Overview

Global economic conditions picked up further over the course of 2017. Indications are that this strength has continued into 2018. This upswing has been most pronounced in manufacturing and industrial activity, and has been more synchronised across economies than has been the case for some time. GDP growth is above estimates of potential in a number of economies and labour markets have tightened further. Although commodity prices have generally risen, broader inflationary pressures have been slow to emerge.

The Chinese economy continued to grow solidly over 2017. Government policies to reduce pollution, dampen housing speculation and contain financial risk are likely to constrain output growth somewhat, with conditions in China's industrial sector already having softened in recent months. Financial conditions continue to be supportive overall, and China is benefiting from the global upswing.

Growth has been stronger than expected in some advanced economies. Labour market conditions have tightened noticeably and unemployment rates have reached low levels in many of these countries. Survey measures of business conditions are at high levels and growth in business investment has picked up. The recently passed tax cuts in the United States are likely to add to demand there. Growth in some economies in east Asia has also picked up, supported by ongoing strong growth in global trade.

The recent synchronised improvement in global growth has boosted commodity prices and other upstream costs in some economies. Wage growth and consumer price inflation have responded only a little to date, however, and remain low in most major trading partner economies. Financial market volatility has picked up in recent days, most notably in equity markets as market participants have begun to reassess the outlook for global inflation and the speed of withdrawal of monetary accommodation. Sovereign bond yields have risen, though credit spreads remain narrow and financial conditions expansionary. The run-up in equity prices at the beginning of the year has largely been reversed, but equity prices generally remain significantly higher than a year ago.

While it is possible that geopolitical events or other risks could derail the expansion, overall prospects for global growth remain positive. An important consideration for the outlook is how far inflation picks up as the global economy strengthens. A larger than expected increase in inflation would have implications both for financial market pricing and exchange rates. On a trade-weighted basis, the Australian dollar has remained within a relatively narrow range for the past couple of years. An appreciating exchange rate would be expected to dampen domestic growth and inflation.

Domestically, the recent run of activity data has been in line with, or a little stronger than, expectations at the time of the November *Statement on Monetary Policy*. The labour market has been particularly strong. GDP growth picked up to 2¾ per cent over the year to the September quarter. The December quarter was affected by temporary declines in some categories of exports. Beyond that, however, GDP growth is expected to increase over the period ahead, to be a little above 3 per cent over both 2018 and 2019. This expectation is unchanged from the forecasts published in November, and implies that spare capacity will gradually diminish.

Prospects for business investment have improved noticeably over the past few quarters. The drag from mining investment has been waning and is likely to end sometime this year. Incomes in the mining sector have continued to be supported by higher than expected prices for bulk commodities. Non-mining business investment grew more quickly over 2017 than over the previous couple of years, and faster than was expected a year ago. Business conditions are reported to be positive, at least outside the retail sector. Forward indicators of non-residential building activity and investment intentions point to solid growth in non-mining investment in the period ahead. The large pipeline of public infrastructure work to be done is supporting GDP growth as well as conditions in some parts of the private sector. It is also encouraging increased investment spending by the firms undertaking this work on behalf of the public sector.

Household consumption growth was weak in the September quarter but indications are that it recovered in the December quarter. Consumption growth is expected to be a little above its decade average in the period ahead. Growth in household incomes has been slow for some time. If this were to persist, it would be likely to constrain consumption spending, particularly in the context of ongoing high levels of household debt. Some support to incomes will have been provided by recent strong employment growth.

Dwelling investment remains at a high level, supported by the large pipeline of work to be done in the south-eastern states. This implies ongoing above-average increases in housing supply in these markets. However, this activity has added little to overall GDP growth recently and this is likely to remain the case in the period ahead. Conditions in established housing markets have eased in Sydney and Melbourne; housing prices have declined in Sydney in recent months, especially at the more expensive end of the market. In Perth and Brisbane, housing prices have been little changed recently. Housing credit growth has drifted lower in recent months, particularly investor credit. At the same time, tighter lending standards have been helpful in containing the build-up of risks in household balance sheets but household indebtedness remains high.

Employment growth was strong over 2017, and most of the jobs created were full time. The unemployment rate trended down over the year. Forward indicators of labour demand suggest that employment will continue to expand in coming months, though not at quite as rapid a rate as seen recently. Labour supply has also increased significantly over the past year, largely driven by increased participation by women. It is unclear whether participation rates will increase further and, if so, by how much; this represents an uncertainty around the question of how spare capacity in the labour market is likely to evolve.

Wage growth remains subdued and is forecast to increase gradually. Despite the recent and forecast improvements in labour market conditions, the unemployment rate is likely to remain above estimates of full employment in Australia for some time. Wage growth has also been slow to pick up in some other advanced economies where labour markets are already tighter, suggesting that some structural factors could also be holding wage growth down. In addition, in Australia new enterprise bargaining agreements are tending to incorporate smaller wage rises than the agreements they replace. Other things being equal, this will induce some inertia that will limit overall wage growth for a time. Reports of labour shortages have become more common in recent months. In some pockets of the labour market there have also been signs of a pick-up in wage growth.

Inflation remains low and this is likely to continue for a while yet. Both CPI and underlying inflation were a little below 2 per cent over 2017. Slow growth in labour costs has weighed on price growth, particularly for retail goods and some market services. Strong competition among retailers is contributing to ongoing deflation in prices of consumer durables and several other retail categories; food prices (excluding volatile fruit and vegetable prices) have been broadly flat for some time. Inflation in home-building costs has picked up in the eastern capital cities but remains subdued elsewhere, as does rent inflation nationally. Higher fuel prices, electricity charges and ongoing increases in tobacco excise added to headline inflation over 2017. Utility prices will also add to headline inflation in the March quarter.

The forecasts for inflation are similar to those published in the November *Statement*. Inflation is likely to increase gradually over time, as the economy and labour market strengthen. Underlying inflation is expected to be around 2¼ per cent by mid 2020. Headline inflation is expected to remain a little higher than underlying inflation, boosted by ongoing increases in tobacco excise. A key question shaping the inflation outlook is how quickly wage growth and inflation might pick up as spare capacity is absorbed.

Over the course of 2017, the unemployment rate declined and inflation increased a little. The accommodative setting of monetary policy has played a role here. Further progress on both fronts is expected over the next couple of years. It will be some time, however, before the economy reaches current estimates of full employment and inflation returns to the midpoint of the target. Accordingly, at its recent meetings the Reserve Bank Board has judged that holding the cash rate at its current level of 1.5 per cent was consistent with sustainable growth in the economy and achieving the medium-term inflation target.