

5. Economic Outlook

The outlook for the Australian economy is little changed since the August *Statement*. GDP growth over the first half of 2019 was stronger than it was over the second half of last year and recent data have been consistent with a continuation of moderate growth. The labour market and inflation forecasts are also little changed although wage growth is no longer expected to pick up.

Growth in Australia's major trading partners is expected to remain around its recent pace over the next two years. This is a little lower than forecast three months ago because there are more signs that the slowing in export-oriented sectors associated with the US–China trade and technology disputes is spilling over to the service sectors.

There are a number of global and domestic uncertainties around the forecasts. A renewed escalation of US–China trade and technology tensions would further increase uncertainty and depress business investment, although recent progress on negotiations suggests that this outcome is now less likely. The Chinese authorities also continue to face a number of policy trade-offs and it is uncertain how they will be resolved. Global financial conditions have remained accommodative since the start of the year, offsetting some of the impact of the trade dispute on the global economy. However, there are potential events that could lead to a material tightening in financial conditions, which would weigh on growth.

One near-term downside risk to the Australian economy is housing construction activity. A

larger-than-expected contraction in dwelling investment could delay the gradual improvement in GDP growth. Further out, the outlook is more balanced. A lagged response to rising housing prices and a period of low building activity means that dwelling investment would be stronger in the medium term than currently expected. Mining activity also has some upside risk.

Domestic growth is expected to strengthen

Australian GDP growth was lower than expected over the year to the June quarter, although GDP growth was firmer in the first half of 2019 than in the second half of 2018. Recent partial indicators point to moderate GDP growth in the September quarter and a similar outcome is forecast for the December quarter, resulting in year-ended growth of 2¼ per cent over 2019 (Table 5.1) (Graph 5.1).

Year-ended growth is forecast to increase to 2¾ per cent over 2020 and around 3 per cent over 2021, 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 outlook for consumption growth continues to be one of the important sources of uncertainty for the domestic growth forecasts, although the risks in the medium term are balanced. Growth in consumption is expected to increase gradually, supported by an increase in household disposable income growth and the recent improvement in the

Table 5.1: Output Growth and Inflation Forecasts^(a)

Per cent

	Year-ended					
	June 2019	Dec 2019	June 2020	Dec 2020	June 2021	Dec 2021
GDP growth	1.4	2¼	2½	2¾	3	3
(previous)	(1¾)	(2½)	(2¾)	(2¾)	(3)	(3)
Unemployment rate ^(b)	5.2	5¼	5¼	5¼	5	5
(previous)	(5.2)	(5¼)	(5¼)	(5¼)	(5)	(5)
CPI inflation	1.6	1¾	2	1¾	1¾	2
(previous)	(1.6)	(1¾)	(1¾)	(1¾)	(2)	(2)
Trimmed mean inflation	1.6	1½	1¾	1¾	1¾	2
(previous)	(1.6)	(1½)	(1¾)	(1¾)	(2)	(2)
	Year-average					
	2018/19	2019	2019/20	2020	2020/21	2021
GDP growth	2.0	1¾	2¼	2¾	2¾	3
(previous)	(2¼)	(2)	(2½)	(2¾)	(3)	(3)

(a) Technical assumptions set on 6 November include the cash rate moving in line with market pricing, TWI at 60, A\$ at US\$0.69 and Brent crude oil price at US\$61 per barrel; shaded regions are historical data; figures in parentheses show the corresponding forecasts in the August 2019 Statement

(b) Average rate in the quarter

Sources: ABS; RBA

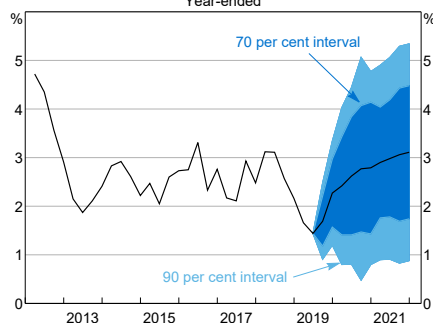
established housing market. Dwelling investment is expected to subtract from GDP growth for several quarters, though this drag is expected to diminish through 2020, and subsequently return to making a positive contribution to growth. Public demand and business investment are expected to continue supporting growth over the forecast period, complemented by ongoing growth in exports. Mining investment is also expected to make a material contribution to growth.

The domestic forecasts are conditioned on the technical assumption that the cash rate moves in line with market pricing, which implies some chance of a 25 basis point cut to the cash rate by the middle of 2020. The exchange rate is assumed to be constant at its current level, which is 1 per cent higher than where it was at the time of the August *Statement*. Oil prices are assumed to remain at current levels, which are about 5 per cent higher than they were at the

time of the August *Statement*. The population aged 15 years and over is assumed to grow by 1.7 per cent per annum over 2020 and 2021. (For an example of how movements in the exchange rate technical assumption can affect the forecasts see Box E: Scenario Analysis Using the MARTIN Model).

Graph 5.1

GDP Growth Forecast*



* Confidence intervals reflect RBA forecast errors since 1993

Sources: ABS; RBA

Consumption growth is expected to recover gradually

Over the past year consumption has been significantly weaker than expected. There was a modest improvement in the June quarter but recent indicators have been weak. Growth in consumption over 2019 is expected to be 1½ per cent, which is at the bottom end of the range of outcomes over the past decade. Growth in consumption is expected to increase gradually over subsequent quarters, to be close to 2½ per cent over 2020 and 2¾ per cent over 2021.

Consumption growth will be supported by an expected pick-up in growth in household disposable income and the recovery in housing markets. Household disposable income growth has been very slow in recent years. The forecast pick-up in growth in household disposable income arises from growth in labour demand, the recent monetary policy easing lowering household interest payments and the low- and middle-income tax offset lowering tax payments. The overall expected increase in income has been revised down slightly in the near term to reflect the effects on small business income from the ongoing drought and downturn in housing construction activity, and continuing evidence of strong tax collections.

The household saving ratio has increased modestly since the end of 2018 and is expected to remain broadly unchanged over coming years.

Dwelling investment will decline in the near term before turning around

Dwelling investment is expected to continue to decline over the coming year. The outlook for dwelling investment has been revised lower in the near term, consistent with the June quarter outcome and soft building approvals data more recently. Despite the stronger-than-expected recovery in established housing markets, there is

little evidence of a pick-up in the early stages of residential development activity. Developers in the Bank's liaison program report that improved market sentiment has yet to translate to much of an increase in sales. The trough in dwelling investment is expected to occur in late 2020, before a recovery in residential construction gets underway through 2021. The pick-up in dwelling investment over 2021 has been upwardly revised, partly reflecting the stronger-than-expected increase in established housing prices.

Public demand and non-mining business investment are expected to continue to support growth

Growth in public consumption is expected to moderate from its current very strong rate, partly because some of the expenditure in the June quarter was temporary. Spending on the NDIS is expected to support growth in public consumption, making up around one-quarter of growth in 2019/20 and 2020/21. Public investment is expected to grow moderately over coming years, supported by transport infrastructure projects, partly offset by the expected decrease in investment following the completion of the rollout of the National Broadband Network.

Non-mining business investment is expected to contribute to growth over the forecast period. Non-mining investment declined in the June quarter, driven by a decrease in non-residential construction work that partly reflected a shift in the timing of some infrastructure construction projects. A pick-up in work on these projects is expected to add to growth in the near term. Further out, growth is expected to be a little weaker, based on the lower investment expectations reported in the Australian Bureau of Statistics Capital Expenditure (Capex) survey.

... as is mining activity

Mining investment increased in the June quarter, driven by machinery & equipment investment and exploration activity. Taken

together with the Capex survey, business liaison and company announcements, this suggests that mining investment is around its trough and that the wind-down of the mining investment boom (and associated drag on GDP growth) is complete. Mining investment is expected to pick up gradually over the next year or two as firms seek to sustain, and in some cases expand, production. There is some possibility that expenditure will be higher than expected, including from projects currently under consideration.

Partial trade data suggest resource exports increased in the September quarter. They are expected to increase further over the coming year, supported by growth in iron ore and coking coal production, as well as the continued ramp-up of LNG exports. Growth in resource exports is then expected to slow as LNG projects reach their targeted production levels and a couple of existing gas fields begin to deplete.

Rural exports are expected to be lower because of the drought

Rural exports are forecast to decline over the next year before picking up. Given the Bureau of Meteorology is forecasting drier-than-average conditions across most of Australia until at least the end of this year, the drought is expected to weigh on rural exports (and farm incomes) for longer than previously expected. Planting of summer crops is likely to be lower this season and smaller national herd and flock sizes will constrain meat production until producers can rebuild livestock numbers. Both developments imply that it will take longer for rural exports to stabilise.

Service exports are forecast to continue growing steadily, underpinned by overseas student enrolments and the exchange rate depreciation over the past year. Manufactured exports are expected to continue growing over the forecast period, especially exports of medicinal & pharmaceutical goods and professional &

scientific instruments, which have increased strongly over recent years.

Imports were weak in the June quarter, and partial trade data suggest a small decline in the September quarter, consistent with slower private sector demand growth over recent quarters. Further out, imports are expected to increase at a moderate pace.

The terms of trade are expected to decline gradually

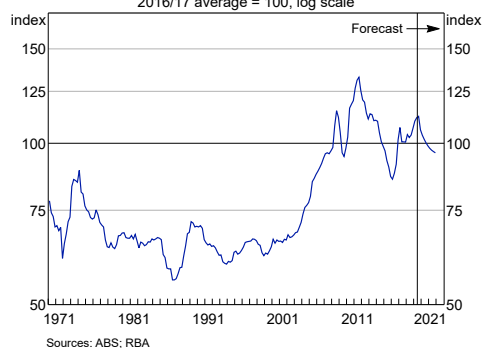
The terms of trade remain elevated, reflecting still-high resource export prices, particularly for iron ore (Graph 5.2). The terms of trade are expected to decline gradually as Chinese demand for bulk commodities moderates. The higher level of the terms of trade is not having a large impact on economic activity. Iron ore export volumes were already running at close to capacity, and because higher prices are seen as temporary, they have not spurred investment in new capacity. Although higher prices boost mining profits and tax receipts, the effect of this on the economy has been small.^[1]

The broader outlook for coal prices has not changed markedly; an expected increase in coking coal supply is likely to lower prices, and the gradual transition away from coal-fired power generation is expected to continue weighing on thermal coal prices.

Graph 5.2

Terms of Trade

2016/17 average = 100, log scale



The unemployment rate is expected to decline a little ...

Employment growth has continued to be stronger than expected, particularly given that output growth has been weaker than expected. Leading indicators suggest that these positive labour market conditions will persist over the next six months; job vacancies have declined a little but remain at a high level, while firms' hiring intentions remain above average. Above-trend GDP growth is expected to support employment growth over 2020 and 2021 and the employment to working-age population ratio is forecast to increase further.

There is always uncertainty around how much of any increase in labour demand will be met by a change in unemployment, participation or an adjustment in the average hours worked. Over the past couple of years, employment growth has encouraged a larger-than-usual response from people to either enter the labour force or defer leaving. The participation rate is expected to increase modestly from its current high rate, while the unemployment rate is expected to decline to 4.9 per cent by the end of 2021 (Graph 5.3). This unemployment rate profile is unchanged from the August *Statement*.

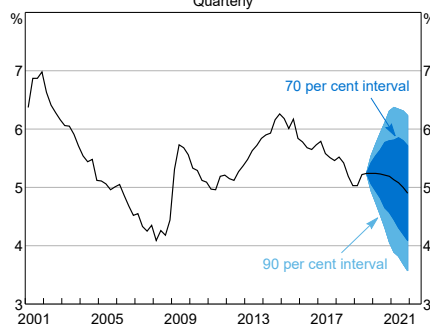
The unemployment rate is expected to remain above the rate consistent with full employment (also known as the non-accelerating inflation rate of unemployment or NAIRU) for the next couple of years. The central estimate of this rate is around 4½ per cent, although there is considerable uncertainty around how much spare capacity there currently is (and will be) in the labour market. In particular, a key uncertainty is whether further increases in labour demand will be met by rising labour force participation.

... but will not generate much inflationary pressure

Wages growth is expected to remain around the current rate over the next couple of years. Private sector wage price index (WPI) growth is expected to increase very modestly, consistent with the gradual decline in labour market spare capacity. This is a little lower than previously forecast. In the near term, this is in line with company and union expectations; the majority of companies in the liaison program as well as surveyed unions continue to anticipate little change in wages growth over the next year. Wages growth, however, will be boosted a little in the September quarter by the 3 per cent increase in the award and minimum wage. Public sector wages growth is expected to remain broadly stable over the next few years, given that there is no indication that there will be changes to the government wage caps that have been in place in most jurisdictions for many years.

Average earnings from the national accounts, which is a broader measure of labour costs, is expected to grow at a slightly stronger pace than the WPI. This assumes that whatever factors have been dragging on earnings growth in recent years, such as compositional changes in the labour market or weakness in non-wage labour costs, have dissipated. Growth in unit

Graph 5.3
Unemployment Rate Forecast*
Quarterly



* Confidence intervals reflect RBA forecast errors since 1993
Sources: ABS; RBA

labour costs is expected to be fairly subdued over the next few years; the recent pick-up in unit labour cost growth, as a result of particularly weak productivity outcomes, is expected to be temporary.

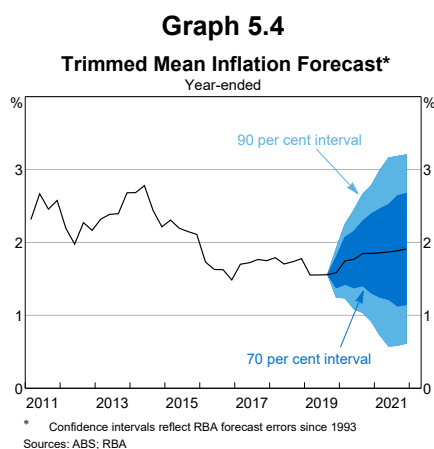
Trimmed mean inflation is expected to increase to around 1¾ per cent over 2020 and to around 2 per cent over 2021 (Graph 5.4). Headline inflation is expected to follow a similar profile, although the increase in fuel prices in the December quarter to date is expected to boost inflation by 0.2 percentage points in the quarter. Inflation in the September quarter was as expected at the time of the *August Statement*. Although new dwelling prices were again lower than forecast, there was a bit more pass-through from the lower exchange rate to higher retail prices than expected. Inflation is expected to increase a little over the forecast period as labour market spare capacity declines a little and as growth picks up to above potential. It remains uncertain how fast spare capacity will be absorbed and how fast this will translate into sustained wage and inflationary pressure.

There are a number of factors affecting inflation that are likely to dissipate over time, although the timing of this dissipation is unclear. New dwelling inflation is expected to remain subdued until residential construction activity starts to pick up in 2020. Rent growth, which is generally a slow-moving component of CPI, is expected to pick up gradually as housing demand from continued strong population growth more than offsets the slower additions to the housing stock. Over the past year, a number of administered price decisions (such as child care reform) and policy changes in utilities have weighed on inflation. There are no known large administered price changes in the near term, but there is considerable, policy-dependent uncertainty around the outlook for these prices (discussed further below). Working in the opposite direction, the recent increase in grocery food inflation related to the drought is

likely to be temporary. Further, the upward pressure on consumer durables prices from the exchange rate depreciation over the past year is expected to wane over 2020.

Risks to global growth are mostly to the downside

A number of uncertainties pose downside risk to the global outlook. Further escalation of US–China trade and technology tensions is possible. Some progress on negotiations has been made recently, however, so there is still a possibility a deal will be reached soon. If that were to happen, global growth could surprise on the upside as firms make up for delayed capital spending. But if a deal is not reached soon, the more prolonged period of unresolved trade tensions would further increase uncertainty and depress business investment. These effects would have wide-ranging negative implications for global growth but will be most concentrated in the United States, China and the more export-oriented economies in east Asia. There is also a risk that the spillovers to service sectors and labour markets could be larger than expected. The timing and form of the United Kingdom's expected exit from the European Union continues to pose risks to growth in Europe.



China's slowing growth trajectory and the interaction of domestic policies and external pressures continue to pose risks to the demand for bulk commodities and Australia's terms of trade. Targeted fiscal and monetary policy measures have supported Chinese domestic demand and have helped to offset the effects of the US–China trade and technology disputes. However, the overall stimulus might still not be enough to avoid a sharper slowing in growth than we expect or the Chinese Government desires. This could prompt authorities to respond with more aggressive policy easing. However, they may be reluctant to do so, given their desire to avoid adding to already-high levels of debt and fuelling currency depreciation pressures, which could exacerbate tensions and encourage capital outflows. The evolution of policies towards property markets, infrastructure spending and the environment will also be important for China's growth trajectory and, in particular, the outlook for Chinese steel demand.

Global financial conditions have remained accommodative since the start of the year, offsetting some of the impact of the trade dispute on the global economy. Overall, asset prices continue to suggest that market participants expect an extended period of monetary policy accommodation that will support the global economic expansion. There are, however, several possible triggers that could lead to a tightening in financial conditions through higher risk premiums and financial market volatility. Both are currently low, but could increase if market participants become more concerned about the global growth outlook or if political risks escalate.

Dwelling investment presents a downside risk in the near term ...

The data show that the domestic economy has reached a gentle turning point. Recent evidence suggests that the modest pick-up in growth that occurred in the first half of the year has

continued, but it is possible that growth does not increase by as much as forecast. One factor that could be softer than forecast over the next year or so is housing construction; this would, in turn, have broader economic implications.

The timing and size of the expected decline in dwelling investment is uncertain. The recent increase in established housing market prices in some markets will, in time, support demand for new dwellings. It is possible that this support will come sooner than expected, given the extent of the turnaround in prices that has already occurred. However, conditions in the earlier stages of residential development have been weak for some time. The long lead times on higher-density construction mean the supply response is likely to be slower than the historical average response to changes in established housing prices and interest rates would suggest. Tight conditions on lending to developers may mean it is even more protracted than we expect. This raises the risk that dwelling investment could decline by more than currently forecast in the near term. This would have implications for employment and profits from businesses in the construction sector, and thus weigh on household income growth and consumption. Other parts of the economy with linkages to the residential construction sector, such as business services and manufacturing, could also be affected.

The labour market has been surprisingly resilient to the below-trend GDP growth over the past year. Given the weakness in GDP growth, especially in the second half of last year, there would typically have been more of a slowing in employment growth by now. It is possible that the lags between growth and employment are longer than usual and a weakening in the labour market is still to come, although leading indicators do not suggest a material change is likely in the next couple of quarters.

... but risks to growth and inflation are more balanced further out

The risks around the outlook for growth are more balanced in 2021. Although the possible downside risks to dwelling investment could persist, a lagged response to housing prices and a period of low building activity means that dwelling investment would be stronger in the medium term than currently expected. The expected rise in mining activity also has some upside risk.

In contrast to the near-term risks for the sector, residential construction could contribute more to growth towards the end of the forecast period than expected. Our current projections take account of the longer lags involved in high-density construction than in the detached home building activity that dominated past housing cycles in Australia. As a result, the increase in dwelling investment is expected to occur a little later than the historical average response to changes in established housing prices and interest rates would suggest. This timing reflects the large recent addition to the housing stock, tighter credit conditions and lack of pre-sales activity. However, these factors could weigh less on activity than expected and so dwelling investment could be stronger. A stronger recovery in dwelling investment becomes more likely the longer the weakness in construction persists because, in an environment of strong population growth, this will lead to an undersupply of housing and more upward pressure on established prices.

Sustained strength in established housing price growth could boost consumption growth by more than expected. It could also be associated with credit growth picking up faster than growth in household disposable income. International experience suggests that high household debt can amplify economic and financial shocks such as an unexpected increase in unemployment or slower-than-expected income growth, including through the effects

on household consumption. That said, in Australia, financial stability concerns are mitigated by the fact that the bulk of debt outstanding is owed by higher-income households who are less likely to experience sustained unemployment and generally have a high capacity to make repayments.

The expected rise in mining activity also has some upside risk. The forecast for mining investment incorporates available information on sustaining and expansionary projects that are underway or have received (or are expected to receive) positive final investment decisions. If work on these projects were to be accelerated or more spending was required than expected, this would boost GDP growth. There are also some mining projects for which investment decisions have not been made, but could commence around the end of the forecast period. These projects would further boost GDP if they were to proceed. The current high level of the terms of trade could also persist for longer, or support growth by more than our current forecasts assume.

For wage and price inflation, the risks to the forecasts in 2021 also appear evenly balanced. Wages growth could pick up faster than expected if GDP growth is stronger and erodes spare capacity in the labour market by more than we currently expect. Against that possibility, an extended period of low wages growth and inflation may move wage-setting norms even lower than they are currently. The increase in the superannuation guarantee in 2021 could affect wages growth, but this will depend on labour market conditions and the response of wage-setting bodies at the time.

At a more disaggregated level, the downside risks to administered and electricity prices inflation that had been flagged have largely materialised over the past year. The risks around these prices now appear to be more balanced over the next few years. Electricity prices are expected to rise at a below-average pace and

could decline because the amount of renewable energy coming online over the next few years will weigh on wholesale electricity prices. However, the outlook for network costs (around 40 per cent of consumer electricity prices) is more uncertain. Inflation in the prices of food and consumer durables has increased recently as a result of the pass-through of the exchange rate depreciation as well as the drought. Future

outcomes will be influenced by any pick-up in consumer demand and any changes to competition dynamics in the industry. Finally, the pace at which housing-related costs pick up will largely depend on how quickly the expected pick-up in residential construction activity offsets demand for new housing from strong population growth. ✎

Endnotes

- [1] See RBA (2019), 'Box B: The Recent Increase in Iron Ore Prices and Implications for the Australian Economy', *Statement on Monetary Policy*, August Available at <<https://www.rba.gov.au/publications/smp/2019/aug/box-b-the-recent-increase-in-iron-ore-prices-and-implications-for-the-australian-economy.html>>.

