5. Economic Outlook

The outlook for the Australian economy is for growth to pick up over the next two years, supported by accommodative monetary policy, a pick-up in mining investment and a turnaround in dwelling investment. GDP growth was lower than forecast in the September quarter and this partly explains the downward revision to the forecasts for year-ended growth over the next few quarters compared to those presented in the November *Statement on Monetary Policy*. The forecasts have also been revised a little lower in the near term to account for some effect from the recent bushfires and the coronavirus outbreak in China; beyond the near term, forecasts for growth are largely unchanged.

The labour market and inflation forecasts are little changed from the November *Statement*. The unemployment rate is forecast to fall to around 4¾ per cent in 2021. Wages growth is expected to continue at around its current pace over the forecast period. Inflationary pressures in the economy remain subdued. Inflation is expected to increase a little over the next couple of years, as spare capacity in the economy declines, to be around 2 per cent by the end of 2021.

Before the coronavirus outbreak in China, there had been signs of stabilisation in the global economy, particularly in relation to trade and manufacturing following the easing of US–China trade tensions, and the global outlook appeared to be on a firmer footing. However, the near-term outlook for growth in Australia's major trading partners has been revised lower following the coronavirus outbreak and the outlook for India has also been revised lower given domestic developments there.

The risks to global growth remain on the downside and the near-term outlook is more uncertain. The coronavirus outbreak is a significant near-term risk for Chinese growth, with spillover effects to other economies, particularly within Asia, because of fewer Chinese travellers, weaker Chinese demand for other exports and disruption to global supply chains. There will be near-term spillover effects to Australia, including through reduced numbers of tourists and a delayed arrival of students from China, along with lower commodity prices. While the recent US–China phase one trade agreement offers some near-term stability, the deal has limited scope and leaves some issues unresolved, which could result in a future escalation in the US–China trade tensions.

There are a number of uncertainties regarding the domestic economic outlook. In the near term, the bushfires and other recent climate-related events will weigh on the economy. The effects of the coronavirus on the Australian economy are quite uncertain, particularly because these events are still evolving. A shift down in households' expectations about future income growth and a restructuring in household balance sheets could weigh on consumption growth for longer than currently assumed. The risks around the expected turnaround in dwelling and business investment are balanced. The risks to the wage and price inflation forecasts are also balanced, and will depend, in

Table 5.1: Output Growth and Inflation Forecasts[a]

Per cent

	Year-ended					
	Dec 2019	Jun 2020	Dec 2020	Jun 2021	Dec 2021	Jun 2022
GDP growth	2	2	2¾	3	3	3
(previous)	(2¼)	(2½)	(2¾)	(3)	(3)	(n/a)
Unemployment rate[b]	5.2	5¼	5	5	4¾	4¾
(previous)	(5¼)	(5¼)	(5¼)	(5)	(5)	(n/a)
CPI inflation	1.8	1¾	1¾	1¾	2	2
(previous)	(1¾)	(2)	(1¾)	(1¾)	(2)	(n/a)
Trimmed mean inflation	1.6	1¾	1¾	1¾	2	2
(previous)	(1½)	(1¾)	(1¾)	(1¾)	(2)	(n/a)
	Year-average					
	2019	**2019/20**	**2020**	**2020/21**	**2021**	**2021/22**
GDP growth	1¾	2	2¼	2¾	3	3
(previous)	(1¾)	(2¼)	(2¾)	(2¾)	(3)	(n/a)

(a) Technical assumptions include the cash rate moving in line with market pricing, TWI at 58, A$ at US$0.67 and Brent crude oil price at US$54 per barrel; shaded regions are historical data; figures in parentheses show the corresponding forecasts in the November 2019 *Statement on Monetary Policy*

(b) Average rate in the quarter

Sources: ABS; RBA

part, on the pace at which spare capacity in the economy is absorbed as growth picks up.

Domestic growth is expected to strengthen

Australian GDP growth was a little lower than expected in the September quarter and recent monthly indicators point to moderate GDP growth in the December quarter. Overall, GDP growth is expected to have been 2 per cent over 2019 (Table 5.1, Graph 5.1). The bushfires and the coronavirus are expected to weigh modestly on growth in late 2019 and into early 2020, but growth should recover relatively quickly, to be around 3 per cent over 2021 (see 'Box B: Macroeconomic Effects of the Drought and Bushfires').

Growth in consumption is expected to increase gradually, supported by the ongoing improvement in housing market activity and moderate growth in household income. The outlook for household income and consumption growth continues to be an important source of uncertainty for the domestic growth forecasts. Although dwelling investment is expected to subtract from GDP growth for a few more quarters, recent data have provided further confidence that dwelling investment will contribute to growth further out. Public demand and business investment (particularly mining-related) are expected to support growth over the forecast period. Exports are expected to increase over 2020, led by resource exports, although the recent bushfires and the outbreak of coronavirus are expected to weigh on service exports and the drought is expected to depress rural exports. Export growth is expected to taper towards the end of the forecast period as some older LNG gas fields are depleted.

The domestic forecasts are conditioned on the technical assumption that the cash rate moves in line with market pricing, which implies one

25 basis point cut in the cash rate around the middle of 2020. Market expectations for the cash rate are broadly unchanged relative to the November *Statement*. The exchange rate is assumed to be constant at its current level, which is a little lower than at the time of the November *Statement*, and is now around the bottom of its range of recent years. The population aged 15 years and over is assumed to grow by 1.7 per cent per annum over 2020 and 2021. This is broadly unchanged from the November *Statement*.

Consumption growth is expected to recover gradually

Growth in consumption was weaker than expected in the September quarter and monthly indicators suggest consumption remained subdued in the December quarter. Growth in consumption is expected to increase only gradually; in part this is because, after a prolonged period of low income growth, household spending patterns are adjusting to the realisation that future income growth is likely to be lower than previously thought (Graph 5.2). Furthermore, this process of adjustment may include a period of debt reduction, but it is uncertain how long this adjustment will take. Working in the other direction, the significant increase in household wealth over recent quarters and stronger housing market activity are expected to provide support for consumption growth over 2020.

The forecast for household disposable income has been revised a little higher in the first half of 2020 because of expected non-life insurance claims and transfers to households that have suffered losses in the bushfires, but the effects on income growth will be temporary. Further out, small business income is expected to be supported by the recovery in the construction sector and an improvement in farm incomes. The main driver of labour income growth is expected to be a pick-up in employment growth, rather than an increase in wages growth (see below).

The household saving ratio increased strongly in the September quarter and is expected to remain broadly unchanged over coming years.

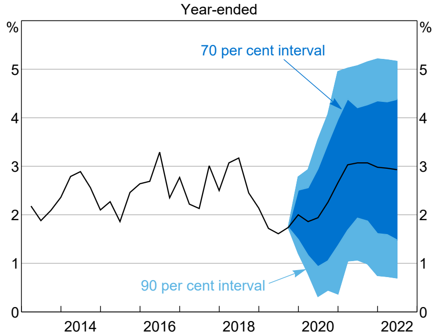
Employment growth is expected to pick up but wages growth is expected to be unchanged

Employment growth slowed in the December quarter, following a sustained period of much stronger employment outcomes than the weak domestic activity over 2019 would have suggested. Leading indicators of labour demand are a bit mixed (see 'Domestic Economic Conditions' chapter). Information from the

Graph 5.1

GDP Growth Forecast*

Year-ended



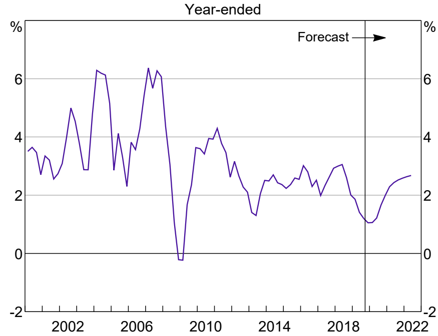
* Confidence intervals reflect RBA forecast errors since 1993

Sources: ABS; RBA

Graph 5.2

Household Consumption Growth

Year-ended



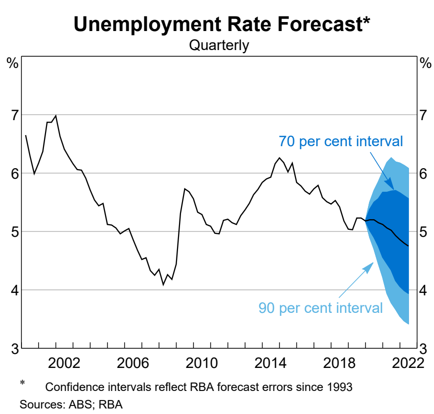
Sources: ABS; RBA

liaison program suggests firms' hiring intentions have continued to moderate but generally remain positive. The forecast for employment growth over the first half of 2020 has been revised down as a result of the overall signal from leading indicators and the downward revision to GDP growth in the near term. Employment growth is expected to pick up again as GDP growth picks up. The participation rate is expected to be largely unchanged over the next couple of years.

The unemployment rate is expected to remain in the 5–5¼ per cent range for some time (Graph 5.3). As GDP growth picks up, the unemployment rate is expected to decline to be around 4¾ per cent in 2021. This forecast implies that the unemployment rate will remain a little higher than estimates of the unemployment rate associated with full employment and that some spare capacity in the labour market will remain for a couple of years.

Wages growth was broadly as expected in the September quarter. The majority of firms in the liaison program continue to expect little change in wages growth over the next year, and only very few firms expect stronger wages growth outcomes in the year ahead. There is also no indication that there will be changes to the government wage caps that have kept public sector wages growth stable over recent years.

Graph 5.3



The superannuation guarantee is legislated to increase from 9.5 per cent of ordinary time earnings to 12 per cent between 2021 and 2025. The increase will be gradually phased in with 0.5 percentage point annual increases from July 2021. Based on evidence from previous increases in superannuation as well as the international literature on increases in mandated benefits, it is expected that increases in superannuation payments will be offset to a large extent by lower wages growth outcomes. It is expected that the adjustment to each increase will take a couple of years, although the timing and extent of the adjustment is very uncertain. If the increase in the superannuation guarantee is not fully offset by lower wages growth, overall labour costs would increase for employers.

In terms of the forecasts, the increase in the guarantee is expected to largely offset the boost to wages growth from the gradual decline in labour market spare capacity.

Dwelling investment is expected to turn around towards the end of 2020

Dwelling investment is expected to continue to decline over coming quarters because the completion of residential buildings has continued to significantly outpace the commencement of new buildings. Following the rebound in established housing markets, there is evidence of a pick-up in the early stages of residential development activity, broadly consistent with the forecasts presented in the November *Statement*. Building approvals appear to have troughed in the December quarter and greenfield lot sales have edged higher. Developers in the Bank's business liaison program report that sales of new housing have increased, although by less than what would historically be associated with very strong growth in established housing prices partly because of tight financing conditions for buyers. The trough in dwelling investment is expected to occur in the second half of 2020, before a recovery in residential construction gets underway through 2021.

Public demand is expected to remain strong in the near term

Public demand growth was stronger than expected in the September quarter and the latest information from the state and federal mid-year budget updates points to further growth in public investment in the near term. Ongoing expenditure on transport infrastructure projects is expected to be partly offset by reduced capital expenditure on the National Broadband Network. The outlook for public consumption is broadly unchanged.

Since the mid-year updates were released, the Australian and New South Wales Governments have announced an additional $3 billion for bushfire recovery, equivalent to 0.15 per cent of annual GDP. Much of the additional expenditure is likely to be public investment to rebuild infrastructure and public buildings. The timing of these expenditures is unclear, but they are likely to contribute to growth over the next year or so.

Business investment growth is expected to pick up from recent weakness

Mining investment was weaker than expected in the September quarter as work on some LNG plants was finalised during the quarter. Information from company liaison and the recent Australian Bureau of Statistics (ABS) Capital Expenditure (Capex) survey nonetheless continues to support the view that mining investment is passing through a trough. Growth is expected to pick up noticeably over 2020 and 2021 as work commences on a number of sustaining and expansionary projects. There are also some projects under consideration but not yet approved, which, if they were to proceed, would further contribute to growth in the latter part of the forecast period.

Non-mining business investment was also weaker than expected in the September quarter, led by a sharp drop in investment in machinery & equipment. Although the weakness was broadly based across industries, it was particularly concentrated in industries exposed to the slowdown in dwelling investment and consumption since mid 2018. The recent Capex survey indicates machinery & equipment investment is also likely to be weaker than previously expected over the remainder of 2019/20. As a result, the forecast for non-mining investment has been lowered for the next few quarters. Other forward indicators suggest that non-residential construction activity is likely to continue growing steadily (largely driven by commercial property), in line with expectations at the time of the previous *Statement*. From late 2020, non-mining business investment growth is expected to increase modestly, in line with a broader pick-up in private demand over the forecast period. Recent bushfire events and air quality concerns have also disrupted some investment activity in the December and March quarters, but this could be more than offset in subsequent quarters once rebuilding efforts get underway (see 'Box B: Macroeconomic Effects of the Drought and Bushfires').

Exports are expected to continue growing over the coming year, although there are some near-term risks

Restrictions on travel following the outbreak of coronavirus in China will reduce tourism and education exports for the next quarter or two, before recovering. Reflecting this, export growth has been downgraded in the March quarter but, as discussed below, assessing this risk is difficult given the situation is still evolving. The recent bushfires are also likely to have weighed on service exports (particularly international tourism) in recent quarters. Over the next few years, education-related travel exports are expected to continue growing modestly, based on government forecasts for student visas.

The broader outlook for resource exports is little changed – export volumes are expected to increase modestly over 2020 then stabilise, with little additional production coming online and global demand fairly steady. LNG production and exports ramped up faster than expected over 2019, and some further modest growth is expected over the next few quarters before stabilising around the end of this year. Over 2021 and 2022, however, LNG export volumes are expected to decline gradually as older gas fields start depleting.

Ongoing adverse weather conditions continue to weigh on rural exports, which are expected to decline by more than previously expected over the next year or so, reflecting both updated information on the effects of drought conditions as well as disruptions and losses to produce and livestock caused by the recent bushfires.

Imports were a little weaker than expected in the September quarter, and partial trade data suggest a further decline in the December quarter, consistent with slower domestic demand growth over recent quarters. Further out, growth in imports is expected to pick up in line with growth in domestic demand.

The terms of trade are expected to decline

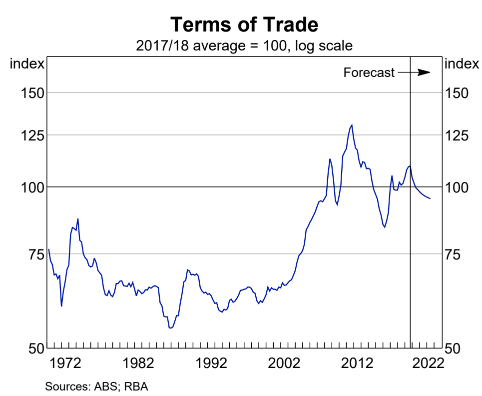
The terms of trade are expected to decrease in the near term, reflecting recent falls in some commodity prices (particularly iron ore) in response to the coronavirus outbreak (Graph 5.4). Further out, the terms of trade are expected to continue to decline, but more gradually, as Chinese demand for bulk commodities moderates and global supply remains ample.

Inflation is expected to increase only modestly

There has been little change to the underlying inflation forecast since the November *Statement* (Graph 5.5). The December quarter inflation outcome was as expected and there have been small but offsetting changes in the determinants of inflation since then. There is still expected to be some spare capacity in the labour market over the next few years, and inflation expectations remain low. As such, underlying inflation is expected to increase modestly to around 2 per cent over 2021. The decline in fuel prices in the quarter to date is expected to subtract from headline inflation in the near term; further out, headline inflation is expected to follow a similar profile to underlying inflation.

Inflation is expected to remain low across a range of components of the CPI for some time. The upward pressure on consumer durables prices from the exchange rate depreciation over the past year or so is expected to have largely run its course. While there have been some reports from liaison that retailers have reduced the degree of discounting, an environment of subdued consumer spending will continue to weigh on retail prices in the near term. The drought-related increases in a wide range of food prices are likely to persist for some time (and may be compounded by the effects of the

Graph 5.4



bushfires); however, the upward pressure is expected to wane eventually. New dwelling inflation is expected to remain subdued until residential construction activity starts to pick up in 2020. Rent growth, which is a slow-moving component of the 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. The amount of renewable energy coming online will also put downward pressure on electricity prices.

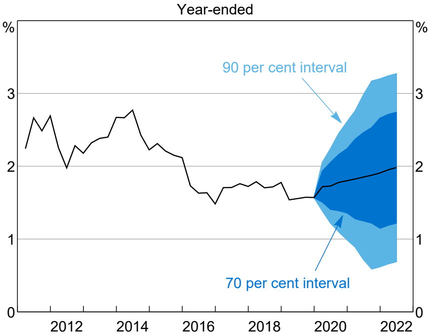
Downside risks to global growth remain

The coronavirus outbreak is a significant near-term risk to the economic outlook for China and Australia's other key trading partners in Asia. There is considerable uncertainty regarding the possible duration and severity of the outbreak, and the effect it will have on economic activity may be larger than currently projected. By comparison, the effects of the Severe Acute Respiratory Syndrome (SARS) outbreak were concentrated in the June quarter of 2003, and mainly affected a number of Asian economies and Canada. The economic effects were largest for the economies at the epicentre of the crisis. For example, it resulted in a sharp one-quarter reduction in GDP growth in China, before recovering fairly quickly, supported by

Graph 5.5

Trimmed Mean Inflation Forecast*

Year-ended



* Confidence intervals reflect RBA forecast errors since 1993

Sources: ABS; RBA

stimulatory policies. It is hard to know whether there will be any sizeable spillover effects this time. However, the integration of China with the global economy has increased since the SARS outbreak, and China is now a more important source of global demand, and also plays a more significant role in terms of global manufacturing and supply chains. On the other hand, the Chinese authorities are likely to respond to any prolonged weakness with additional stimulus.

The progress in addressing the US–China trade and technology dispute has reduced an important downside risk to global growth. However, the phase one agreement reached between the two countries has limited scope and leaves some issues to be still negotiated and resolved. The potential for an escalation of the dispute remains and continues to pose a key downside risk to the global outlook, particularly through the effects of uncertainty on trade and investment.

More broadly, the Chinese authorities face policy trade-offs that are important to the outlook for the Chinese economy, demand for bulk commodities and Australia's terms of trade. The authorities are seeking to strike a delicate balance of avoiding a sharp slowdown in economic growth while preventing an increase in leverage, continuing to facilitate a shift away from shadow banking, preventing speculative activity in the property market and protecting the environment. The emerging configuration of policies to achieve these competing objectives will be important for China's growth trajectory and the outlook for Chinese steel demand.

Globally, financial market conditions remain accommodative and could ease further if growth were to surprise to the upside or if downside risks were to recede further, in an environment of muted inflationary pressures and accommodative monetary policy. On the other hand, financial conditions could tighten over the coming year, for example, if underlying political issues were to resurface or the stabilisation in global economic activity proves to be short-lived. In addition, valuations in many markets are at historically high levels and could reprice abruptly.

The economic impact of the bushfires and coronavirus on the Australian economy is uncertain

The forecasts incorporate a near-term impact of the recent bushfires and coronavirus on the forecasts. However, the effects on economic activity from the coronavirus are particularly uncertain because the situation is still evolving and relevant economic data are yet to be published. In the case of the bushfires, it is particularly hard to assess potential indirect effects on activity and these could present some downside risk to the forecasts in the near term. Indirect effects could include potential loss of productivity in major cities because of smoke pollution. Other indirect effects could include disruptions to regional supply networks, reduced consumer and business confidence that spills over into lower consumption and/or investment growth.

The bushfires are also expected to have an effect on some consumer prices. Liaison reports that transport disruptions in the March quarter resulted in temporary increases in some food prices. Over a longer period, the increased likelihood of longer and more extreme weather events is likely to lead to further increases in insurance premiums.

The outbreak of coronavirus is expected to lead to lower GDP growth in the March quarter, because fewer overseas students and tourists are expected to travel to Australia. There is significant uncertainty around how things will evolve. For Australia, a more severe scenario could also result in less Chinese demand for Australian exports of bulk commodities and food exports in the near term, and could lead to lower commodity prices than currently forecast. This could further weigh on GDP growth over the next quarter or so. On the other hand, the recovery phase could be faster than expected, depending in part on how effectively the outbreak is contained and the stimulus measures introduced by the Chinese authorities. The Australian dollar exchange rate is also likely to depreciate in a more severe scenario, which would provide some offsetting support to the domestic economy.

Risks to business and dwelling investment are balanced

While there could be some near-term effects from the bushfires and the coronavirus on growth, they are currently expected to be relatively modest and short-lived. The central forecast is for a pick-up in economic activity, underpinned by an increase in mining investment in the near term, a turnaround in dwelling investment by the end of 2020 and a gradual strengthening in consumption over coming quarters. The risks to the outlook for business investment are balanced and, while the timing of the trough in housing construction activity is uncertain, the risks around the dwelling investment outlook are more balanced than they have been for some time.

There is a possibility that there will be more mining investment than is currently factored into the forecasts, particularly towards the latter part of the forecast period. The current forecasts incorporate available information on projects that are underway or imminent. However, company information and business liaison suggest that there are some additional mining projects for which investment decisions have not yet been made, but which could commence around the end of the forecast period, further adding to GDP growth. On the other hand, the sharp decline in non-mining machinery & equipment investment in the September quarter was a surprise. An extended period of slow domestic demand could weigh further on firms' investment expenditure plans, although this would leave investment at historically low levels relative to GDP.

The signs of a trough in the early stages of residential building activity have become clearer and the recent increase in established housing prices in some markets has begun to support demand for new dwellings. Currently, dwelling investment is expected to recover more slowly than average historical relationships with interest rates and established housing prices would imply. This judgement reflects the effects of the shift in composition towards higher-density dwellings, tight credit conditions and information from the Bank's business liaison program.

Consumption growth could remain subdued for longer than expected …

Some of the uncertainty around the consumption outlook comes from uncertainty around the outlook for the labour market and household income growth. Any deterioration in labour market conditions would weigh on labour income growth and consumption, particularly given high levels of household debt. Some of the slowing in consumption growth in recent quarters could be related to households lowering their expectations of future income growth following a protracted period of low income growth. If so, it is unclear how long this adjustment process might take. The gradual pick-up in consumption growth in the forecasts is also underpinned by the increase in housing prices and activity in the housing market. Given the recent increase in mortgage payments, it is possible that some of the recent weakness in consumption growth also reflects decisions by some households to improve their balance sheet positions. This adjustment process could also put more downward pressure on consumption growth than we have currently factored into the forecasts.

… although the risks to wages and price inflation are balanced

For wage and price inflation, the risks to the forecasts appear to be evenly balanced. Wages growth could pick up faster than expected if labour market conditions tighten by more than we currently expect. As noted above, the increase in the superannuation guarantee in 2021 is expected to constrain wages growth for many wage earners, although the timing and extent of this is highly uncertain.

Domestic inflationary pressures will depend on how fast the economy recovers from the weakness over the past year and how much businesses and households' inflation expectations remain anchored at low levels. At a more disaggregated level, the risks to inflation appear relatively balanced. The pace of inflation in housing-related CPI components, currently around multi-decade lows, will depend on how quickly residential construction activity increases relative to the demand for housing. Inflation in the prices of food and consumer durables, which has increased over 2019 as a result of the pass-through of the exchange rate depreciation as well as the drought, will also be influenced by any pick-up in consumer demand and any potential changes to competition dynamics in the retail industry.