Overview

In the second half of 2013, growth in Australia's major trading partners looks to have continued at close to the average pace of the past decade. Economic growth in China remained a little above the government's target of 7.5 per cent for 2013, supported by consumption and investment. In Japan, economic conditions showed further improvement towards the end of last year, consistent with expansionary fiscal and monetary policy and the associated depreciation of the yen. In the rest of east Asia, growth over recent quarters appears to have been close to its average of the past decade and was broad based across consumption, investment and exports. There are signs that economic growth in India has improved somewhat, and inflation has eased a little but remains high. The recovery in the US economy strengthened through the second half of 2013, driven by private demand, and the labour market continued to improve. The recent agreement on the budget implies a smaller contraction in public demand than was scheduled to occur. In the euro area, there are tentative signs of a gradual recovery. Inflation in the major economies remains low, although it has increased in Japan.

With the global economy evolving broadly as expected since the November *Statement*, the Bank's forecast for growth in Australia's major trading partners is little changed. Year-average trading partner growth in 2014 is expected to be a bit faster than in 2013, at around 4½ per cent, driven by a recovery in the advanced economies. It is expected to return to its decade average of around 4 per cent in 2015.

Overall, commodity prices are lower in the past three months than in the preceding period, with spot prices for iron ore and coking coal having declined over the past couple of months. While global demand for commodities is expected to continue to expand, commodity prices, and hence Australia's terms of trade, are likely to decline gradually over coming years on the back of strong growth in global production of bulk commodities. This follows a number of years of high investment in the resources sector in Australia and elsewhere.

Financial markets have been focused on two factors in recent months: the policy actions of the major central banks and developments in emerging markets. The US Federal Reserve started the process of reducing its asset purchases and also indicated that it is likely to keep the policy rate at its current low level for a considerable period. Meanwhile, the European Central Bank stated that it will take further action to address the risk of deflation, if needed, and the Bank of Japan stands ready to increase the extent of its stimulus, but so far it has not suggested that this will be needed to meet its inflation goal. The response of most bond markets to these developments was fairly muted, with yields largely unchanged. Moreover, borrowing costs of countries in the periphery of the euro area declined to their lowest level in some time. Corporate bond spreads in the United States and the euro area continued to narrow. In contrast, financial conditions in some emerging markets have become more unsettled of late. In these cases, bond and equity prices have fallen and exchange rates have depreciated noticeably. This recent weakness follows from a general lessening of the appetite for risk compounded by country-specific problems.

The Australian dollar has depreciated by around 5 per cent since the November *Statement* in response to economic developments both at home and abroad. This unwound the appreciation over the preceding few months, leaving the currency around 12 per cent lower than it was at the time of the May *Statement*. If sustained, lower levels of the exchange rate will assist in achieving balanced growth in the economy.

The economy looks to have expanded at a below-trend pace over the second half of 2013, although a range of indicators suggest that conditions have been more positive of late. Below-trend growth has occurred against the background of declining mining investment, subdued growth of non-mining business investment, ongoing fiscal restraint and the high level of the exchange rate that had prevailed. It is too early to have seen the effects of the most recent movements in the Australian dollar on economic activity, but the effects of the lower currency would be expected to begin to appear in the traded sector over the year ahead.

Consumption growth was a little below average over the year to the September quarter, consistent with little growth in employment and slow growth of wages. However, indicators of consumption have been more positive of late. Growth of retail sales picked up over the latter months of last year and the Bank's liaison points to further growth around the turn of the year. Measures of consumer sentiment remain a little above average, notwithstanding a small decline. The run-up in housing and equity prices over the past year or so would typically be associated with consumption growing a bit faster than incomes, so the household saving rate may decline a little in coming quarters.

While dwelling investment made only a minor contribution to growth in the economy over the year to the September quarter, a strong increase in approvals for residential building points to a pick-up in investment in the coming year. Low lending rates and the continued strength in the established housing market are providing support to new dwelling activity. Nationally, housing prices have increased by around 10 per cent over the past year, with recent increases broad based across capital cities. Demand for established housing has been strong by both investors (particularly in New South Wales) and repeat-buyers, with the value of loan approvals to these buyers increasing strongly over 2013. Accordingly, growth of housing credit, while still low by historical standards, is gradually picking up, and more so for investors.

Mining investment appears to have declined over the past year and is expected to fall further over the next few years. This has been, and will continue to be, associated with lower capital imports and rising exports as more resource projects reach completion. Indeed, exports have grown strongly of late, largely reflecting higher resource exports. Exports of services and manufactured goods have been little changed over the past year, although the depreciation of the exchange rate should provide support for these exports over time.

Non-mining business investment remains subdued. While this is consistent with measures of business conditions and confidence having been below average over the past year, in the past few months these measures have improved noticeably. Some measures of business conditions have increased to be a little above average. However, at this point, surveys of investment intentions for non-mining investment remain subdued and liaison suggests that firms want to see a substantive improvement in demand conditions before committing to hiring new workers or increasing investment significantly.

The labour market has remained weak, a result of growth in economic activity having remained below trend. There has been little employment growth over the past year, the unemployment rate has edged higher and the participation rate has declined noticeably. Much of the weakness in employment has been accounted for by business services, which in part reflects the effects of the shift from the investment to the production phase of the resources boom. Forward-looking indicators of labour demand, such as vacancies and job advertisements, have shown tentative signs of stabilising over recent months, but remain at low levels consistent with only slow growth of employment in the months ahead.

Weakness in the labour market has seen growth of wages slow further. Various measures of wage growth are now around the lowest they have been over the past decade or longer. Wage growth is likely to remain moderate for some time given the weak labour market, with fiscal restraint also weighing on public sector wage growth.

Consumer price inflation was higher than expected in the December quarter, for both tradable and non-tradable items, and picked up in the second half of 2013. In the quarter, much of the pick-up was attributable to tradables prices, which have increased in recent quarters after declining markedly since 2010. However, non-tradables inflation (abstracting from increases in administered prices) also increased in the quarter. The various measures of underlying inflation suggest that the quarterly pace picked up to between ¾ and 1 per cent in the December quarter, and in year-ended terms underlying inflation is now a touch above 2½ per cent.

There are several possible explanations for the higher-than-expected inflation outcome. For tradable items, it could be that higher import prices, following the depreciation of the exchange rate, have been passed through to final consumer prices a little faster than in the past. For non-tradable items, it could be that slower growth of labour costs is taking longer than usual to pass through to final prices. More generally, margins in both the traded and non-traded sectors may have increased. Such a rise in margins appears to be at odds with the below-trend growth of consumption, at least over the year to the September quarter. However, more recently there have been tentative signs of improved trading conditions for the retail sector, housing construction and domestic travel and leisure. If the higher-than-expected inflation did result from a strengthening in demand, this would suggest that there is less spare capacity in the economy than previously thought. Alternatively, it could be that there is less spare capacity because the productive potential of the economy has been growing more slowly than previously thought given subdued non-mining investment. It is equally possible that the quarterly outturn reflects a degree of random noise in the data. It is not possible to distinguish clearly between the different explanations because of the inability to directly observe pass-through, margins, costs or noise. Some combination of these may be at work.

The outlook for the domestic economy is a little stronger over 2014 than at the time of the November *Statement*. The revision reflects, in part, the effect of the lower exchange rate, which is expected to provide some boost to activity in the traded sector. As foreshadowed by the improvement in a number of indicators of activity over recent months, GDP growth is likely to strengthen a little in 2014 though to a pace that is still only trend at best. Growth is then expected to pick up to an above-trend pace by mid 2016. The outlook for the next year or so reflects the substantial fall in mining investment and planned fiscal restraint. At the same time, low interest rates are stimulating prices and turnover in the established housing market as well as dwelling construction. Over time, these conditions can be expected to lead to higher consumption growth and provide support for non-mining investment. Also, resource exports are expected to continue to make a significant contribution to output growth for some time as resource investment projects reach completion.

With growth of economic activity expected to remain below trend for a few more quarters at least, it is likely that employment growth will be only moderate over the coming year and the unemployment rate will continue to edge higher. From around early 2015, stronger economic growth should underpin an increase in labour demand, with growth in employment increasing and the unemployment rate declining gradually.

The inflation forecasts have been revised higher in the short term, reflecting the effect of the depreciation of the exchange rate since November and the higher-than-expected December quarter CPI outcome, offset somewhat by the impact of the softer outlook for wages growth. Underlying inflation is expected to be close to 3 per cent over the year to June 2014. Given the slow growth of wages and limited domestic cost pressures more generally, underlying inflation is then expected to decline to be closer to 2½ per cent. Headline inflation is expected to peak a bit higher than underlying inflation, reflecting movements in some volatile items. As these effects drop out of the year-ended rate, headline inflation is also forecast to decline. Over the forecast period, inflation is expected to be consistent with the 2 to 3 per cent target.

Overall, the risks surrounding the forecasts for the global economy appear to be broadly balanced for most countries. However, in the United States more positive economic conditions and recent progress in addressing budget funding issues suggest that the risks there are now somewhat to the upside. In the euro area, the risks are still to the downside, reflecting the ongoing need for resolution of its banking and fiscal problems. Financial market volatility and capital outflows affecting some emerging market economies remain an important concern. If these problems were to deepen and become more widespread, they could impinge upon the global outlook.

For the domestic economy, there are both downside and upside risks for economic activity and inflation. The magnitude and timing of the decline in mining investment over the forecast period remains an important source of uncertainty, as does the anticipated pick-up in non-mining investment. For the household sector, the weak growth of labour income could weigh on spending, although rising asset prices and higher turnover of housing could work to boost consumption by more than expected.

There are a number of plausible explanations for the higher-than-expected inflation data in the December quarter, and so the implications of that for activity and inflation are unclear at this stage. In particular, there is uncertainty about the speed and extent of pass-through of the lower exchange rate, which is working to increase inflation, and the weaker growth of wages, which is working in the other direction.

After reducing the cash rate by 25 basis points in August, the Board kept the cash rate at 2.50 per cent. This has left interest rates for household and business borrowing at historically low levels. Over the past few months, there have been further signs that very stimulatory monetary policy is working to support economic activity. This is clearly evident in the housing market and indications are that dwelling investment will pick up in the coming quarters. There have also been some recent signs of a modest improvement in consumer spending and a recent pick-up in business sentiment. These developments, and the depreciation of the exchange rate over recent months, suggest that there are reasonable prospects for activity outside the resources sector to pick up over time. Nevertheless, it is likely that the unemployment rate will continue to edge higher for a few quarters, and turn down only after growth rises to an above-trend pace. The recent further depreciation of the exchange rate will also add to inflation for a period. But domestic cost pressures remain contained and, over the forecast period, inflation is expected to remain consistent with the target.

At the December and February meetings, the Board judged that, given the substantial degree of policy stimulus that had been imparted and evidence of its effects, it was prudent to hold the cash rate steady. At present, market pricing suggests no change to the cash rate is expected for about a year.

The Board will continue to assess the outlook and adjust policy as needed to foster sustainable growth in demand and inflation outcomes consistent with the inflation target over time. Based on the outlook for inflation and activity as it currently stands, the Board's view is that a period of stability in the policy rate is likely.