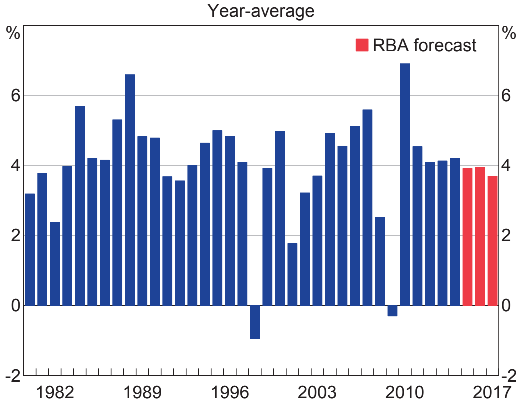
6. Economic Outlook

The International Economy

The outlook for GDP growth of Australia's major trading partners (MTPs) is unchanged from the November *Statement*. Over the next few years, growth is expected to remain around its current rate, which is slightly below its decade average (Graph 6.1). Accommodative monetary policies and low oil prices are likely to support growth in Australia's MTPs which, for the most part, are net oil importers. Globally, core inflation has been stable at low rates, reflecting spare capacity in many labour, product and commodity markets. This, together with the decline in oil prices over the past three months, suggests that headline inflation rates will remain below central bank targets for some time yet.

Growth in China is expected to moderate over the next few years, largely as forecast previously. In the near term, weakness in investment growth and industrial production is expected to be partly offset by the effects of more accommodative monetary and fiscal policies of late. The Chinese economy is expected to continue to slow over the medium term, partly for structural reasons, including the moderation in the growth of both productivity and the urban workforce.

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



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

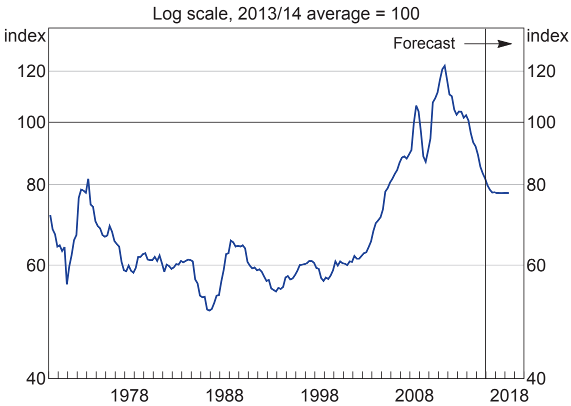
Over the next two years, Japanese GDP is expected to grow at around its trend rate. In other east Asian economies, the ongoing weakness in external demand conditions is likely to continue to dampen export growth despite recent exchange rate depreciations, and investment growth is likely to be lower as a result. Although growth in the region is expected to pick up, it is likely to remain below its decade average over the next two years.

The US and euro area economies are expected to grow at above-trend rates over the next two years. In the United States, monetary policy is likely to remain very accommodative, notwithstanding expected increases in the US Federal Reserve's policy rate. Conditions in the US labour market remain strong and should support consumption growth and above-trend growth more generally, despite weakness in the manufacturing sector, which is likely to endure for some time. In the euro area, growth is expected to remain above trend, supported by accommodative monetary policy, low oil prices and a gradually improving labour market.

A further decline in commodity prices over the past three months has contributed to downward revisions to the outlook for Australia's terms of trade of around 4 per cent since the previous *Statement*

(Graph 6.2). The forecasts for iron ore and coal prices are lower, reflecting a weaker outlook for Chinese steel demand and an expectation that there will be only a limited reduction in global supply from high-cost miners, particularly those in China. The sharp fall in the oil price has also affected the terms of trade and its outlook. In the near term, lower oil prices imply an increase in the terms of trade because Australia is currently a net importer of oil and gas. However, because the price of liquefied natural gas (LNG) is linked to the price of oil, this effect will be increasingly mitigated as exports of LNG ramp up in the years ahead.

Graph 6.2
Terms of Trade



Sources: ABS; RBA

Domestic Activity

In preparing the domestic forecasts, a number of technical assumptions have been employed. The forecasts are conditioned on the assumption that the cash rate moves 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 (TWI at 62 and A$ at US$0.72). This is close to the exchange rate assumptions underlying the forecasts in the November *Statement*. The forecasts assume the price of Brent oil will be US$35 per barrel over the forecast period, which is around 30 per cent lower than the assumption used in November and in line with near-term futures pricing. Similar to the previous *Statement*, the working-age population is assumed to grow by 1.5 per cent over 2016 and 1.6 per cent over 2017, drawing on forecasts from the Department of Immigration and Border Protection.

The starting point for the forecasts is that the Australian economy grew, as expected, at a below-average pace over the year to September 2015. Activity continued to shift from mining to non-mining sectors of the economy. Services sector output grew by around 3½ per cent over the year to September, while goods-related output grew only modestly. Mining investment continued to decline sharply, although this was partly offset by contributions from resource exports. Net service exports also made a significant contribution to growth, partly reflecting the effects of the exchange rate depreciation. Non-mining business investment was little changed over the year. Dwelling investment continued to grow strongly and consumption growth picked up to be close to its decade average. Public demand grew at a below-average pace over the year.

Forecasts for GDP growth are little changed from those presented in the November *Statement*. Year-ended GDP growth is forecast to be 2½–3½ per cent over the year to December 2016, and to increase to 3–4 per cent over the year to June 2018 (Table 6.1).

Low interest rates and ongoing growth in employment are expected to lead to a further pick-up in household incomes and demand. Forecasts for growth in household income have been revised up in line with a slightly stronger forecast of employment in the near term. Meanwhile, consumption growth is projected to increase to be a little above its longer-term average over the forecast period, consistent with the forecasts in the November *Statement*. Together, the forecasts for household consumption and income growth imply a more modest decline in the household saving ratio than previously expected. The high

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

	Year-ended					
	Dec 2015	Jun 2016	Dec 2016	Jun 2017	Dec 2017	Jun 2018
GDP growth	2½	2–3	2½–3½	2½–3½	2½–3½	3–4
CPI inflation	1.7	1½	2–3	2–3	2–3	2–3
Underlying inflation	2	2	2–3	2–3	2–3	2–3
	Year-average					
	2015	2015/16	2016	2016/17	2017	2017/18
GDP growth	2½	2–3	2–3	2½–3½	2½–3½	2½–3½

(a) Technical assumptions include A$ at US$0.72, TWI at 62 and Brent crude oil price at US$35 per barrel; shaded regions are historical data
Sources: ABS; RBA

level of residential building approvals is likely to translate into continued strong growth in dwelling investment in the near term. However, the decline in higher-density dwelling approvals and the easing in housing market conditions are likely to see growth in dwelling investment moderate gradually.

The outlook for resource exports has been lowered somewhat over the forecast period. In part, this reflects an assessment that some large LNG projects will start production a bit later than previously thought, although the anticipated magnitude of the eventual ramp-up in production has not changed. Despite the decline in iron ore prices, low-cost producers in Australia are continuing to expand supply much as previously anticipated. The scope for additional growth in coal exports appears limited, however, given weak global demand for coal and the relatively high cost of some Australian production; the profile for coal exports has been lowered accordingly. Meanwhile, the depreciation of the exchange rate is assisting domestic producers of tradable items. Net service exports are forecast to continue growing strongly.

As earlier expected, mining investment is likely to fall further over the forecast period, as large resource-related projects are completed and few new projects are likely to commence. The lack of a pipeline of new projects has been factored into the outlook for some time and, given this, the recent declines in commodity prices are not expected to result in a significant additional reduction in mining investment.

The outlook is for non-mining business investment to remain subdued in the near term. The ABS capital expenditure survey of firms' investment intentions and the low level of non-residential building approvals suggest that the profile of non-mining investment will be a bit weaker than earlier anticipated. However, some of the preconditions for a pick-up in investment are in place. In addition, survey measures of business conditions remain above average, including now for the goods-related sector, parts of which are relatively capital intensive compared with much of the services sector. The depreciation of the Australian dollar has added support to demand and investment in industries producing tradable goods and services.

Labour market conditions have improved by more than expected at the time of the November *Statement*. Employment growth was above average over 2015 and the unemployment rate was around ½ percentage point lower in the December quarter than earlier anticipated. The participation rate has grown broadly in line with expectations at the time of the November *Statement*. A concentration of economic activity in labour-intensive service sectors, such as household services, may help to explain the strength in employment growth over 2015 despite below-average GDP growth. The low growth of wages also appears to be consistent with more employment growth than there would have been otherwise. These factors are likely to continue to support employment growth for a time. In addition, leading indicators of labour demand, such as job advertisements and vacancies, remain on an upward trend and point to further employment growth over coming months. While employment growth is expected to slow somewhat from the rapid pace seen in the December quarter, it is forecast to remain strong enough to reduce the unemployment rate further. The participation rate is likely to rise further over coming years as individuals are encouraged to enter the labour market as employment opportunities improve.

Inflation

Wage growth has been broadly in line with expectations at the time of the November *Statement*. It is not expected to increase much over the next couple of years, given continued spare capacity in the labour market and information from the Bank's liaison with businesses that suggests employers remain under pressure to contain costs. Further, survey data suggest that firms and unions anticipate that wage growth will remain low.

The December quarter inflation outcome was broadly in line with expectations in the previous *Statement*. The forecast for underlying inflation is little changed. Underlying inflation is expected to remain low over the forecast period.

Domestic inflationary pressures are expected to remain subdued. Inflation in the prices of non-tradable items is forecast to pick up gradually but remain below its inflation-targeting average during the forecast period. This is consistent with the expectation that there will still be spare capacity in the labour market over the next couple of years, albeit less than earlier forecast, and growth of labour costs will remain low. Also, spare capacity in a number of product markets is likely to constrain the ability of many firms to expand their margins.

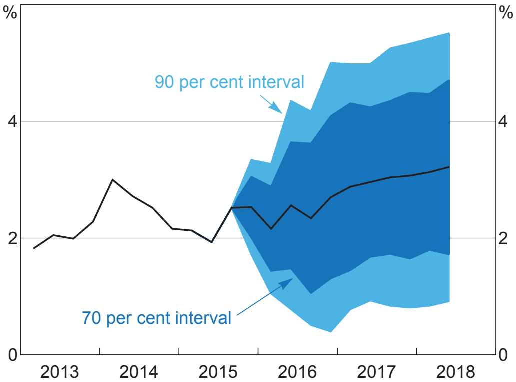
The prices of tradable items are expected to rise over the next few years, as the exchange rate depreciation since early 2013 has led to increases in import prices, which are expected to be gradually passed on to the prices paid by consumers. Based on historical relationships, the direct effects of the exchange rate depreciation since early 2013 are expected to add around ½ percentage point to underlying inflation over each year of the forecast period. However, assessments of the size and timing of exchange rate pass-through are inevitably imprecise and other influences are also at work. Heightened competitive pressures, including from new entrants into the Australian retail market, and greater efforts by retailers to reduce their costs and improve efficiency, are expected to continue to limit the extent to which higher import prices are evident in final retail prices for some time.

Headline inflation has been low over the past year or so, partly as a result of factors that are likely to have a temporary effect. Most notable are lower fuel prices and earlier changes to utility prices stemming from regulatory decisions. As the direct effects of these factors pass, headline inflation is expected to pick up. Lower fuel and utility prices have reduced input costs for a range of businesses, and these lower costs could be expected to be passed on gradually to the prices these businesses charge for their goods and services. The magnitude and timing of these indirect effects on inflation are difficult to gauge. A further increase in the tobacco excise later in 2016 is expected to contribute a bit less than ¼ percentage point to headline inflation, but to have little effect on underlying inflation.

Uncertainties

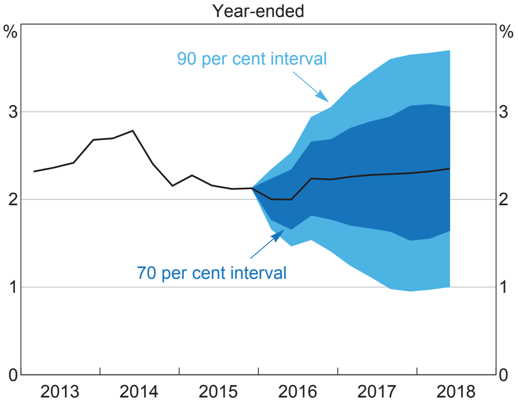
The forecasts are based on a range of assumptions about the evolution of some variables, such as the exchange rate, and judgements about how developments in one part of the economy will affect others. These assumptions and judgements may not hold true, and other unforeseen events may occur, so the economy is likely to evolve differently to what has been forecast. The significant amount of uncertainty these factors generate can be demonstrated by the width of the confidence intervals around the forecasts based on historical forecast errors (Graph 6.3; Graph 6.4 and Graph 6.5).

Graph 6.3
GDP Growth Forecast*
Year-ended



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

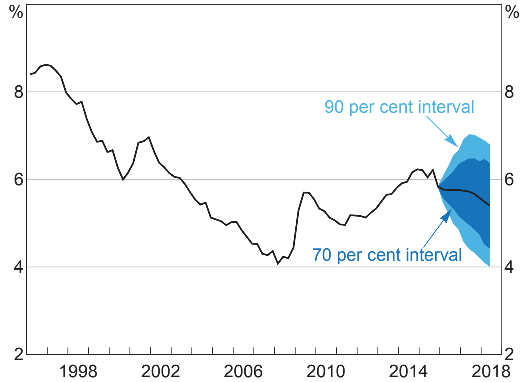
Graph 6.4
Trimmed Mean Inflation Forecast*
Year-ended



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

One of the key sources of uncertainty for the forecasts continues to be the outlook for growth in China and the implications of high levels of debt there. Ultimately, this has implications for commodity demand and commodity prices, and hence for our forecasts for the terms of trade. The outlook for commodities also depends on the responsiveness of supply to the decline in prices seen to date. Domestically, the outlook for the labour market and the response of households to developments in income growth and wealth effects from the housing market are important sources of uncertainty.

Graph 6.5
Unemployment Rate Forecast*
Quarterly



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

Chinese growth and debt

The outlook for China's growth is a significant uncertainty for the outlook for the Australian economy. Conditions in the Chinese construction and industrial sectors remain subdued and are unlikely to improve quickly given the large stock of unsold housing and substantial excess capacity in the manufacturing and mining industries. Policymakers have responded with a wide range of measures, including easing fiscal and monetary policies, encouraging infrastructure project approvals and increasing the extent of directed lending by 'policy' banks. Although monetary policy has scope to ease further, the authorities' efforts to maintain currency stability in the face of capital outflows and intensified depreciation pressures could limit their appetite to undertake a more sizeable easing in monetary policy. Moreover, the response of investment growth to the easing in financial conditions to date has been relatively muted, and there is uncertainty about how effective current measures will be in supporting activity in the next few quarters. While consumption growth has been resilient so far, there is a risk that continued weakness in a sizeable part of the economy will eventually weigh on growth in household incomes and consumption.

Another uncertainty relating to the Chinese economy concerns the substantial stock of debt, particularly in light of weak profitability in some parts of the economy. Excess capacity in much of the industrial sector has contributed to disinflationary pressures, which have raised the real (inflation-adjusted) interest rates faced by firms and thereby increased the burden of servicing debts. Although recent cuts to interest rates by the People's Bank of China have helped to mitigate this effect, it has the potential to cause financial distress, especially in parts of the economy where leverage is already high, and to exacerbate the slowing in economic activity. This poses risks for financial institutions with sizeable on- and off-balance sheet exposures to these firms and to China's growth trajectory more generally.

Any sharp slowing in China is likely to have significant implications for economic conditions in the Asian region and for commodity exporters, including Australia. It is likely that economies with well-established and credible policy frameworks will be more resilient in the face of such shocks. The willingness and ability of policymakers globally to employ monetary and fiscal policy will also affect economic outcomes. A depreciation of the Australian dollar in response to negative developments in external conditions would help to buffer domestic economic conditions.

Commodity prices and trade

The outlook for commodity prices is sensitive to demand, particularly from the Chinese industrial sector, and the responsiveness of supply to the decline in prices seen to date. For oil, the current forecasts assume that prices remain around current levels and that there is only a limited reduction in supply from higher-cost producers. However, it is possible that there is a more substantial response of supply to the sharp fall in prices. Alternatively, additional supply from countries such as Iran could result in even lower prices.

There is some uncertainty about how lower oil prices will affect LNG production in Australia. Most of Australia's LNG producers have long-term contracts to sell particular quantities of LNG to buyers and the forecasts assume that LNG export volumes will not be affected by lower prices over the forecast period. However, lower oil prices will affect the value of LNG sales.

Producers of bulk commodities have generally been reducing their costs of production, aided in part by the low price of oil, which is an important input for extraction and transport of many commodities. However, the ability of firms to keep reducing costs appears relatively limited and this could, in time, lead some firms to exit. While the possibility of significant cuts to global production represents an upside risk to commodity prices, the possibility of unexpected cuts to Australian production represents a downside risk to the forecast for export growth.

The labour market

There is uncertainty about the extent to which the recent pace of improvement in labour market conditions will be sustained. Employment growth is forecast to ease somewhat from the above-trend pace experienced over 2015. It could decline by more than is forecast, but it is also possible that the recent strong growth of employment contains information about the economy not apparent in the national accounts data. Were such strength to be sustained, the unemployment rate could decline more quickly than forecast.

Some indicators do suggest that employment growth may turn out to be stronger than currently forecast. Survey measures of business conditions in the goods-related sector have improved of late, following earlier increases in the services sectors. The depreciation of the exchange rate and low wage growth are helping to restore the international competitiveness of Australia's labour. While temporary factors may have supported household services employment in 2015, particularly in health & social assistance, hiring related to long-run trends, such as the ageing of the population and the related increase in demand for home-based care services, are likely to continue to support the growth of household services employment over the forecast period.

The extent to which the labour supply will increase over the forecast period is also uncertain. In particular, the participation rate is forecast to increase as more people enter the labour market in response to a perceived improvement in their employment prospects. However, the extent to which the participation rate can rise is uncertain. The ageing of the population is likely to limit the increase, but this may be offset for some time by the fact that each generation has tended to have a higher participation rate than the one preceding it. If the participation rate does not rise to the extent expected over the forecast period, the unemployment rate may fall more quickly than currently anticipated. As always, there is uncertainty about the rate of population growth, which also affects labour supply.

Households' expenditure and housing markets

If employment growth does turn out to be stronger than currently anticipated, then labour income growth could pick up more quickly than expected, or vice versa. Household income has grown at a below-average pace in recent years and a sustained period of stronger growth would be likely to support stronger growth of consumption. Consumption growth will also depend on how households respond to the change of momentum in housing prices and associated wealth effects. Relatively few households appear to have used the earlier increase in the value of their dwellings to trade up or increase their leverage for the purposes of consumption, so a levelling out in housing prices may have only a muted effect on consumption growth.

The impact of slowing housing price growth on future growth in dwelling investment is unclear. In the period ahead, dwelling investment seems likely to be supported by continued strong demand from foreign buyers. Information from the Bank's liaison suggests that foreign buyers tend to have long-term motivations for investment and may be relatively unconcerned about temporary fluctuations in housing price growth. Population growth, employment prospects and expectations for future housing price growth are likely to be important considerations for domestic buyers. Some geographic areas appear to be at risk of reaching a point of oversupply, particularly the inner-city areas of Melbourne and Brisbane.