Overview

The Australian economy is gradually coming out of a soft patch. GDP growth has been recovering since its low point last year; it picked up a little in the first half of 2019 and moderate growth is expected over the remainder of the year. Growth is expected to reach 2¾ per cent over 2020 and around 3 per cent by the end of 2021. This outlook is largely unchanged from three months ago, and is supported by the low level of interest rates, recent tax cuts, ongoing spending on infrastructure, the upswing in housing prices in some markets and a brighter outlook for the resources sector.

The labour market has been resilient to this period of slow growth. In particular, employment has continued to expand noticeably faster than growth in the working-age population. Labour supply has increased to meet rising demand, with the participation rate at record highs in recent months. The unemployment rate has been broadly steady at around 5¼ per cent for some months. It is expected to decline only gradually over the next couple of years, to a little below 5 per cent. At this level, the unemployment rate will still be somewhat short of the central estimate of the rate consistent with full employment, of around 4½ per cent.

Inflation remains low and steady. CPI inflation was 0.3 per cent in the September quarter and 1.7 per cent over the year; the outcomes for trimmed mean inflation were similar, at 0.4 per cent in the quarter and 1.6 per cent over the year. Inflation is expected to pick up in the period ahead, but only gradually, to be close to 2 per cent over both 2020 and 2021.

These outcomes have occurred in the context of a global economy that has slowed and where the outlook has also eased. Ongoing trade and technology disputes have weighed on global trade and investment. Nonetheless, in the major advanced economies, labour markets are tight and wages growth has picked up, though inflation remains low. Given this low inflation, central banks in a number of economies have eased policy in recent months in response to the risks to the outlook. More recently, financial market sentiment has improved a little and expectations of further monetary policy easing have been scaled back. Financial conditions both globally and in Australia remain accommodative; bond yields and credit spreads are low, and equity prices have been rising.

In China, the trade-related tensions have added to existing domestic factors that were already contributing to an easing in growth, including earlier measures to address risks from high debt. The authorities have introduced a range of limited stimulus measures to counter the slowing in growth. These policy measures have been tilted towards steel-intensive activities, including public infrastructure projects; this has supported Chinese steel production and, in turn, demand for Australian bulk commodities, even as Chinese growth more broadly has slowed. This has been positive for iron ore prices and, together with the effects of past supply disruptions, has resulted in Australia's terms of trade holding up a little higher than earlier expected.

Domestically, a defining feature of economic developments over the past several years has been very slow growth in household income. Growth in labour income has picked up a little in recent quarters, after being weak for a number of years. However, this has been offset by weak farm incomes resulting from the drought, a downturn in housing-related business income, and ongoing strong growth in tax payments. The payment of the low- and middle-income tax offset is expected to temper the latter trend over the second half of 2019.

Recent developments show that a protracted period of weak income growth will eventually induce households to adjust their spending patterns, though this can take a while. This possibility has been flagged for some time as a risk to the outlook for consumption growth. Together with the downturn in the housing market, slow income growth has contributed to a considerable slowdown in consumption lately. Consumption grew by only 1½ per cent over the year to the June quarter. In nominal terms, growth in retail spending has been steady at a low rate, but rising prices have implied that the volume of retail sales declined over the year to the September quarter. Food prices have been boosted by the effect of the drought, while consumer durables prices have seen some pass-through of the earlier depreciation of the exchange rate. Some households have responded by switching to cheaper products or spending less on other things. Consumption growth is expected to pick up gradually in the period ahead, but the timing of the turnaround, the speed of its trajectory and the influence of the housing market on it are key uncertainties for the outlook.

The established housing market is turning around, especially on the east coast. Housing prices have been rising in most capital cities other than Perth. Some other indicators, such as auction clearance rates, have also been higher than earlier in the year. This turnaround has come sooner and faster than had previously been expected. Housing loan approvals have been increasing over recent months, although this is yet to translate into faster growth in housing credit. As was the case following earlier episodes of declining interest rates, most borrowers initially maintain their loan payments as mortgage interest rates fall, so their debt amortises faster than otherwise. Mortgage interest rates are now at record low levels. Competition for the most creditworthy borrowers remains strong.

It is uncertain how quickly the turnaround in the established market will flow through to new housing construction. Dwelling investment has declined significantly in recent quarters and indications from building approvals are that this could continue for a while yet. Lower mortgage rates and higher prices for comparable established properties are yet to spur a pick-up in overall activity in the market for new homes, though greenfield land sales have ticked up recently. It is possible that the pipeline of existing work to be done will provide less support to activity than expected, and hence that dwelling investment declines a bit faster than expected, in the near term. If this should occur, it would sow the seeds of a sharper recovery in dwelling investment further out.

Recent developments have shown that dynamics in the housing market can have more pervasive effects than we had expected. The decline in housing prices and turnover weighed on household spending decisions and housing-related inflation in the prices of new homes. It has also reduced unincorporated business income related to the housing industry and measures of the activity involved in buying and selling homes.

Business investment is expected to increase at a moderate pace over the next few years. The wind-down of the mining investment boom is largely complete, so mining investment is expected to contribute to this growth. Public investment spending is expected to remain at a high level but to contribute less to overall growth than it had in recent years. The lower exchange rate has encouraged services and manufacturing exports and reduced imports, thereby supporting growth. Resource exports have been recovering from earlier supply disruptions.

Recent outcomes show that the labour market can be more resilient to periods of slow growth than is sometimes appreciated, but labour supply can also vary considerably, with material implications for wages growth. Employment growth is forecast to remain above growth in the working-age population over the period ahead. However, this is likely to reduce unemployment only gradually, and so spare capacity is expected to remain in the labour market over the next couple of years. Consistent with this outlook, wages growth is low and shows little sign of picking up. Private sector wages growth is expected to remain close to its current rate, having picked up marginally over the past couple of years. In the public sector, wages growth is expected to continue to be constrained by government wages caps. Faster wages growth would be needed for inflation to be sustainably within the 2–3 per cent target range.

The low inflation outcome in the September quarter was in line with the Bank's expectation three months ago. Higher prices for food and consumer durables, as noted above, were offset by weak housing-related inflation, including rents as well as the prices of newly built homes. Electricity prices also declined in the September quarter, as a result of government initiatives.

Looking forward, ongoing slow wages growth is likely to keep domestic inflation pressures contained. Over time, the downward pressure on inflation from housing-related prices should wane. However, this is likely to be offset by a decline in inflation as the effects of the earlier exchange rate depreciation and the effect of the drought on food prices wash through.

In recent months, the Reserve Bank Board's deliberations have taken place in a context of monetary policy already being accommodative, with further stimulus being delivered in June and July. Interest rates globally are also very low, and many central banks have reduced their policy rates in recent months in response to concerns about downside risks to growth, in an environment where inflation is already low.

At the same time, spare capacity remains in the Australian economy, and inflation is below the medium-term target band. Wages growth is also low, and it is increasingly clear that lower unemployment is needed to generate wages growth that is consistent with sustainably achieving the inflation target. These considerations pointed to a case for further easing. While rising asset prices and increased borrowing are expected outcomes of lower interest rates, the Board assessed that the current level of risk in household balance sheets and the financial system did not outweigh this case for easing. The Board also judged that there was not a case to hold some stimulus in reserve to address potential future shocks, because experience has shown that the level, not the change, in interest rates is the key driver of demand.

In discussing the policy decision in October, the Board was mindful that rates were already very low and that each further cut brings closer the point at which other policy options might come into play. It also took into account the possibility that further easing could unintentionally convey an overly negative view of the economic outlook, or that the usual channels of policy transmission might be less effective at low interest rates. That said, the Board still assessed that lower rates would support the economy via a lower exchange rate, higher asset prices and a boost to aggregate household disposable income. Accordingly, it reduced the cash rate at the October meeting, to 0.75 per cent.

At its November meeting, the Board considered an updated set of forecasts. These forecasts imply some progress towards the medium-term inflation and full employment goals, but this progress is expected to be only gradual. The Board also recognised that global financial markets appear to have passed a trough of pessimism. In light of these circumstances and having cut the cash rate by ¾ percentage points over the past six months, to a new low of 75 basis points, the Board judged that it was appropriate to hold rates steady at its November meeting. This allows time to assess the effects of the recent easing of monetary policy as well as global developments. Given the outlook, the Board is prepared to ease monetary policy further if needed to support sustainable growth in the economy, full employment and the achievement of the medium-term inflation target over time.