

2. Domestic Economic Conditions

Overall conditions in the domestic economy are positive, supported by low interest rates and continued strength in the global economy. There is now more momentum in domestic demand than has been the case for some time. This had been associated with strong growth in labour demand and labour supply, although both have moderated recently. The unemployment rate has been little changed since mid last year.

The latest GDP data suggest that growth in domestic final demand picked up further over 2017, driven by stronger growth in business investment and resilient growth in household consumption and public spending (Graph 2.1). This was associated with stronger growth in imports. Growth in exports was subdued over the year, partly because of temporary supply disruptions, and dwelling investment declined

from high levels. Real GDP increased by 0.4 per cent in the December quarter to be 2.4 per cent higher over 2017, which is a bit below estimates of potential growth (Table 2.1).

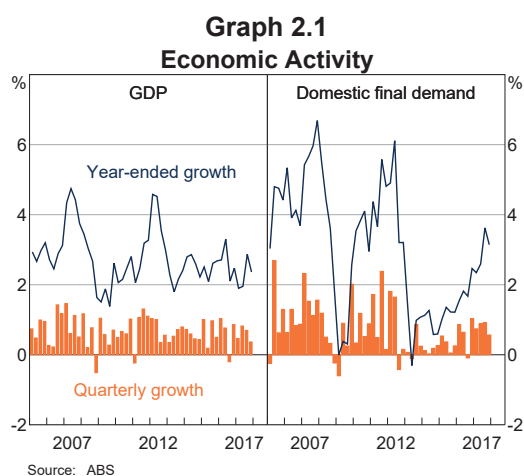


Table 2.1: Demand and Output Growth
Per cent

	December quarter 2017	September quarter 2017	Year to December quarter 2017
GDP	0.4	0.7	2.4
Domestic final demand	0.6	0.9	3.1
– Consumption	1.0	0.5	2.9
– Dwelling investment	–1.3	–1.7	–5.8
– Mining investment	–10.2	–1.8	–12.0
– Non-mining investment	2.1	5.0	12.4
– Public consumption	1.7	0.2	4.9
– Public investment	–0.9	5.3	4.9
Change in inventories ^(a)	0.0	0.1	–0.1
Exports	–1.8	1.2	0.8
Imports	0.5	2.2	6.6
Nominal GDP	0.8	0.7	3.5
Terms of trade	0.1	–0.2	–1.0

(a) Contribution to GDP growth
Sources: ABS; RBA

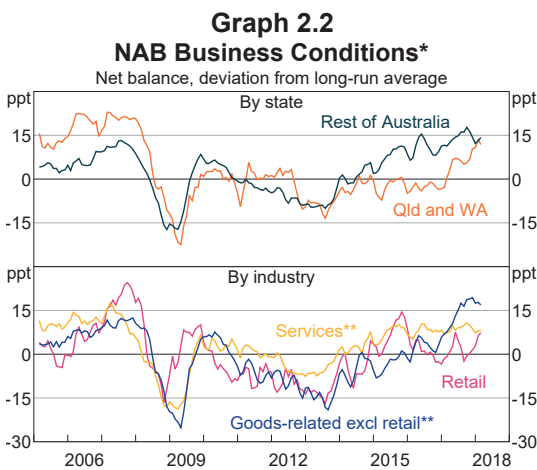
More recently, growth in economic activity appears to have strengthened further in the first quarter of 2018, and year-ended GDP growth is expected to be at or above estimates of potential over the next couple of years. This should continue to support employment growth. As spare capacity in the economy is reduced further, there should be some upward pressure on wages growth and inflation.

Business conditions remain favourable and private investment growth has picked up

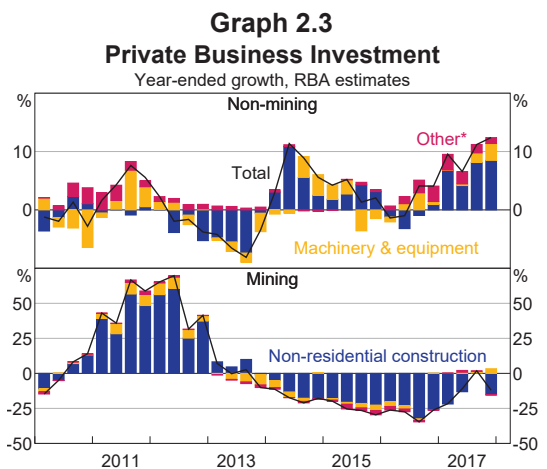
Survey measures of overall business conditions are around their highest levels since before the global financial crisis (Graph 2.2). Conditions are above their long-run average in all states, and have improved noticeably in Queensland and Western Australia since late 2016. By sector, conditions have strengthened for firms in goods-related industries and remain above average in the services sector. Growth in profits has picked up in most non-mining industries since late 2016, following subdued growth for much of the period after the financial crisis; growth in profits (excluding mining and

financial firms) was around 10 per cent in 2017. Survey measures of business conditions in the retail industry have improved of late to be above average; this follows a period in which conditions for retail firms tended to be weaker than in most other industries, partly reflecting robust retail competition and slower growth in retail spending.

Private business investment increased over 2017, as continued strength in non-mining investment more than offset a decline in mining investment (Graph 2.3). Non-mining investment rose by 12½ per cent over the year, and growth was broad based across asset types. The main driver of growth was non-residential construction activity, particularly office building work. This reflects strong demand for office space in both Sydney and Melbourne, against a backdrop of relatively little new supply being added in recent years. Construction of hotels also contributed to growth in non-residential construction. In the mining sector, investment declined by 12 per cent over 2017 as work on some large liquefied natural gas (LNG) projects approached completion.



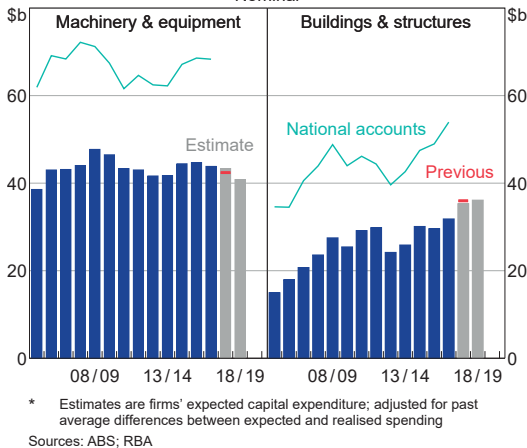
* Three-month moving average
** Goods-related includes manufacturing, construction, wholesale and transport; services includes business and personal services
Sources: NAB; RBA



* Includes cultivated biological resources (mainly livestock, vineyards and orchards), computer software, research development, mineral exploration and artistic originals
Sources: ABS; RBA

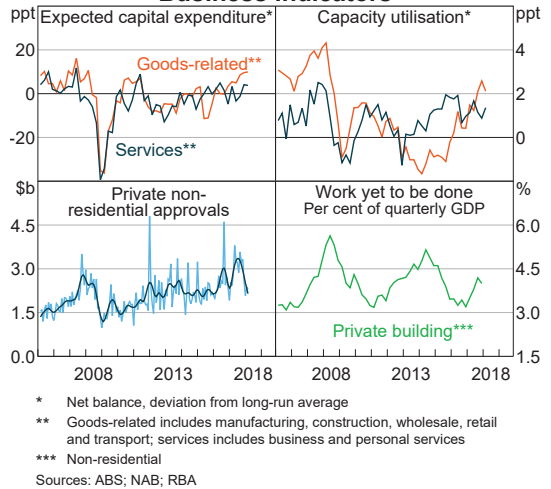
Business investment is expected to continue growing over the next few years, as non-mining investment continues to expand and the drag from mining investment diminishes. Investment intentions for 2017/18 and 2018/19 reported by non-mining firms in the Australian Bureau of Statistics' (ABS) capital expenditure (Capex) survey point to solid growth in buildings & structures investment, while expectations for growth in machinery & equipment expenditure are more moderate (Graph 2.4).¹ The positive outlook for investment in buildings & structures is consistent with the increase in building approvals during 2017 and the pick-up in the stock of work yet to be done over the past year (both of which have been led by office buildings; Graph 2.5). Information from the Bank's liaison program suggests that tenant demand for new office space is expected to remain strong, while hotel construction is also expected to pick up in coming years, reflecting improved conditions for the tourism sector. Survey measures of expected capital expenditure and capacity utilisation also point to continued growth in non-mining business investment.

Graph 2.4
Non-mining Capital Expenditure*
Nominal



1 The Capex survey does not cover certain industries, including agriculture, health and education, and it doesn't cover certain types of investment, such as in software and research & development.

Graph 2.5
Business Indicators

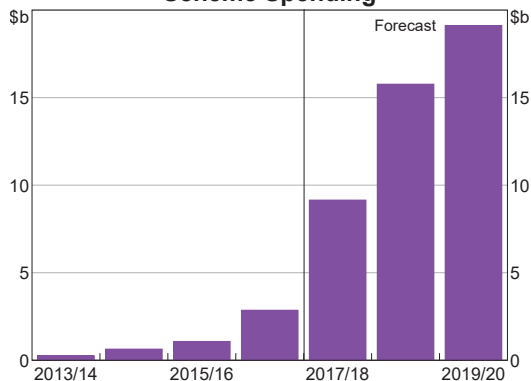


Mining investment is expected to decline a bit further, as the final phase of construction for large LNG projects concludes. The expected size of this decline – and therefore the overall drag on GDP growth – is little changed from a few months ago, but it now looks like it will take longer: both the Capex survey and information from the Bank's liaison program suggest that the trough in mining investment may now be later than mid 2018.

Public spending is also supporting economic activity

Public demand continued to support GDP growth in the December quarter and increased by around 5 per cent over 2017. Public consumption, which accounts for around 80 per cent of public demand, grew strongly in the quarter, supported in part by spending associated with the National Disability Insurance Scheme (NDIS) (Graph 2.6). The NDIS provides support to individuals (currently aged under 65 years) with significant and permanent disabilities, and spending on this initiative is expected to increase over the next couple of years as the program expands. While some

Graph 2.6
National Disability Insurance Scheme Spending



Source: National Disability Insurance Agency

NDIS spending replaces support from previous programs, a significant proportion of NDIS spending is new.

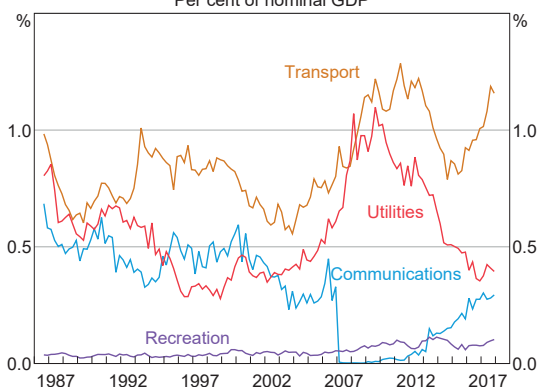
Public investment grew by 5 per cent over 2017, despite declining a little in the December quarter, and is expected to continue to support growth for some time. The strength in public investment has been driven by an increase in infrastructure construction, particularly in communications and transport (Graph 2.7). Liaison with private sector firms indicates that demand for business services from the public sector remains positive, driven

by major infrastructure projects in New South Wales and Victoria, as well as defence contracts in South Australia.

Household spending has picked up, but remains a source of uncertainty for the growth outlook

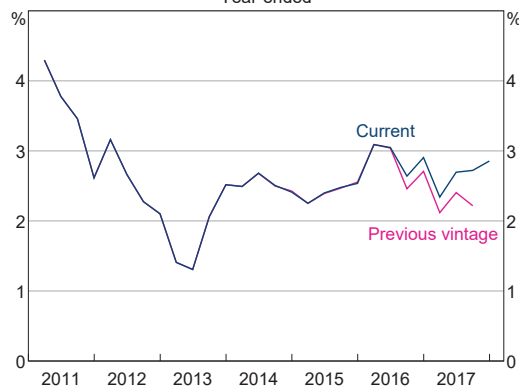
Household consumption grew strongly in the December quarter and revisions to previous data show that consumption growth held up better than previously thought in the second half of 2017 (Graph 2.8). Over the year, consumption grew by almost 3 per cent. Upward revisions to household consumption were particularly large for discretionary categories of expenditure, which tend to be more sensitive to household finances. Spending on overseas travel by Australian residents (which is classified as imports) was a major source of these revisions, while upward revisions to food and health expenditure also lifted essential expenditure (Graph 2.9). More recent indicators suggest that household consumption growth was steady in early 2018: growth in retail sales held up in the first two months of the year. Measures of households' sentiment towards their personal finances remain above their long-run averages, after increasing since the middle of 2017.

Graph 2.7
Public Infrastructure Engineering Work Done
Per cent of nominal GDP



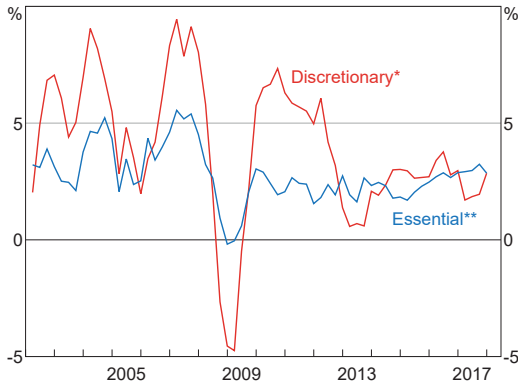
Sources: ABS; RBA

Graph 2.8
Household Consumption Growth
Year-ended



Sources: ABS; RBA

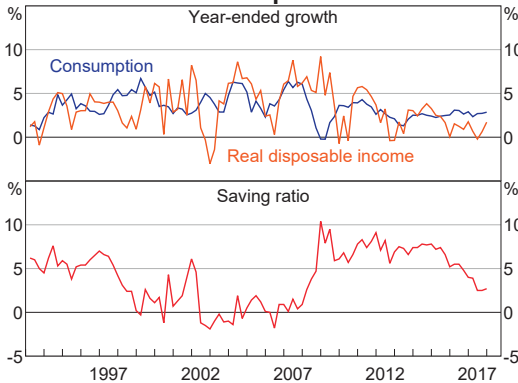
Graph 2.9
Household Consumption Growth
Year-ended



* Includes categories such as recreation and culture, hotels, cafes and restaurants, and air transport
** Includes categories such as food, housing, utilities and health
Sources: ABS; RBA

Household consumption grew at a faster rate than household disposable income over 2017; the household saving ratio is reported to have declined, although it stabilised towards the end of the year as income growth picked up (Graph 2.10). Growth in real household disposable income was below average over 2017 at 1.7 per cent, largely because of low wages growth (see 'Inflation' chapter). The prospect of continued low growth in household income remains a key risk to the outlook for household consumption, especially given high levels of household debt.

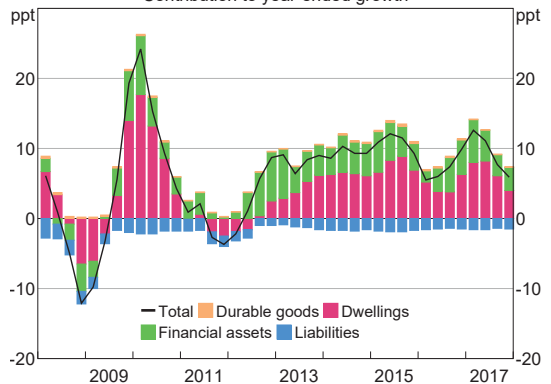
Graph 2.10
Household Consumption and Income*
Year-ended growth



* Disposable income is after tax and interest payments; saving ratio is net of depreciation
Sources: ABS; RBA

Slower growth in household net wealth, particularly in an environment of below-average income growth, adds to uncertainty about the outlook for consumption. Households' nominal net wealth increased by nearly 6 per cent over 2017, which is below the rate of previous years (Graph 2.11). This slowing was largely driven by slower growth in housing prices, which is also expected to have weighed on households' net wealth in 2018 to date. Increases in financial asset prices contributed to growth in household net wealth in 2017, but financial asset price growth has also been lower in early 2018. Growth in household debt has moderated over the past year, but debt remains at a high level as a share of household income.

Graph 2.11
Household Net Wealth
Contribution to year-ended growth



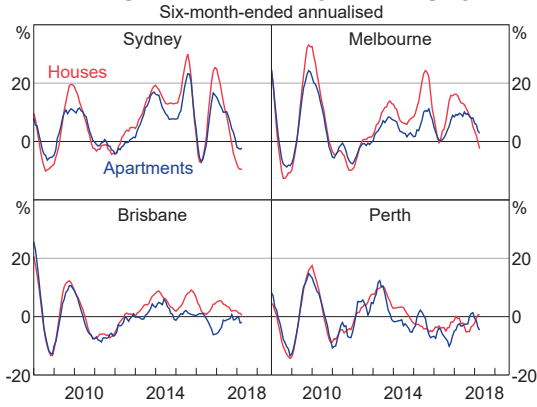
Sources: ABS; RBA

Conditions in the housing market have eased

Housing market conditions in Sydney and Melbourne have continued to ease in 2018, particularly for more expensive properties. Housing prices have declined further in Sydney, while the various data sources suggest that housing prices in Melbourne have been relatively flat or falling over recent months (Graph 2.12). While the number of properties sold at auction

Graph 2.12

Housing Price Growth by Dwelling Type



Sources: CoreLogic; RBA

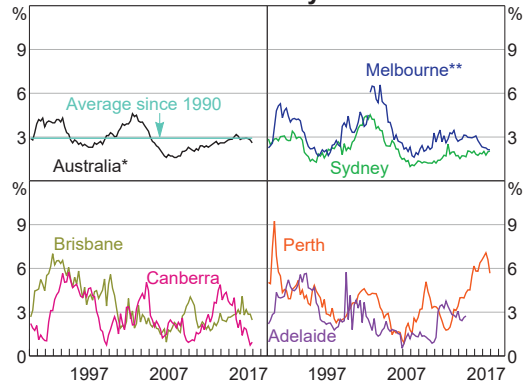
has increased in Sydney and Melbourne over 2018 to date, the number of auctions held has increased by a little more; auction clearance rates have declined to 62 per cent in Sydney and 63 per cent in Melbourne, which is a little below their decade averages. Housing prices in most other capital cities have been little changed, though Hobart housing prices have continued to grow strongly.

Conditions in the rental market remain around average in most capital cities. The pick-up in advertised rent inflation in recent months is mainly due to developments in Perth, where rents are now falling at a much slower rate and the rental vacancy rate has declined a bit from a high level (Graph 2.13). In addition, advertised rents are growing rapidly in Canberra, where the rental vacancy rate is low. In other capital cities, vacancy rates are broadly steady or have declined slightly and advertised rent inflation is little changed.

New dwelling construction declined by 5 per cent over 2017. This follows a few years in which new dwelling construction increased to high levels, supported by low interest rates, strong population growth and higher housing prices in the eastern states. The recent

Graph 2.13

Rental Vacancy Rates



* Excludes Adelaide from March 2015 onwards

** Series break December quarter 2002

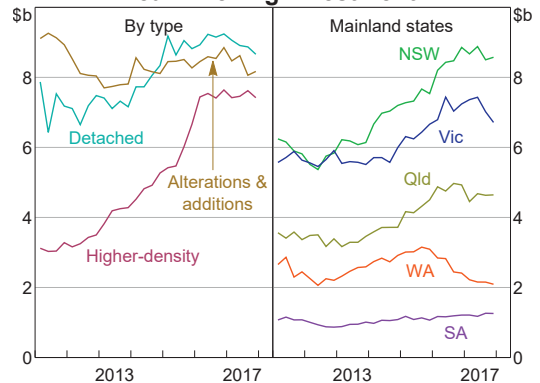
Sources: RBA; REIA; REIV

decline in residential construction activity has been concentrated in detached housing, while higher-density construction activity has remained at high levels (Graph 2.14). Alterations and additions appear to have been less responsive to the cycle in new dwelling construction than in previous episodes.

Liaison with developers indicates that off-the-plan apartment sales in the major east coast cities slowed considerably over the past 12 months, although contacts report differing views on whether demand has now

Graph 2.14

Real Dwelling Investment*



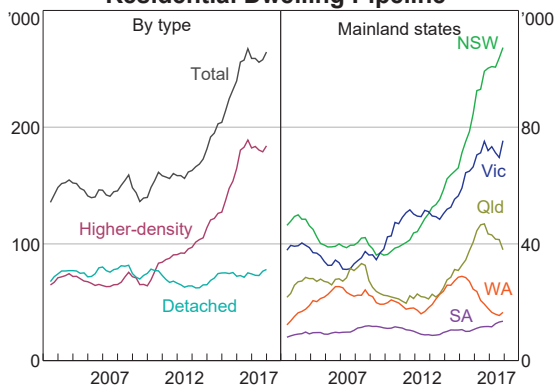
* Reference year is 2015/16

Source: ABS

stabilised or continues to fall. Despite this, the number of residential building approvals edged higher in 2017 – supported by strong higher-density approvals, particularly in Victoria and New South Wales – and have been broadly stable at this high level in 2018 so far.

With building approvals at higher levels than completions, the pipeline of higher-density dwelling projects approved or are underway has remained close to historically high levels, driven by New South Wales and Victoria (Graph 2.15). Liaison with developers indicates that the high-density residential construction sector remains close to capacity in New South Wales. The dwelling investment pipeline should continue to support a high level of dwelling investment for some time yet.

Graph 2.15
Residential Dwelling Pipeline*



* Includes dwellings approved but not yet commenced and private dwellings under construction

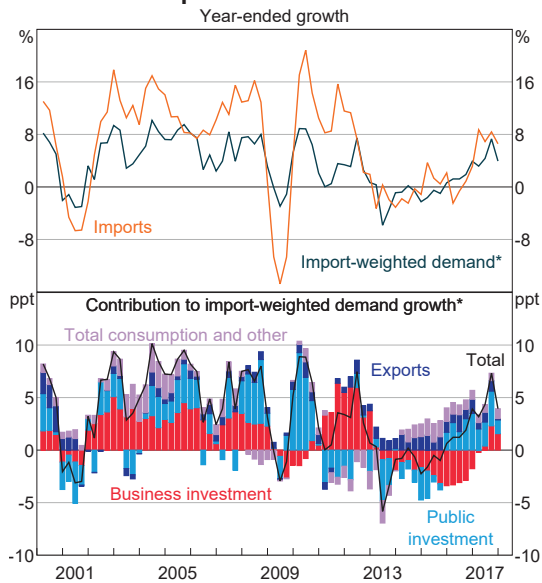
Sources: ABS; RBA

Solid growth in domestic final demand has boosted imports

Consistent with improved domestic economic conditions, imports grew by around 7 per cent over 2017. Growth in imports has been broad based, with consumption, capital, intermediate and service imports all increasing. In particular, strong growth in business and public investment, which are more

import intensive than other components of expenditure, contributed to higher imports over the past year (Graph 2.16).

Graph 2.16
Imports and Demand



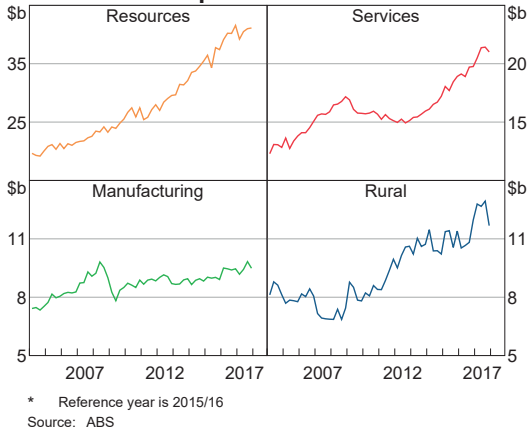
* Import-weighted demand measure constructed by weighting each component of demand by its relative import-intensity, as derived from ABS input-output tables

Sources: ABS; RBA

Exports are rising, but fell in the December quarter

Exports contracted in the December quarter, but increased by around 1 per cent over 2017 (Graph 2.17). Rural exports were particularly weak in the quarter as unfavourable weather conditions resulted in lower output of grains and other crops; this followed the record harvest in 2016/17. Coal export volumes also fell in the December quarter owing to temporary factors, including maintenance at key ports in Queensland and industrial action in New South Wales. While coal exports are expected to recover in the near term, further rail and port maintenance disruptions and weather events could slow this recovery.

Graph 2.17
Export Volumes*



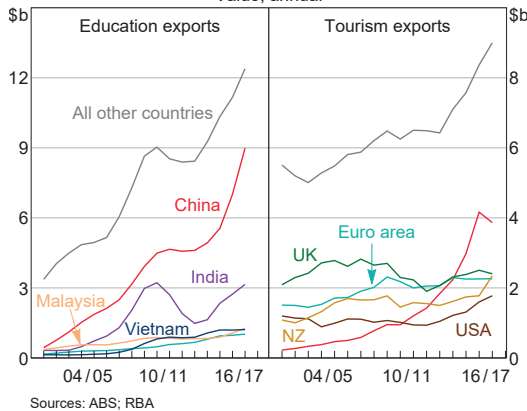
Non-resource export growth over 2017 was driven by service exports, which increased by around 6 per cent. Education and tourism exports continued to grow strongly and have been key drivers of growth in service exports over the past five years or so. The increase in education exports over recent years has reflected strong growth in student numbers from a range of countries including China and India. The increase in tourism exports over recent years has been fairly broad based, with a notable contribution from Chinese tourists (Graph 2.18). The momentum in service exports is expected to

continue, supported by a favourable outlook for growth in Australia’s major trading partners.

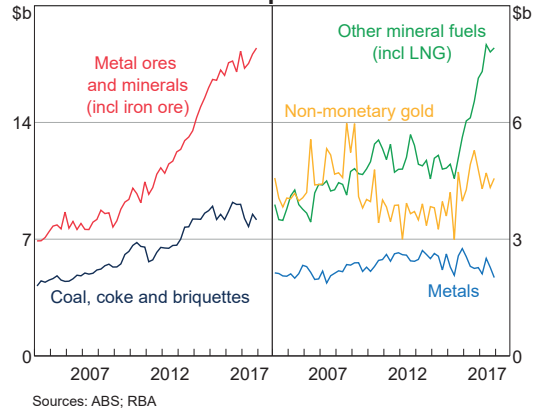
Resource exports remained at a high level over 2017; LNG exports continued to grow (rising by 20 per cent over the year) and iron ore exports increased a little, while coal exports declined (Graph 2.19). Resource exports have grown strongly over recent years as additional productive capacity has come online. Further increases are expected over the next couple of years as existing LNG projects ramp up and other projects are completed. Iron ore export volumes are expected to increase only slightly over the next couple of years because incremental productivity improvements by the major miners are likely to be partially offset by lower volumes of lower-grade iron ore from smaller-scale producers. By 2020, most of Australia’s major resource projects are expected to have reached their steady-state production levels. While resource export volumes will be at historically high levels, from that time they are not expected to make further material contributions to GDP growth.

Higher resource export revenues over recent years contributed to the trade balance moving into surplus and the current account deficit narrowing (Graph 2.20). More recently, however,

Graph 2.18
Travel Service Exports by Destination
Value, annual

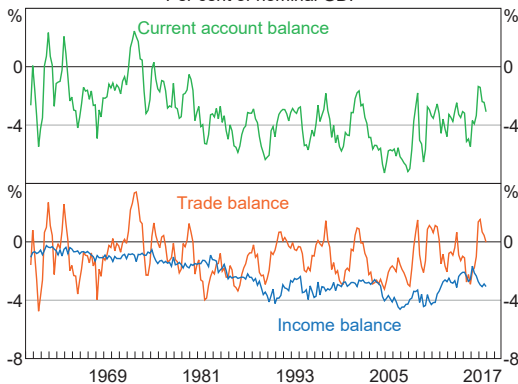


Graph 2.19
Resource Export Volumes



the trade surplus has moderated because import volumes increased and growth in overall export volumes eased. Australia's ongoing net foreign liability position with the rest of the world (and the income flows associated with this position) means that the net income balance has remained in deficit.

Graph 2.20
Current Account Balance
Per cent of nominal GDP



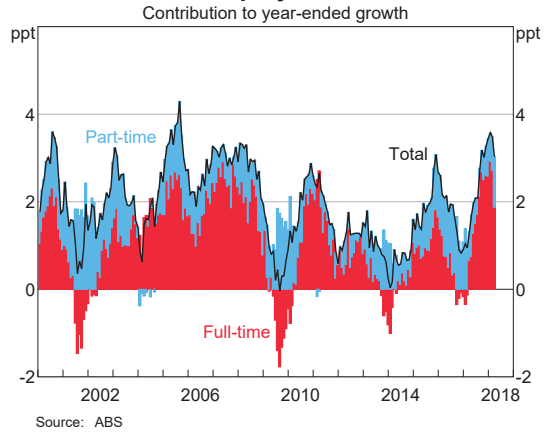
Sources: ABS; RBA

Employment growth has been considerably above population growth

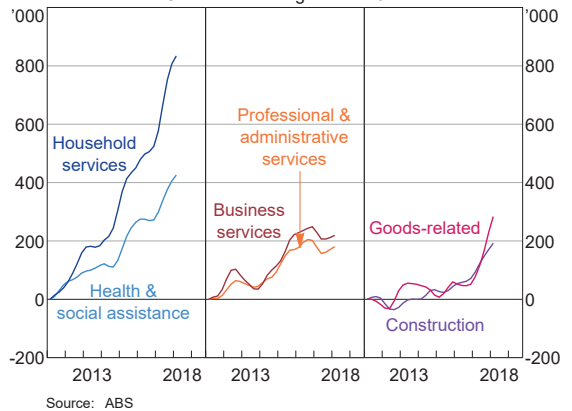
Employment grew by 3½ per cent over the past year. This is the strongest rate of growth since 2008 and full-time employment contributed the bulk of that growth (Graph 2.21). Employment growth has moderated in recent months, though it remains higher than working-age population growth. Leading indicators of labour demand, such as job vacancies and hiring intentions, continue to point to above-average growth in employment over the next six months, though it is not expected to be as strong as seen over the past year.

There has been strong employment growth in the health care & social assistance, education and construction industries over the year (Graph 2.22). Employment in the health care & social

Graph 2.21
Employment



Graph 2.22
Employment by Sector
Cumulative change since 2011



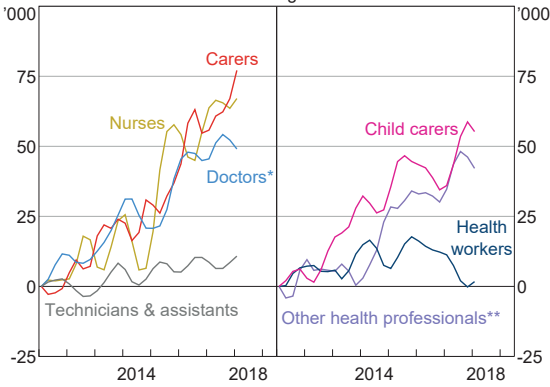
assistance industry has increased by around 130 000 over this period and now represents 14 per cent of total employment. In particular, there has been strong growth in the number of aged and disabled carers and childcare workers (Graph 2.23). The rollout of the NDIS and the gradual ageing of the population are likely to continue to support demand for health-related jobs for some time.

High levels of residential and infrastructure building activity continue to support growth in construction employment. Construction employment is now close to 10 per cent of

Graph 2.23

Health and Social Assistance Employment

Cumulative change since 2011



* Includes but not limited to medical practitioners, speech pathologists and dentists

** Includes but not limited to physiotherapists, occupational therapists and pharmacists

Sources: ABS; RBA

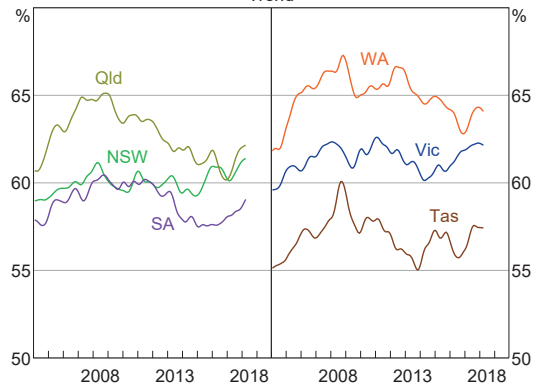
total employment, and this is estimated to be its highest share since the early 1900s. In the business services sector, employment has been little changed for the past two years. However, there are large divergences within the sector. Employment in some parts of the professional, scientific & technical industry has increased; information from the Bank’s liaison program has pointed to strength in demand for workers with specialised information technology skills. However, there has been little change in employment within the financial & insurance industry over recent years.

Employment growth has been broad based across all states over the past year (Graph 2.24). Employment growth has outpaced population growth in all states, even in Victoria, where population growth has been fastest at almost 2½ per cent. In Western Australia and Queensland there has been an increase in employment growth and participation over the past year, consistent with the improvement in economic conditions. Part of the labour market adjustment following the end of the mining investment boom has occurred through adjustment in both interstate and overseas migration.

Graph 2.24

Employment-to-Population Ratio by State

Trend



Source: ABS

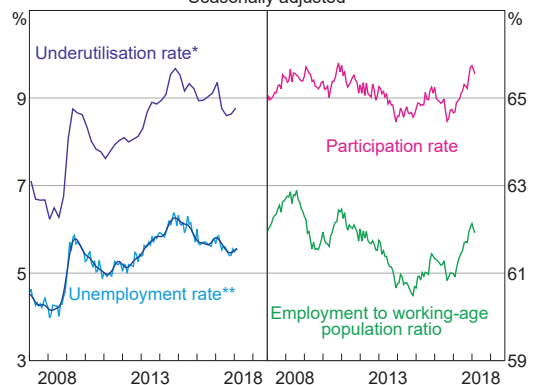
The supply of labour has also grown strongly and the unemployment rate has been little changed recently

The participation rate has increased sharply since late 2016, notwithstanding a modest decline over the past couple of months. It is currently at 65½ per cent, which is close to its record high (Graph 2.25). This rise in participation is consistent with strong growth in the demand for labour, but the increase since late 2016 has been relatively large compared with previous episodes of strong

Graph 2.25

Labour Market

Seasonally adjusted



* Hours-based measure

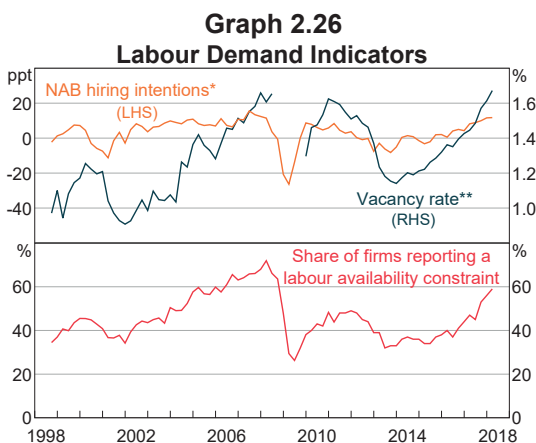
** Trend unemployment in dark blue

Sources: ABS; RBA

employment growth. The increase in labour market participation has been most notable for females, especially those aged 25–44 years, and older males (See ‘Box B: The Recent Increase in Labour Force Participation’).

Overall, the unemployment rate has declined over recent years, but it has been little changed at around 5½ per cent since mid last year. This implies that there is still spare capacity in the labour market: the unemployment rate is around ½ percentage point above conventional estimates of full employment in Australia. A broader measure of labour market underutilisation, which captures the additional hours that underemployed people would like to work as well as hours of work sought by the unemployed, has declined over the past year, but remains elevated.

Even though there is still spare capacity in the labour market overall, information from business surveys and the Bank’s liaison program provide evidence of emerging labour shortages in some parts of the economy. A higher share of firms report that it is more difficult to find suitable workers, while job vacancies continue to increase as a share of the labour force (Graph 2.26).



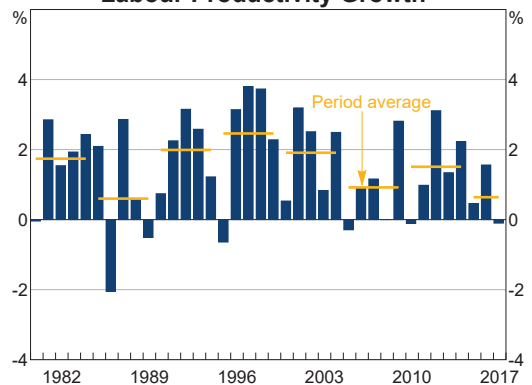
* Net balance of employment intentions for the following period; deviation from average
 ** Vacancies as a per cent of the labour force; this survey was suspended between May 2008 and November 2009
 Sources: ABS; NAB; RBA

Information from liaison suggests that the range of skills that are in short supply within the construction and the professional, scientific & technical industries appears to have broadened in recent months.

Labour productivity growth has been low

Measured labour productivity growth has been low for several years (Graph 2.27). In recent quarters, growth in GDP has been outpaced by both growth in employment and the total number of hours worked. This implies that labour productivity has fallen, although this measure can be quite volatile. Measured multifactor productivity growth – which accounts for capital as well as labour inputs to production – has also been relatively low in recent years.

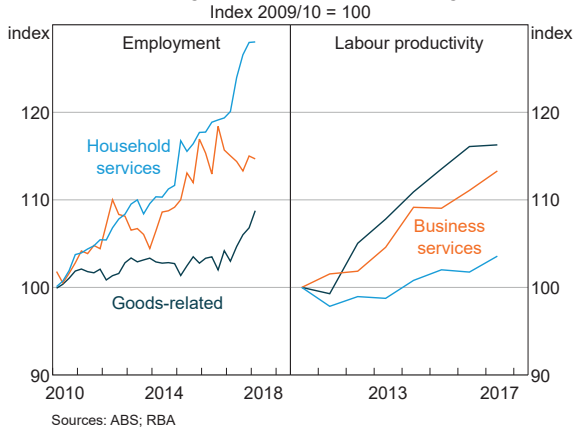
Graph 2.27
Labour Productivity Growth*



* Calendar year growth in GDP per hour worked
 Source: ABS

The concentration of recent employment growth in household services has contributed to low growth in labour productivity, because measured productivity growth in household services has typically been quite low (Graph 2.28). More generally, labour productivity is particularly difficult to measure in industries such as health and education, where it is relatively challenging to measure output and quality improvements

Graph 2.28
Employment and Productivity



can be hard to quantify. In contrast, labour productivity growth in goods-related industries has been relatively high in recent years; this has been related to the increase in mining production. Over the past year, there has been strong growth in construction employment, where the level of labour productivity is around a third of that in the mining industry. ✎