economy was already facing headwinds as a result of the earlier deleveraging and a range of structural factors. A further escalation of disputes with the United States would be likely to disrupt investment plans and the downward pressure on growth could be larger than current policy settings can counteract. In that event, the government could introduce further policy easing but would be constrained by a desire to avoid a rebound in economy-wide leverage. A further depreciation in the renminbi could also support growth, but recent currency moves have already aggravated trade tensions. The evolution of policies towards property markets, infrastructure spending and the environment will also be significant for China’s growth trajectory and, in particular, the outlook for Chinese steel demand.

Global financial conditions have become more accommodative since the turn of the year, which will offset some of the impact of the trade dispute on the global economy. A material tightening in financial conditions could still weigh on global growth, however, and there are several possible triggers for such a scenario. Risk



premiums are currently very low and could increase if market participants become more concerned about the global growth outlook. Conversely, there are also scenarios where global financial conditions could remain accommodative for an extended period.

### **The near-term risks to domestic growth and inflation are more to the downside**

In the near term, the risks to domestic growth are more to the downside. It is possible that employment growth, which is stronger than can be explained by recent activity indicators, will moderate by more than forecast. If these outcomes occur, wages growth and labour income growth may be lower than expected and this would have implications for consumption growth in coming quarters. Weak residential construction activity in the near term may depress profits from 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. Weak conditions in the earlier stages of residential development also raise the risk that dwelling investment will decline by more than currently forecast in the near term.

For some time, it has been noted that 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. There is now less certainty around the increase in wages growth. Furthermore, there has been little inflationary pressure evident in advanced economies that have experienced a stronger pick-up in wages growth associated with very tight labour market conditions. It may be the case that the lags between any pick-up in wages growth and price inflation are longer than they have been in the past, or it may be that other more structural factors, such as the ongoing disinflationary effects of technological advances and globalisation are more material.

In the near term, administered and housing-related inflation are likely to remain low. A number of state governments announced further cost-of-living initiatives, which will also weigh on inflation. Electricity prices are likely to grow at a below-average pace over the forecast period, and may even fall. Wholesale electricity 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. Advertised rents are falling or stable in most capital cities and some developers have been offering purchase incentives on new dwellings, which lowers measured prices. Any turnaround in these housing-related costs seems some way off. While there is some uncertainty around how long developers will offer discounts on new dwellings, the longer building activity stays low, the more likely it is that population growth will induce demand pressures on rents further out.

Other sources of uncertainty around the inflation forecast have more two-sided risks. These include uncertainty about the extent of any further pass-through from the earlier exchange rate depreciation to retail prices in the near term, and how long the temporary effects of the drought will persist in food prices. Overall, dynamics in retail prices will depend on a number of factors, such as movements in the exchange rate (which is assumed to remain constant over the forecast period), the degree to which consumer spending will pick up and the effect of heightened competition.

### **The medium-term risks to the economic and inflation outlook are more balanced**

The medium-term risks around the household consumption forecasts are more balanced than they have been for some time. This is partly because consumption has already slowed, and partly because some established housing markets appear to have stabilised earlier than



previously assumed. This has reduced the risk of sustained weakness in some types of housing-related consumption, such as household appliances and furnishings.

Recent policy measures, including the cuts in the cash rate and the tax offsets, provide a reasonable amount of stimulus for the household sector. Together with the stabilisation in the housing market, the combined effect could be larger than is embodied in the forecast. However, the high level of household debt remains a key consideration for household consumption, and it is uncertain how much of the stimulus will be used by households to pay down debt more quickly. Household consumption accounts for close to three-fifths of GDP so, if consumption growth was to exceed expectations, it would affect the forecasts for overall GDP growth, employment growth and inflation.

The signs of stabilisation in some established housing markets also present some upside risk to dwelling investment towards the end of the forecast period. If housing prices recover faster than expected, property developers could respond by more than expected. This scenario is more likely if the weakness in construction is initially more prolonged than expected because, in an environment of strong population growth, this will lead to an undersupply of housing and more upward pressure on prices.

Activity in the mining sector may also support the economy by more than expected. Based on current information, the strength in iron ore prices over 2019 is expected to have only a small direct effect on the real economy. Information from liaison and company reports suggest that mining investment and export volumes are unlikely to respond much to these higher prices, since a large part of the iron ore price increase is because of temporary supply factors. This is in contrast to the response to higher prices seen a decade ago, when a large structural increase in

global demand (led by China) drove an intensive period of investment to lift export capacity.

Although the forecasts assume that the higher iron ore prices will not significantly increase mining investment or exports, the strength in prices over 2019 is nonetheless materially boosting mining sector profits. While the bulk of these profits will accrue to foreign shareholders, some will flow to domestic households through direct and indirect share ownership. The combination of additional household income and an increase in household wealth could provide additional support for consumption. Public sector revenue will also receive a boost, mainly through Australian Government income tax receipts and Western Australian Government mining royalties. It remains uncertain how the public sector might respond to the revenue gains.

Separate from the effects of higher iron ore prices, it is also possible that mining investment in general could be stronger than currently expected. There is some uncertainty regarding the timing and magnitude of spending on projects that are under way or that have been approved and are expected to commence within the forecast period. There are also some projects that have not had a final investment decision but which are likely to proceed. Given these uncertainties, a conservative outlook has been incorporated into the central forecast. Should there be more expenditure on approved projects than is currently incorporated, or if more projects are approved and commence, there would be a larger contribution to growth from the mining sector.

Overall, this range of developments suggest that, beyond the next few quarters, the risks around the forecasts are more balanced. Should a number of the upside risks come to pass, it is possible that the combined effect would be greater than the sum of the expected effects from each individual source of stimulus. ✎

