Overview

The Australian economy is evolving broadly as expected. The Bank's forecasts are little changed from those published in the May *Statement on Monetary Policy*. The economy is expected to grow at an annual rate of around 3 per cent over the next couple of years, which is a bit higher than estimates of potential growth. The unemployment rate is accordingly expected to edge lower. Underlying inflation is higher than late last year; it is expected to reach around 2 per cent over the second half of 2017 and increase a little thereafter. The forecast for headline inflation has been revised a little higher, and lies between 2 and 3 per cent over much of the forecast period.

The outlook continues to be supported by accommodative monetary policy and an improvement in the global economy. Recent GDP data for Australia's major trading partners have been broadly consistent with the Bank's earlier expectations. Growth in the major advanced economies has been above potential rates for some time, with recent data showing that GDP growth in the June quarter was generally a bit stronger than in the previous quarter. Stronger global activity has been especially evident in international trade, which, along with accommodative policies, has supported growth in much of the Asian region. More recently, business investment growth has picked up in a number of economies.

In China, recent growth was a touch stronger than earlier expected. Conditions have strengthened in the residential construction and manufacturing industries. This has resulted in higher demand for steel, and contributed to the recent increases in iron ore and coking coal prices and the improved outlook for these prices. The Bank's forecast for Australia's terms of trade has accordingly been revised up slightly since the previous *Statement*, but still implies a decline from the recent peak.

The outlook for the Chinese economy has a significant bearing on the outlook for Australian exports and the terms of trade. Despite the stronger growth recently, Chinese GDP growth is still expected to slow next year, reflecting longer-term structural factors. There continues to be uncertainty about how the authorities will negotiate the difficult trade-off between growth and the build-up of leverage in the Chinese economy. To address risks in the shadow banking sector, the authorities have recently sought to improve coordination among financial regulators and have announced tighter regulatory measures, but such measures are difficult to calibrate.

Globally, inflation pressures remain subdued. Some increase in inflation is expected over the next couple of years, though, as spare capacity in many advanced economies' labour markets is absorbed and wage growth picks up. Despite the low inflation outcomes, markets expect monetary policy in a number of advanced economies to be somewhat less accommodative than was anticipated a couple of months ago. Sovereign bond yields have increased in response to these changes in expectations in the advanced economies, but are still low compared with a longer run of history. More

broadly, global financial conditions remain highly accommodative. Market volatility has been low.

The US dollar has experienced a broad-based depreciation and is now lower in trade-weighted terms than it was at the time of the US election. Consistent with that, a number of currencies are close to their highs of the past few years against the US dollar, including the euro, the Canadian dollar and the Australian dollar. On a trade-weighted basis, the Australian dollar has risen to levels last seen in late 2014.

Domestic economic data have been mostly positive in recent months, and consistent with the central forecasts for inflation and the unemployment rate. GDP growth looks to have recovered in the June quarter, following a March quarter outcome that was weaker than expected, partly because of bad weather and other temporary factors.

The forecast pick-up in inflation reflects a number of factors. As spare capacity in the labour market declines, this is expected to lead to a gradual increase in wage growth from its current low rates. Higher utilities inflation will add to overall inflation over the next year, although it is difficult to know exactly how much higher energy costs will be built into the prices of other goods and services. Headline inflation will also be boosted by further tobacco excise increases over the next couple of years. Working in the opposite direction are the effects of the recent exchange rate appreciation, ongoing competition in the retail industry and low rent inflation.

By the end of the forecast period, the unemployment rate is forecast to be a little under 5½ per cent. This forecast is little changed from three months ago, and implies that some spare capacity in the labour market will remain. Recent stronger conditions in the labour market have afforded greater confidence in this forecast. Since the start of the year, around 165 000 full-time jobs have been created, average hours worked have increased and labour force participation has risen. Employment has increased in every state over this period, including in the mining-exposed states. This suggests that the drag on economic activity from the earlier declines in the terms of trade and falling mining investment is running its course. The unemployment and underemployment rates have both edged lower. Indicators of labour demand point to continued employment growth and little change in the unemployment rate over coming quarters.

Wage growth is expected to remain subdued, but to increase gradually over the forecast period as labour market conditions continue to improve. The increase in minimum and award wages announced by the Fair Work Commission will add a little to wage growth in the September quarter. The experience of some economies that are already close to full employment suggests that declining spare capacity might take some time to flow through to wage and thus price inflation. Inflationary pressures could instead emerge more quickly if workers seek to 'catch up' after a long period of low wage growth.

The recent growth in employment is supporting growth in household income and indications are that growth in household consumption increased in the June quarter. Further out, continued employment growth and somewhat faster average household income growth are expected to support consumption growth, which is forecast to be a little above its post-crisis average in the period ahead.

A number of factors could offset the forces supporting stronger consumption growth. Slow real wage growth is likely to weigh on consumption, especially if households expect the slow growth to continue for some time. Some households may also feel constrained from spending more out of their current incomes

because of elevated levels of household debt. This effect would become more prominent if housing prices and other housing market conditions were to weaken significantly. Household debt is likely to remain elevated for some time: housing credit growth overall has been steady over the past six months, but has continued to outpace income growth. The composition of that debt is changing, however, as lenders respond to regulators' recent measures to contain risks in the mortgage market. Investor credit growth has moderated and loan approvals data suggest this will continue in coming months. Also, new interest-only lending has declined recently in response to the higher interest rates now applying to these loans and other actions by the banks to tighten lending standards.

Dwelling investment is likely to recover from the partly weather-related weakness of the March quarter and stay at a high level over the next year or so, sustained by the large pipeline of residential building work already approved or underway. However, dwelling investment is not expected to make a material contribution to GDP growth. The number of new residential building approvals has stepped down since last year; if they remain at this level, dwelling investment would be expected to start to decline in a year or so. Conditions in the established housing markets of the two largest cities remain fairly strong, although housing price growth appears to have eased a bit in recent months, more so in Sydney than in Melbourne. Housing prices in Perth have declined a little further, while growth in apartment prices in Brisbane has been weak.

Firms continue to report that business conditions are above average; survey measures are at their highest levels since early 2008 and conditions are above average in all non-mining industries. Export volumes look to have increased in the June quarter; coking coal exports returned to pre-cyclone levels in May and June, and liquefied natural gas exports continue to increase. Resource exports are forecast to continue to add to GDP growth over the forecast period, while the drag from declining mining investment is close to an end.

Non-mining business investment is expected to increase gradually later in the forecast period as growth in demand increases, although uncertainty remains about the timing of any pick-up. Many of the conditions that would typically be associated with stronger growth in investment are in place, including low interest rates and high capacity utilisation. Some spillover from the large pipeline of public infrastructure activity to private sector investment could also be envisaged. Similarly, the outlook for private non-residential construction has improved a little recently with the level of approvals trending higher. However, other leading indicators of business investment remain mixed.

The forecasts for economic growth and inflation in Australia are based on the technical assumption that the exchange rate will remain around its current level. Further exchange rate appreciation would tend to generate a slower pick-up in economic activity and inflation than currently forecast.

Since August last year, the Board has held the cash rate steady at 1.5 per cent to provide the appropriate support for the economy in an environment of low inflation. The Board has sought to do this while balancing the risks associated with rising household indebtedness. The recent data are consistent with a gradual increase in inflation and a decline in the unemployment rate. Accordingly, at its recent meetings the Board has judged that holding the stance of policy unchanged would be consistent with sustainable growth in the economy and achieving the medium-term inflation target.