Overview

In recent months, growth in Australia's major trading partners appears to have remained at around its long-term average rate. The pace of growth in China has increased a little through the year and is consistent with the Chinese Government's target of 7½ per cent. The expansion in activity has been driven by domestic demand. In Japan, following the adoption of more expansionary fiscal and monetary policies late last year, the economy looks to have picked up further in the second half of this year. In the rest of east Asia, growth has continued at around its decade-average pace, while conditions remain fairly subdued in India. The US economy appears to have been growing at a moderate pace; the partial shutdown of the US federal government in the first half of October is expected to have had only a minor effect on activity. The economy in the euro area remains weak but has shown some signs of improvement. Globally, inflation pressures are contained and monetary conditions remain highly accommodative in most economies.

Overall, the outlook for the global economy is much as it was a few months ago and so the forecast for growth in Australia's major trading partners in both 2013 and 2014 is little changed from the August *Statement*. Trading partner growth in 2013 is expected to be slightly below its longer-run average, reflecting a short period of slower growth around the beginning of the year. Growth in 2014 is expected to be a little above average. The prospect of a pick-up in conditions in many advanced economies is likely to see growth for the world as a whole improve from a below-average pace in 2013 to around average in 2014.

Commodity prices have been little changed over the past few months. Spot prices for iron ore and coking coal increased, in line with the expansion of Chinese steel production, but this has been offset by slight declines in the prices of some other commodities. The supply of bulk commodities is expected to continue to increase on the back of high levels of investment in the resources sector globally. This should see commodity prices, and hence Australia's terms of trade, decline further over the coming years from their still historically high levels.

The stance of US monetary policy remained the focus of financial markets over the past few months. Expectations that the Federal Reserve might have begun to pare back its asset purchases as early as October saw yields rise further through to early September. Following the Federal Reserve's mid September meeting, the Fed announced that it was leaving the scale of its asset purchases unchanged for the time being, which saw yields retrace much of the increase observed over earlier months. These developments also had a significant effect on emerging markets, with those countries considered most at risk of capital outflows experiencing rising yields and sizeable depreciations of their exchange rates. That pressure then eased as expectations about the timing of the Fed's decision to reduce its asset purchases were pushed back. More generally, volatility in financial markets has abated with the uncertainty about the US debt ceiling having only a limited impact.

Following the depreciation of the Australian dollar through to early August, the exchange rate was relatively stable until the announcement by the Federal Reserve and the subsequent reassessment by markets of the likely path of US monetary policy. This change in view, along with some more positive Chinese data, saw the Australian dollar appreciate. This recent appreciation means that, on a trade-weighted basis, the Australian dollar is now 6 per cent lower than it was at the time of the May *Statement*.

The Australian economy has expanded at a bit below trend pace this year. Business surveys and the Bank's liaison suggest that current business conditions have been below average for some time. Consistent with this, business investment declined in the first half of the year; estimates suggest that much of this owed to a large fall in mining investment, but there was also a small decline in non-mining investment. Statements by mining companies, information from the Bank's liaison, and a lack of spending on the planning and development of new projects suggest that the level of mining investment will continue to decline over the next few years. Also, non-mining investment looks likely to remain subdued in the near term, with the ABS capital expenditure survey implying a small decline in that part of non-mining investment that is captured by the survey. However, survey-based measures of business confidence and some more timely surveys of current business conditions have increased markedly over the past two months to above-average levels. It is too early though to know whether this improvement will be sustained and the extent to which businesses might be encouraged to take on new risks, increase investment and add to employment.

Growth in household consumption appears to have remained below average over the past year, although indicators have been a bit more positive of late. Retail sales increased modestly over the year to September. However, growth looks to have picked up through the September quarter and there are reports from liaison of some improvement in sales in October. Also, measures of consumer sentiment are now well above long-run average levels.

Meanwhile, conditions in the established housing market have continued to strengthen. Nationally, dwelling prices are now above their late 2010 peak, housing turnover and loan approvals have picked up noticeably over recent months, auction clearance rates remain high, and surveys suggest that households are more optimistic about the housing market. Improved conditions in the established housing market are providing an impetus for dwelling investment, which looks likely to maintain its upward trend. Residential building approvals and other forward-looking indicators of activity, such as loan approvals and first home owner grants for new dwellings, have increased noticeably over the past year.

The large volume of mining investment in recent years has added significantly to capacity, supporting strong growth in resource exports, particularly of iron ore. This growth has resulted in exports making a substantial contribution to aggregate growth over the past year. Resource exports are likely to continue to grow strongly as more mining investment projects are scheduled for completion in the coming years. Other exports have fared less well given the high value of the Australian dollar, although the depreciation since earlier this year will provide some assistance for businesses in the traded sector.

Labour market conditions remain soft. Employment has been little changed since earlier this year, while the unemployment rate has edged higher and the participation rate declined noticeably over that period. At the same time, however, total hours worked have continued to trend higher and more recently there are signs that forward-looking indicators of employment growth may no longer be declining. Nevertheless, indicators of job advertisements and vacancies, as well as surveys of firms' employment intentions, remain consistent with only modest employment growth in the near term.

The softening in labour market conditions observed over the past year or so has seen a broad-based decline in wage growth across industries. Some measures of wage growth are around their lowest in a decade. Moreover, there has been no growth in measured unit labour costs over the past year, notwithstanding a slowing in labour productivity growth to around its long-run average.

Consumer price inflation has been at or below the middle of the inflation target range over the past year, consistent with the generally subdued growth of domestic demand and costs. While inflation picked up in the September quarter, much of this owed to an increase in the price of fuel. Non-tradables inflation has been relatively stable over the past four quarters and, abstracting from what is likely to have been some small impact from the introduction of the carbon price, it is close to the lowest levels seen over the past decade. Prices of tradable items have increased in each of the past two quarters, following a significant decline over the past few years in response to the earlier appreciation of the exchange rate and strong competitive pressures. The exchange rate depreciation since earlier this year has been pushing up import prices, although historical experience would suggest that it is unlikely to have had much effect on most consumer prices as yet; that is expected to occur gradually over the coming quarters.

The various measures of underlying inflation were between ½ and ¾ per cent in the September quarter, which was a touch above earlier expectations. As a result, underlying inflation was a little above 2¼ per cent over the year, close to where it has been for some time. Underlying inflation in year-ended terms still embodies a small contribution from the introduction of the carbon price.

The forecast for the domestic economy has been revised to account for some developments working in different directions. Based on company statements and the Bank's liaison, mining investment looks like it might decline more than was previously anticipated. Also, the appreciation of the exchange rate since the previous *Statement* means that the traded goods sector will be a bit more constrained than was envisaged at that time. Working in the other direction are the improvement in housing market conditions and the recent pick-up in measures of business and consumer confidence. The net effect of these developments is that GDP growth is now expected to remain below trend through next year, before picking up through 2015. The forecast for growth to pick up about a year from now is based on the stimulatory effect of low interest rates, the expectation that growth in Australia's trading partners will be close to, if not above, average, further strong population growth and the need to add to the capital stock after a long period of subdued investment (outside of the resources sector). The recent improvement in sentiment, if sustained, bodes well for the willingness of businesses to invest and expand their operations.

With the economy expected to expand at a below-trend pace over the coming year, employment is expected to continue to grow at a slower rate than the population. Accordingly, the unemployment rate is likely to continue to drift higher for a year or so, but is forecast to decline through 2015 as non-resource activity picks up.

Overall, the inflation outlook is little changed since the previous *Statement*. Inflation, on an underlying basis, is forecast to remain at or below the centre of the target range over the forecast period. This reflects slightly higher-than-expected inflation of late, offset by the effect of slightly softer labour market conditions on domestically generated inflationary pressures. Also, the depreciation of the exchange rate since earlier in the year is expected to push prices of tradable items gradually higher in coming quarters, but by slightly less than was expected three months ago.

For most countries, the risks to the outlook appear to be broadly balanced, with the exception of the euro area where ongoing banking and fiscal problems suggest that the risks are still tilted to the downside. Relative to earlier years, growth in China has slowed to a more sustainable pace. However, uncertainties surrounding how reforms will proceed and the challenges in managing an increasingly dynamic economy could see growth either stronger or weaker than the Chinese Government's target. In the United States, growth could either be above or below the forecast depending, in part, on the outcome of upcoming decisions about the fiscal position and the debt ceiling.

For the Australian economy, there are both upside and downside risks for growth and so for inflation. Some of these relate to the path for business investment. There is uncertainty surrounding the profile for mining investment, which will depend on the viability and timing of some projects as well as any variations in costs for projects already underway. Also, it is difficult to predict the timing and strength of the expected upturn in non-mining investment. While the near-term indicators remain subdued, other factors – including the low level of interest rates and the recent improvement in consumer and business confidence – suggest that there is the potential for a stronger recovery in non-mining investment than currently anticipated. In addition, the extent to which household spending responds to rising household wealth remains to be seen.

The path of the exchange rate is also a significant source of uncertainty for the domestic economy. The Australian dollar appreciated significantly over the past decade, as higher commodity prices led to increased capital inflows to fund the substantial increase in mining investment. The appreciation helped to shift demand to external sources, which enabled domestic capacity to accommodate the unprecedented increase in mining investment. But commodity prices have fallen since their peak two years ago, and mining investment has begun to decline from the record level reached this past year. The exchange rate depreciated earlier this year, but has since retraced some of that decline, in large part reflecting the influence of developments offshore. With the terms of trade forecast to decline only modestly over the coming years, there is some chance that the exchange rate will remain around current levels over the forecast horizon. However, lower capital inflows associated with the decline in mining investment could act to reduce the exchange rate, as could a reduction in stimulatory monetary settings in large economies. A lower exchange rate is likely to be needed to achieve balanced growth in the economy. A lower exchange rate, if it came about, would also see growth strengthening sooner than forecast and place some upward pressure on inflation for a time.

In August, the Board decided to reduce the cash rate by 25 basis points to support growth in the economy while observing that the inflation outlook remained consistent with the inflation target. This brought the cash rate to a low of 2.50 per cent, 225 basis points below where it had been two years earlier, and borrowing rates to their lowest levels for decades. Since the August meeting, there has been further evidence that this cumulative easing in monetary policy is supporting activity in interest-sensitive sectors. Monetary policy acts with a lag, and so the effects of the reductions in the cash rate on activity still have further to run. The stimulus is clearly evident in the housing sector, where prices have accelerated a little in recent months, borrowing is rising a little faster and indicators of construction are moving higher. Also, savers continue to shift towards assets with higher returns and risk, and measures of business and consumer confidence have moved higher to above average levels. So although growth is forecast to remain a bit below trend for a time, there is a reasonable prospect that private demand beyond the resources sector will strengthen over time. Meanwhile, the outlook is for inflation to remain consistent with the medium-term target.

At the meetings since August, the Board judged that given the substantial degree of monetary policy stimulus that had already been put in place, it was appropriate to hold the cash rate steady, but not to close off the possibility of reducing it further, should that be needed to support economic activity consistent with the inflation target.

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.