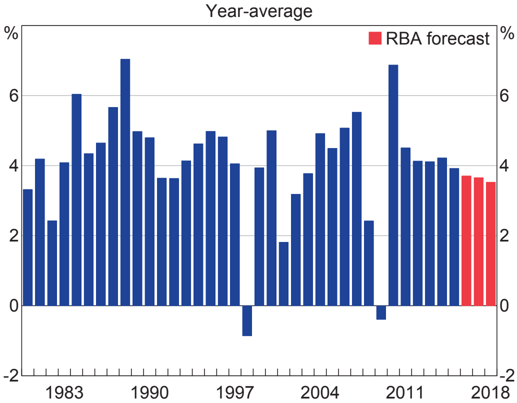
6. Economic Outlook

The International Economy

The assessment of the global economy is largely unchanged from the August *Statement*. GDP in Australia's major trading partners has grown at a little below its decade-average rate over the past year. Growth is expected to decline gradually over the next few years, driven by further easing of growth in China, in part because the strength in the Chinese property market is not expected to be sustained (Graph 6.1). Growth in east Asian economies (other than China and Japan) is expected to remain below average in the near term, before picking up gradually towards potential by mid 2018 as external demand conditions recover and accommodative monetary and fiscal policies continue to provide support.

GDP growth in the major advanced economies is expected to be a little above potential over the next couple of years, partly because monetary policy is expected to remain accommodative. However, potential growth rates in these economies are generally lower than their long-term average growth rates because of slower growth in the working-age population, productivity and investment, and, in some cases, the lingering effects of the global financial crisis.

Graph 6.1
Australia's Trading Partner Growth*
Year-average



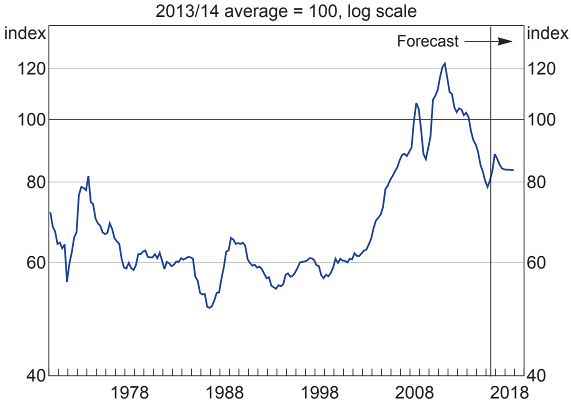
* Aggregated using total export shares
Sources: ABS; CEIC Data; RBA; Thomson Reuters

The United Kingdom's referendum vote to leave the European Union had little immediate impact on economic outcomes. Longer term, however, there are still risks to the UK economy depending on the nature of the UK's exit. The ongoing weakness of the European banking system also continues to pose downside risks. More broadly, political developments could have implications for global economic activity.

Global price and wage pressures have remained largely muted, but are expected to pick up as spare capacity in labour and product markets gradually declines. Labour productivity growth has been weak, which has contributed to above-average growth in unit labour costs in the United States and Japan. If weak productivity growth continues, there may be less spare capacity than indicated by current estimates and potentially a sharper pick-up in inflationary pressures, all else being equal. Furthermore, the increases in the prices of oil and other commodities since around the turn of the year have contributed to global inflation, following a period where commodity prices fell markedly. A sharper pick-up in global inflationary pressures than has been anticipated could lead to tighter-than-expected monetary policy in other economies and a depreciation of the Australian dollar. However, if inflation remains at low rates and below central bank targets for an extended period in some economies, this may lead to lower inflation expectations and therefore lower inflation than would be implied by the degree of spare capacity.

Australia's terms of trade increased in the June quarter for the first time in 2½ years, and look to have risen again in the September quarter, led by higher bulk commodity prices. The terms of trade are forecast to remain above the levels reached in early 2016 (Graph 6.2). The outlook for commodity prices, particularly coal prices, is more positive than previously thought, reflecting an improved outlook for Chinese steel production in the near term and cuts to the production of bulk commodities in China, although current levels of spot prices are not expected to be sustained.

Graph 6.2
Terms of Trade
2013/14 average = 100, log scale



Sources: ABS; RBA

Domestic Activity

The domestic forecasts are conditioned on a number of technical assumptions. The cash rate is assumed to move broadly in line with market pricing as at the time of writing. This assumption does not represent a commitment by the Reserve Bank Board to any particular path for policy. The exchange rate is assumed to remain at its current level over the forecast period (trade-weighted index (TWI) at 65 and A$1=US$0.77). The TWI is a little higher than the assumption underlying the forecasts in the August *Statement*. The forecasts are also based on the price of Brent crude oil being US$50 per barrel over the forecast period, which is 10 per cent higher than the assumption used in August and in line with futures pricing in the near term. The population aged over 15 years is still assumed to grow by 1.5 per cent over 2016 and by 1.6 per cent over 2017 and 2018, drawing on forecasts from the Department of Immigration and Border Protection.

The starting point for the forecasts is that the Australian economy grew at around central estimates of potential growth in 2015/16. Growth in the June quarter was moderate and much as expected, although stronger-than-expected public demand growth offset weaker consumption growth. Recent indicators are consistent with moderate growth in the September quarter.

In 2015/16, non-mining activity grew at a pace that was a little above average, supported by low interest rates and the ongoing effects of the earlier exchange rate depreciation. Growth was reasonably broad based. Growth in dwelling investment and public demand was strong and the contribution from household consumption for the year as a whole was around the decade average. Non-mining business investment grew modestly. Meanwhile, mining activity subtracted from GDP growth in 2015/16, as stronger-than-expected growth in resource exports was more than offset by a substantial decline in mining investment.

Overall, the forecasts for GDP growth are similar to those presented in the August *Statement*. Growth is expected to be around 2½–3½ per cent over the year to June 2017, and then increase to around 3–4 per cent over the year to December 2018 (Table 6.1).

Low interest rates and gains to employment and wealth are expected to continue to support household demand. Consumption growth is projected to increase gradually over the forecast period. Expectations for longer-term growth in household consumption have been lowered slightly relative to the period prior to the global financial

Table 6.1: Output Growth and Inflation Forecasts[a]
Per cent

	Year-ended					
	Jun 2016	Dec 2016	Jun 2017	Dec 2017	Jun 2018	Dec 2018
GDP growth	3.3	2½–3½	2½–3½	2½–3½	2½–3½	3–4
CPI inflation	1.0	1½	1½–2½	1½–2½	1½–2½	1½–2½
Underlying inflation	1½	1½	1½–2½	1½–2½	1½–2½	1½–2½
	Year-average					
	2015/16	2016	2016/17	2017	2017/18	2018
GDP growth	2.8	2½–3½	2½–3½	2½–3½	2½–3½	2½–3½

(a) Technical assumptions include A$=US$0.77, TWI at 65 and Brent crude oil price at US$50 per barrel; shaded regions are historical data
Sources: ABS; RBA

crisis, when growth was boosted by strong growth in income, rising labour force participation and rising debt and housing equity withdrawal. The effect on GDP of the downward revision to the forecasts for consumption growth has been offset by a downward revision to import growth. The forecasts for growth in consumption and disposable income now imply a slightly more gradual decline in the household saving ratio than had been projected in the August *Statement*. How households decide to consume and save out of their income in the future remains a key source of uncertainty in the forecasts.

The already substantial amount of residential construction work in the pipeline increased in the June quarter and building approvals in the September quarter are consistent with further increases. Accordingly, the forecast for dwelling investment has been revised up slightly. Dwelling investment is expected to grow for the next year or so, although at a gradually diminishing rate.

The forecasts for growth in public demand are little changed. Solid growth in public demand is expected over the forecast period, consistent with state and federal government budgets, which together imply ongoing growth in public investment.

The outlook for the level of resource exports is lower than previously expected. The liquefied natural gas (LNG) export profile has been revised lower, reflecting more conservative assumptions about the production capacity of the LNG sector, although Australia's LNG exports are expected to continue growing strongly for some time. Coking coal exports are expected to be slightly higher, supported by the improvement in coking coal prices, while thermal coal export volumes are forecast to remain broadly unchanged. The scope for substantial growth in coal exports appears to be limited, as a large number of producers are already operating at close to capacity and are unlikely to undertake new investment given the widely held expectation that prices will decline somewhat in the period ahead.

More generally, the depreciation of the Australian dollar over the past few years is assisting domestic producers of tradable items and service exports are forecast to continue growing at a robust pace for a time.

Mining investment is still expected to continue to fall over the forecast period, as large resource-related projects are completed and few new projects are expected to commence. However, the largest subtraction of mining investment from GDP growth looks to have already occurred. The outlook for non-mining business investment is subdued in the near term, consistent with the ABS capital expenditure survey of firms' investment intentions and the downward trend in non-residential building work yet to be done. However, non-residential building approvals have picked up of late. Non-mining business investment appears to be growing in New South Wales and Victoria, aided by low interest rates and the depreciation of the Australian dollar over the past few years. Moreover, survey measures of capacity utilisation have been increasing over the past couple of years and are currently above their long-term averages.

Labour market outcomes over recent months have prompted a downward revision to the forecasts for employment growth. Leading indicators such as job advertisements and job vacancies also point to more modest growth in employment over the next six months than earlier envisaged. The participation rate is expected to remain around current levels, which is somewhat lower than the profile underlying the forecasts in August.

The combination of these changes means that there has been little change to the forecast for the unemployment rate, which is expected to edge lower over the forecast period. This implies that there is likely to be a degree of spare capacity in the labour market for some time.

Inflation

The September quarter underlying inflation outcome was broadly in line with expectations at the time of the August *Statement*. As a result, there has been little change to the forecast for underlying inflation; it is expected to remain at around 1½ per cent over 2016 and to pick up to around 1½–2½ per cent by the end of the forecast period. There has been some upward revision to the forecast for headline inflation given the legislated rise in the tobacco excise, which is expected to add about 0.4 percentage points to headline inflation in 2017 and 0.3 percentage points in 2018. Headline inflation is expected to pick up to around 1½–2½ per cent by early 2017 and to remain in that range over the rest of the forecast period.

Wage growth appears to have stabilised, although at low levels. Liaison suggests that private sector wage growth is likely to remain broadly stable in the year ahead and that the risks of further declines in growth have diminished somewhat. Growth in the wage price index (WPI) is expected to pick up gradually as labour market conditions improve and the effect of the large decline in the terms of trade on firms' output prices wanes. However, growth in the WPI is expected to remain low as it is anticipated that there will continue to be spare capacity in the labour market over the next few years. Indeed, liaison suggests that there is not strong 'pent-up' demand for larger wage increases, following below-average increases in recent years.

Broader measures of labour costs, such as average earnings per hour from the national accounts (AENA) – which include both non-wage costs (such as allowances) and any effect on labour costs from changes in the composition of employment – are also expected to pick up. Growth in AENA has increased in recent quarters but had been generally weaker than growth in the WPI over recent years, reflecting cyclical weakness in non-wage costs arising from spare capacity in the labour market and workers moving from high-paying mining jobs to similar types of work at lower levels of pay. Both of these factors are expected to wane over the next few years, so AENA is expected to grow at a faster pace than the WPI towards the end of the forecast period.

The effect of these wage developments on firms' costs and, hence, inflation will depend on how labour costs evolve relative to labour productivity. Unit labour costs have been low for a number of years because wage growth has been matched by growth in productivity. Productivity growth has picked up over the past couple of quarters, but it is projected to settle at a bit below its average rate over the inflation-targeting period. Growth in unit labour costs is expected to rise gradually. As labour costs constitute a sizeable share of the inputs to non-tradables components of the CPI, such as market services, the pick-up in unit labour costs is expected to lead to an increase in non-tradables inflation.

The decline in spare capacity in various product markets is also expected to lead to a gradual pick-up in inflationary pressures. For example, the effects of heightened retail competition on food and consumer durable prices are expected to diminish, although only gradually. However, some product markets are likely to experience surplus capacity for some time. In particular, large additions to housing supply are expected to keep rent inflation low over the next few years.

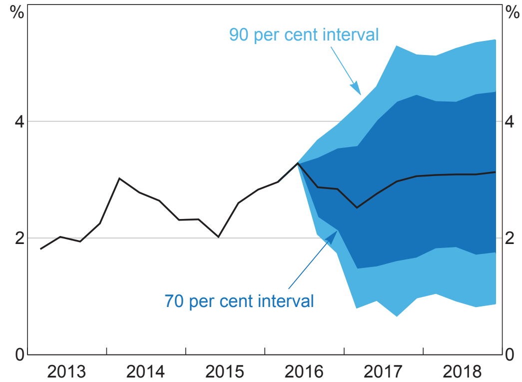
While estimates of the timing and degree of the pass-through of the exchange rate depreciation to final prices are imprecise, it is likely that the boost to the prices of tradables items from the large depreciation since 2013 has largely run its course. The recent increase in prices of commodities, in particular oil, is expected to contribute to inflationary pressures in the period ahead, following a period where fuel prices have subtracted from headline inflation.

Key Uncertainties

The forecasts are based on a range of assumptions about the evolution of some variables, such as the exchange rate and the cash rate, and judgements about how developments in one part of the economy will affect others. One way of demonstrating the uncertainty surrounding the central forecasts is to present confidence intervals based on historical forecast errors (Graph 6.3; Graph 6.4; Graph 6.5).

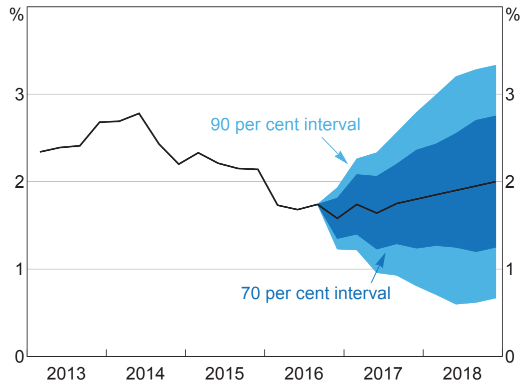
It is also worth considering the consequences that different assumptions and judgements might have on the forecasts and the possibility of events occurring that are not part of the central forecast. A key source of uncertainty for the forecasts continues to be the outlook for growth in the Chinese economy and its implications for commodity prices, Australia's exports and the terms of trade. Higher commodity prices, particularly for oil, are likely to contribute to global inflationary pressures, which could affect the path of monetary policies over the forecast period. This, in turn, could affect financial market prices, particularly exchange rates, which are assumed to be constant in the forecasts. As has been the case for some time, geopolitical risks

Graph 6.3
GDP Growth Forecast*
Year-ended



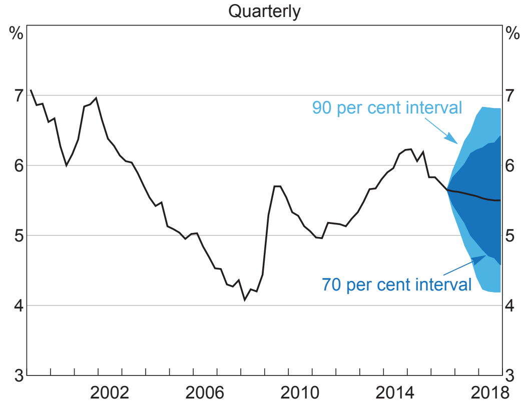
* Confidence intervals reflect RBA forecast errors since 1993
Sources: ABS; RBA

Graph 6.4
Trimmed Mean Inflation Forecast*
Year-ended



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

Graph 6.5
Unemployment Rate Forecast*
Quarterly



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

and global financial stability risks could also affect global growth and financial market prices, should they materialise. Domestically, there is considerable uncertainty about the momentum in the labour market, the extent to which household income and consumption growth will pick up over the next few years and the outlook for the housing market. All these sources of domestic uncertainty present risks to the outlook for activity and inflation.

The Chinese economy, commodity prices and Australia's terms of trade

The outlook for the Chinese economy remains a key source of uncertainty for the outlook for commodity prices, Australia's exports and the terms of trade. One aspect of that uncertainty is the high and rising level of debt, particularly within the corporate sector. Also, the longevity of the current strength in the property sector and the associated demand for upstream manufactured items is hard to predict. A number of local government authorities have responded to sharp rises in property prices by introducing a range of measures, including higher minimum downpayments and direct restrictions on house purchases in some locations. Although to date these initiatives have not stopped the upward trend in housing price growth, it is likely that continued efforts will eventually dampen residential investment and, hence, the demand for steel. The forecasts for iron ore and coking coal demand are predicated on a profile for Chinese steel production that increases a little further from current levels before gradually declining. Furthermore, it is not clear whether the Chinese authorities will continue to enforce policies that have contributed to lower Chinese production of iron ore and coal, given the sharp run-up in prices of bulk commodities, particularly for coal.

There is also uncertainty about how the change in the profile for the terms of trade will affect the domestic economy. The increases in commodity prices are not expected to lead to a material change in mining investment over the forecast period, partly because some of the larger price increases are expected to be temporary. However, with the terms of trade no longer falling and expected to be relatively stable over the forecast period, and the drag on GDP growth from falling mining investment likely to wane, it is possible that nominal income growth, domestic demand growth and inflationary pressures will pick up more quickly than currently forecast.

Global inflationary pressures

Overall, the risks to global inflation appear to have become more balanced. The pick-up in oil and other commodity prices from their troughs around the beginning of 2016 is expected to contribute to global inflationary pressures. These effects have already contributed to a pick-up in producer price inflation, including in China and the United States. At the same time, growth in the major advanced economies is expected to reduce the extent of spare capacity in labour and product markets over the forecast period. Indeed, over the past month, at least some of the increase in US, German and UK sovereign 10-year bond yields can be attributed to an increase in longer-term inflation expectations. Financial market measures of long-term inflation expectations in Australia have also stabilised in recent months, after falling earlier in the year. However, there is uncertainty about the extent to which inflationary pressures will build, given the length of time that inflation has been below central banks' targets.

Momentum in the labour market

Indicators of Australian labour market conditions have been mixed. The decline in the unemployment rate over the past year has been larger than expected. However, the participation rate has retraced its earlier increases and the ABS measure of underemployment has remained relatively high, consistent with employment growth having been driven by part-time work. It is possible that the anticipated growth in the demand for labour will be accommodated by providing part-time workers with additional hours. This could see total hours of employment increase without a reduction in the unemployment rate. Furthermore, while the forecasts make some allowance for the fact that a sizeable contribution to GDP growth comes from LNG production over the next few years, it is possible that there will be less employment generated from GDP growth than envisaged. There is also considerable uncertainty around the projection for the participation rate. The expected improvement in demand could encourage people to enter the labour force. However, it is possible that the participation rate could decline further owing to the ageing of the population, in which case the unemployment rate – and the extent of spare labour market capacity – could fall further than forecast.

Household consumption and saving

Household consumption growth has been supported by low interest rates, rising employment and gains to household income and wealth. The household saving ratio has declined, continuing the trend of recent years. The forecasts assume that households will sustain consumption growth in a period of moderate income growth by reducing their rate of saving gradually over the coming year. However, there is uncertainty about households' consumption and savings decisions.

Households' views about the outlook for the growth of their income and wealth are relevant to those decisions, as are any liquidity or credit constraints that households might face and their expectations about interest rates. In the 1990s and early 2000s, household income growth was relatively strong and this was expected to continue. Additionally, households experienced increased access to credit as a result of financial deregulation and the decline in nominal interest rates as a result of disinflation. These factors allowed households to reduce their saving and increase their leverage over a lengthy period of time. Over the second half of the 2000s, the saving ratio increased significantly, partly in response to the uncertainty created by the global financial crisis as well as strong household income growth associated with the mining investment boom, and has declined only gradually over recent years.

If households become more confident about their future employment, income or wealth, then the saving ratio could fall by more than currently forecast and consumption growth would be stronger. However, the saving ratio may not decline if households come to believe that future income growth will be weak, particularly for those households servicing sizeable debts; if that occurs, consumption would be lower than forecast.

The housing market

Recent strength in dwelling investment, particularly the construction of higher-density dwellings, has played a role in supporting the rebalancing of economic activity away from the resources sector. Low interest rates and increases in housing prices have encouraged a substantial increase in the supply of apartments and the pipeline of residential work yet to be done has increased to historically high levels. While this pipeline should support growth in dwelling investment over the next year or so, the outlook for dwelling investment beyond this period is uncertain.

There is concern about the risk of an oversupply of apartments in specific geographical areas, such as inner-city areas of Melbourne and Brisbane. Outside Western Australia, the supply of housing has to date largely been absorbed by population growth. However, if growth in housing demand does not continue to keep pace with the scheduled large increases in supply, it would place downward pressure on housing prices and rents and increase the risk of off-the-plan apartment purchases failing to settle. If the broader housing market was to weaken substantially, consumption growth may be lower than currently expected in response to wealth and income effects. Consumer price inflation would also be affected as housing costs comprise a significant share of household expenditure.