Overview

Growth in the Australian economy has slowed and inflation remains low. Subdued growth in household income and the adjustment in the housing market are affecting consumer spending and residential construction. Despite this, the labour market is performing reasonably well, with the unemployment rate steady at around 5 per cent. Underlying inflation has been lower than expected, at 1½ per cent over the year to the March quarter, with pricing pressures subdued across much of the economy.

GDP growth is expected to be around 2¾ per cent over both 2019 and 2020. This is lower than previously forecast, reflecting the revised outlook for household consumption spending and dwelling activity. Stronger growth in exports and, further out, work on new mining investment projects are expected to support growth. Forecasts for inflation have also been revised lower. Trimmed mean inflation is expected to be around 1¾ per cent over 2019 and then increase gradually to 2 per cent in 2020 and a touch above 2 per cent by early 2021. In the near term, CPI inflation is expected to run a little above the rate for trimmed mean inflation, driven by the recent increase in petrol prices.

Global growth moderated in the second half of 2018 and looks to have continued at a similar pace into 2019. The moderation was partly driven by a sharp slowing in global trade, related to slower domestic demand in China and a turn in the cycle in the global electronics industry. The resulting shift in economic momentum has been most evident in the trade-oriented economies in parts of Asia and the euro area. Investment and investment intentions have also weakened in some of these economies. Trade tensions remain a downside risk to the global outlook.

In China, the authorities have continued their efforts to support growth through targeted policy easing. GDP growth eased in China in the March quarter, but there are some signs in the most recent monthly data that momentum has picked up again. The authorities have been mindful of the need to ensure that measures to support the economy do not increase financial stability risks.

In contrast to externally focused sectors, consumption growth in the United States, euro area and Japan has been relatively resilient, supported by tight labour markets. Unemployment rates are at very low levels in all three economies and wages growth has increased. As yet, though, this has added little to inflation. Core inflation is now below central banks' targets in all three major advanced economies.

Global financial market conditions have eased further in recent months. Conditions have become more accommodative since the beginning of the year, unwinding the sharp tightening that occurred at the end of 2018. Major central banks have been signalling that they are likely to maintain more accommodative monetary policy than had previously been expected. These revised expectations have flowed through to market pricing, taking sovereign bond yields to low levels. Credit

spreads and other risk premia are also low, which has held down the overall cost of financing for corporations. The easing in financial conditions has also been evident for most emerging market economies, including in China. However, risks remain for some economies, including Argentina and Turkey, that have specific vulnerabilities.

Conditions have also eased in domestic financial markets, with government bond yields falling to historically low levels and equity prices having risen strongly. In addition, pressures in short-term money markets have eased, reducing banks' funding costs. Bank bill spreads are now at their lowest levels since late 2017, though this has not flowed through to most advertised mortgage rates. Although lending practices remain considerably tighter than they were a few years ago, banks continue to compete strongly for lower-risk borrowers among both households and large businesses. Demand for housing credit remains soft.

The Australian dollar is currently around the low end of the narrow range it has been in for some years. Sovereign bond rates in Australia have continued to decline relative to those in the major economies. This has tended to counteract the upward pressure on the exchange rate that would otherwise have come from rising prices for Australia's key commodity exports.

Higher prices for some commodity exports, particularly iron ore, have boosted the outlook for Australia's terms of trade. This follows the supply disruptions arising from mine closures in Brazil, as well as some disruptions in Australia. Oil prices have also increased in recent months, which will feed through to prices of liquefied natural gas (LNG) over time. The terms of trade are still expected to decline over the period ahead, as supply increases and Chinese demand for bulk commodities eases, but to remain above the levels recorded in 2016.

GDP growth was softer than expected over the second half of 2018, after a strong first half of the year. Consumption growth has slowed noticeably, especially for those discretionary items that tend to be correlated with housing conditions. Residential construction activity has declined from its very high level over recent years. Some temporary factors also weighed on growth: drought conditions constrained rural production; supply disruptions affected resource exports; and the winding down of near-complete LNG projects weighed on mining investment. Consumption and dwelling investment are expected to remain soft in coming quarters, but non-rural exports and, further out, a moderate pick-up in mining investment are expected to support growth.

Recent data suggest that retail spending was weak in the March quarter, with retail sales volumes declining in most states. The near-term outlook for consumption growth has been revised lower because weaker housing market conditions and income growth are likely to continue to drag on spending. Further out, though, the anticipated pick-up in income growth should provide some support. Although the pipeline of residential construction work underway should support activity in the near term, dwelling investment is still expected to decline significantly over the next couple of years. Pre-sales activity has been weak, so further downward revisions to the outlook are possible.

Conditions in the established housing market remain soft. Housing prices have continued to decline in the largest cities, although the pace of decline has eased a bit recently. Some other indicators, including auction clearance rates, have improved a little since the end of last year, but generally point to continued soft conditions. Prices have also been declining in many other cities and regional areas. Other than

in Sydney, rental vacancy rates generally remain below average levels.

Growth in non-mining business investment picked up in the December quarter, supported by spending on equipment and construction of private infrastructure. In the near term, non-residential construction is likely to be supported by the elevated level of work underway. Mining investment is likely to start increasing once the final LNG projects are completed and as new investment projects commence.

Public demand growth has been robust in recent quarters, with spending on investment and a range of services provided to households both increasing significantly. Taxation revenue has also grown strongly. While this has helped improve the government sector's financial position, it has tended to offset the support that public demand has given to overall growth.

In contrast to the signal coming from the national accounts, a number of labour market indicators remain positive. Employment growth was strong in the March quarter, following similar outcomes over much of 2018. The vacancy rate remains high and there are ongoing reports of skill shortages for selected occupations.

The unemployment rate has been steady since September at around 5 per cent. Consistent with leading indicators of labour demand, employment growth is expected to grow at around the same rate as the working-age population over the next six months, and then to pick up a little as GDP growth increases. The unemployment rate is forecast to remain around 5 per cent this year and next year, before reaching 4¾ per cent in 2021.

Wages growth has increased gradually over the past couple of years, most clearly in the private sector. Fewer private-sector workers are subject to wage freezes than in recent years. Firms generally expect wages growth to remain unchanged or increase a little this year. Public sector wages have been affected by policies designed to keep average wages growth contained.

Despite strong employment growth and some recovery in growth of average hourly earnings, growth in household income was very low over 2018. Non-labour sources of income have been subdued and are likely to remain so for a while, given the effects of the drought on farm incomes and of soft housing market conditions on the earnings of many other unincorporated businesses. Strong growth in tax payments has also subtracted from disposable income growth over recent years.

Weak growth in household income poses a key risk to the outlook for household consumption, especially in the context of falling housing prices and the need for many households to service high levels of debt. Some recovery in income growth is likely, because employment growth is expected to remain solid, wages are expected to increase and the tax offset for low- and middle-income taxpayers is set to come into effect in the second half of this year.

Inflation was weaker than expected in the March quarter. Trimmed mean inflation was 0.3 per cent in the quarter and in year-ended terms declined to 1.6 per cent; other measures of underlying inflation were generally lower. Inflation was subdued across a broad range of domestic prices, and this more than offset the effects of the drought on some food prices and the pass-through of the earlier exchange rate depreciation to prices of retail goods. Headline inflation was lower than trimmed mean inflation, at 1.3 per cent over the year, largely because of the earlier fall in petrol prices.

Housing-related inflation, including for rents and the prices of newly built homes, has been soft and is likely to remain so in the near term. Slow growth in labour costs and other business costs

has also contributed to low inflation in a range of market services. Administered price inflation has been below average because of a range of policy decisions designed to address cost-of-living pressures. Further initiatives in this area could constrain inflation in utilities and other administered prices; this represents a key uncertainty around the inflation outlook.

Headline inflation will be boosted in the June quarter by the recent increase in petrol prices. Underlying inflation is meanwhile expected to remain low in coming quarters, largely because the weakness in housing-related items is expected to persist for a while. Further out, the forecast for inflation has also been reduced a little, as the softer growth outlook feeds through to the inflation outlook with a lag.

The Reserve Bank Board has maintained the cash rate at 1½ per cent since August 2016. This expansionary setting of monetary policy has helped support growth and create the conditions for the decline in the unemployment rate that occurred over 2018. The lower unemployment rate has led to a modest pick-up in wages growth, and a further increase is expected. Inflation remains subdued, however, with the adjustment in the housing market contributing to weakness in both household spending and the overall rate of inflation.

At its recent meeting, the Board focused on the implications of the low inflation outcomes for the economic outlook. It concluded that the ongoing subdued rate of inflation suggests that a lower rate of unemployment is achievable while also having inflation consistent with the target. Given this assessment, the Board will be paying close attention to developments in the labour market at its upcoming meetings.