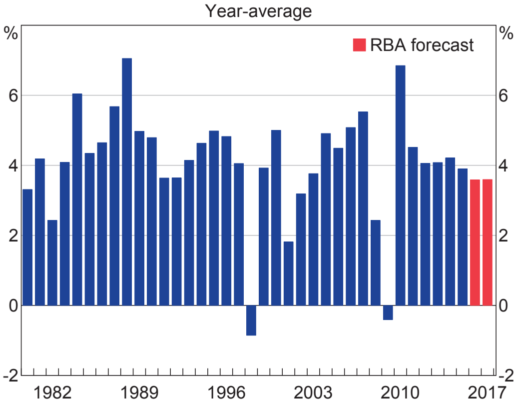
# 6. Economic Outlook

## The International Economy

The outlook for GDP growth of Australia's major trading partners has been lowered a little since the February *Statement*, reflecting weaker-than-expected data for the March quarter across a number of major trading partners, and some reassessment of growth momentum, particularly in Asia. Despite that, the recent rise in commodity prices suggests that Australia's terms of trade are likely to be a bit higher in the near term than earlier forecast.

Over the next two years, growth of Australia's major trading partners is expected to be about ½ percentage point below its decade average (Graph 6.1). Growth will be supported by accommodative monetary policies, less restrictive fiscal policy in some advanced economies and some modest fiscal stimulus in the Asian region.

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




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

Notwithstanding the recent increase, oil prices remain relatively low, which should also support growth because most of Australia's major trading partners are net oil importers.

Growth in China is expected to moderate over the forecast period, largely as forecast previously. In the near term, weaker-than-expected growth of activity in the March quarter is expected to be offset by the effects of policy stimulus over the coming year as the authorities seek to achieve their economic growth target for 2016.

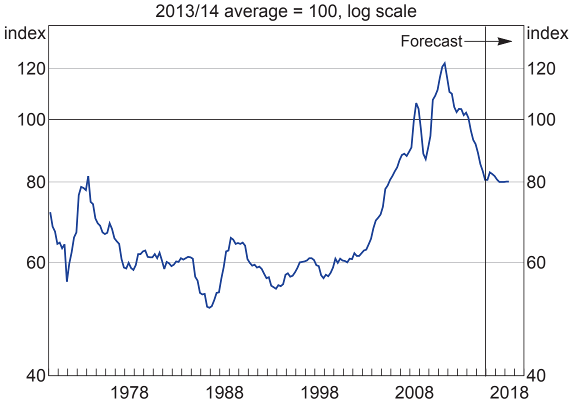
Over the next two years, Japanese GDP growth is expected to be below its trend rate, in part as a result of the scheduled increase in the consumption tax in early 2017. In other east Asian economies, the ongoing weakness in external demand conditions is likely to continue to dampen export demand and investment growth in the private sector; consumption is also likely to be more subdued than previously expected. Although growth in the region is expected to pick up gradually, it is likely to remain below its decade average over the next two years.

Despite some slowing in growth recently, the US economy is expected to grow at an above-trend rate over the next two years. Conditions in the US labour market remain strong and should support consumption growth. US monetary policy remains very accommodative and, after a few years of fiscal consolidation, government spending is likely to add to growth this year. In the euro area, growth is also expected to remain above trend, supported by accommodative monetary policy, fiscal policies that are becoming less contractionary and a gradually improving labour market.

Globally, core inflation has been low for some years, reflecting spare capacity in many labour, product and commodity markets. This suggests that headline inflation rates will remain below central bank targets for some time yet, particularly in advanced economies, although the recent rise in oil prices, if sustained, should place a little upward pressure on inflation.

The terms of trade have been revised a bit higher in the near term since the February *Statement*, following the increase in commodity prices over recent months (Graph 6.2). The rise in commodity prices partly reflects the effect of positive sentiment on commodity demand following the announcement of China's growth target for 2016. However, it is assumed that the prices of bulk commodities will not be sustained at current levels. Indeed, the forecasts for iron ore and coal prices after 2016 have not been revised higher. This reflects an expectation that Chinese steel demand will decline over the next few years, largely as previously forecast. Also, a substantial increase in global production of low-cost iron ore is expected over the next year or two. Furthermore, the forecasts assume that there will be only a limited reduction in the supply of iron ore from high-cost producers, particularly those in China, over the forecast period.

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




Sources: ABS; RBA

The increase in oil prices over recent months has also affected the terms of trade and its outlook. Currently, higher oil prices tend to reduce the terms of trade because Australia is a net oil importer. However, as exports of liquefied natural gas (LNG) ramp up, a rise in oil prices will, by itself, tend to increase Australia's terms of trade because the price of LNG is linked to the price of oil.

## 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 (trade-weighted index (TWI) at 62.5 and A$ at US$0.75). The TWI is little changed from the assumption underlying the forecasts in the February *Statement*. The forecasts are based on the price of Brent crude oil being US$47 per barrel over the forecast period, which is around 30 per cent higher than the assumption used in February and in line with futures pricing for the near term. Similar to the previous *Statement*, the working-age population is assumed to grow by 1.5 per cent over 2016 and by 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 at an above-trend pace over the year to the December quarter 2015. This was stronger than expected at the time of the February *Statement* and, in part, reflected upward revisions to growth, particularly in the September quarter, which is now recorded as having been very strong. Growth was also slightly stronger than expected in the December quarter, though still moderate. Recent indicators are consistent with that moderate pace being maintained in the early part of 2016.

Activity continued to shift from the mining to non-mining sectors of the economy over 2015, supported by low interest rates and the ongoing effects of the exchange rate depreciation since early 2013. Non-mining activity grew at an above-average pace and growth was strongest in industries that provide services to households and businesses. Net service exports increased noticeably over 2015. Growth in household consumption increased in the latter part of the year and dwelling investment continued to grow strongly. Public demand contributed to growth over the year, while non-mining business investment remained subdued. Further sharp declines in mining investment were offset in part by increases in the volume of resource exports.

Overall, the forecast for GDP growth is little changed from that presented in the February *Statement*, although the year-ended growth rate in the near term is a little higher given the recent national accounts data. 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, which is above estimates of potential growth in the Australian economy (Table 6.1).

Low interest rates and gains to employment are expected to support continued strength in household demand, despite only modest growth in household income in the near term. Forecasts for growth in real household disposable income have been revised down as a result of a somewhat weaker outlook for nominal wage growth, which has been offset to some extent by downward revisions to the outlook for inflation. Nevertheless, consumption growth is projected to be a little above its longer-term average over the forecast period, consistent with the forecasts in the February *Statement*. Together, the forecasts for household consumption and income growth imply that the household saving ratio will continue the mild downward trend of the past few years.

The substantial amount of residential construction work in the pipeline is expected to translate into further strong growth in dwelling investment in the near term. However, the decline in higher-density dwelling approvals suggests that the pace of growth in dwelling investment will moderate over time.

The outlook for resource exports by the end of the forecast period is little changed. However, there have been some changes to the profile for iron ore and LNG exports, reflecting expected production delays for some of these projects. While exports of iron ore are expected to increase and production of LNG is set to ramp up substantially, the scope for additional growth in coal exports appears limited, given weak global demand for coal and the relatively high cost of some Australian production. The depreciation of the Australian dollar since

**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 | 3 | 2½–3½ | 2½–3½ | 2½–3½ | 2½–3½ | 3–4 |
| CPI inflation | 1.7 | 1 | 1–2 | 1½-2½ | 1½-2½ | 1½-2½ |
| Underlying inflation | 2 | 1½ | 1–2 | 1½-2½ | 1½-2½ | 1½-2½ |
| | **Year-average** | | | | | |
| | 2015 | 2015/16 | 2016 | 2016/17 | 2017 | 2017/18 |
| GDP growth | 2½ | 2½ | 2½–3½ | 2½–3½ | 2½–3½ | 2½–3½ |

(a) Technical assumptions include A$ at US$0.75, TWI at 62.5 and Brent crude oil price at US$47 per barrel; shaded regions are historical data

Sources: ABS; RBA

early 2013 has been assisting domestic producers of tradable items. Net service exports, which are particularly sensitive to exchange rate movements, are forecast to continue growing.

Mining investment is expected to continue to fall over the forecast period, as large resource-related projects are completed and few new projects are expected to commence, although the extent of this contraction is expected to diminish over time. The recent increases in commodity prices are not expected to result in a significant increase in planned mining investment over the next few years, given the existing capacity and expectations that there will only be moderate growth in global demand for commodities.

Non-mining business investment is expected to remain subdued in the near term, consistent with the ABS capital expenditure survey of firms' investment intentions and the low level of non-residential building approvals. However, very low interest rates and the depreciation of the Australian dollar over the past few years have supported an improvement in business conditions (which is clearly evident in the various survey measures and consistent with the rise in employment) and there is evidence that investment has increased in areas of the economy that have been less affected by the decline in mining investment and commodity prices.

The labour market forecasts are little changed from the February *Statement*. The pace of employment growth has moderated in early 2016, much as expected, following particularly strong outcomes in late 2015. As GDP growth is expected to be a little lower over 2016 compared with 2015, employment growth is also likely to remain lower than last year. Leading indicators of labour demand, such as survey measures of hiring intentions, job advertisements and vacancies, have been mixed of late but, when taken together, they suggest that conditions in the labour market are continuing to improve, albeit at a slower pace than last year. Employment growth is expected to pick up to an above-average pace by the end of the forecast period, driven by a pick-up in GDP growth. Employment appears to have been supported by much lower wage growth than would have been implied by historical relationships with the unemployment rate. In this respect, the forecast for low wage growth can be viewed as providing some further assistance to employment growth. The participation rate is expected to increase as more people enter the labour force in response to the improvement in labour market conditions. In combination, this implies that the unemployment rate is expected to remain around its current rate until mid 2017, before declining gradually, and that there is likely to be a degree of spare capacity in the labour market for some time.

## Inflation

The March quarter underlying inflation outcome was around ¼ percentage point lower than expected at the time of the February *Statement*. The broad-based nature of the weakness in non-tradables inflation and the fact that wage outcomes were lower than expected over 2015 has resulted in a reassessment of the extent of domestic inflationary pressures, leading to downward revisions to the forecasts for inflation and wage growth. Underlying inflation is now expected to remain around 1–2 per cent over 2016 and to pick up to 1½–2½ per cent at the end of the forecast period.

Wage growth has been low over recent years and has been much lower than suggested by its historical relationship with measures of spare capacity, such as the unemployment rate. This may reflect the effect of the decline in inflation expectations and/or the terms of trade, as well as a more flexible labour market than in earlier decades. It is notable also that the phenomenon of surprisingly low wage growth for given labour market conditions has been apparent across a number of advanced economies. Furthermore, the recent inflation data indicate that the weakness in domestic cost pressures is not only evident in low growth of nominal wages but is more broadly based. Indeed, unit labour costs, which incorporate a broader range of labour costs than the wage price index (WPI) and account for changes in the composition of the labour force, have been growing more slowly than the WPI. This reflects the usual cyclical effects of compositional change and weakness in non-wage payments such as allowances. It is also consistent with the movement of workers from highly paid mining-related jobs to other employment.

Given data observed over the past few months, the recovery in wage growth and labour costs underpinning the inflation forecasts has been revised lower. The expectation is that growth in the WPI will remain around current low levels for longer than previously forecast and pick up only very gradually over the forecast period. Unit labour cost growth, which is strongly correlated with non-tradables inflation, is expected to pick up a little faster than the WPI. This reflects an expectation that the dampening effects of compositional change will wane, including because the movement of labour from mining and mining-related firms is already well advanced. In addition, employers may increase bonuses and other labour income payments before increasing the pace of growth in wages. Based on historical experience, unit labour cost growth tends to pick up after the unemployment rate has started to decline. Even so, the increase in unit labour costs is expected to be slower than has occurred in previous comparable episodes, such as the mid 1990s or following the global financial crisis.

The prices of tradable items are expected to rise over the next few years, notwithstanding low global inflation, as the increases in import prices resulting from the exchange rate depreciation since early 2013 are gradually passed through 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 a bit less than 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 in the retail market are expected to continue to limit the extent to which higher import prices become evident in final retail prices for some time.

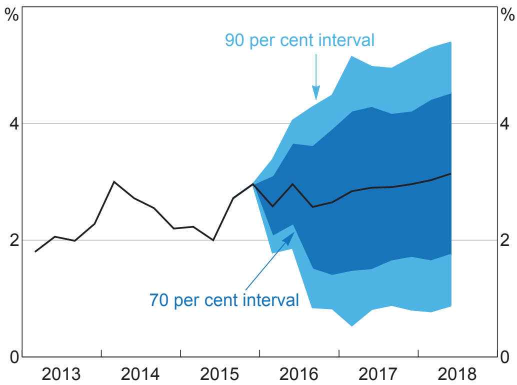
Headline inflation has been lower than underlying inflation over the past year or so, partly as a result of factors that are likely to have a temporary effect, such as lower fuel prices and changes to utility prices stemming from regulatory and policy decisions. As the direct effects of these factors pass, headline inflation is expected to converge towards underlying inflation over the forecast period. The declines in fuel and utility prices over the past year or so have reduced input costs for a range of businesses, and these lower costs are expected to be passed on gradually to the prices that 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 around ¼ percentage point to year-ended 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. 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 and 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. One of the key sources of uncertainty continues to be the outlook for growth in China and the implications of high levels of debt there. In turn,

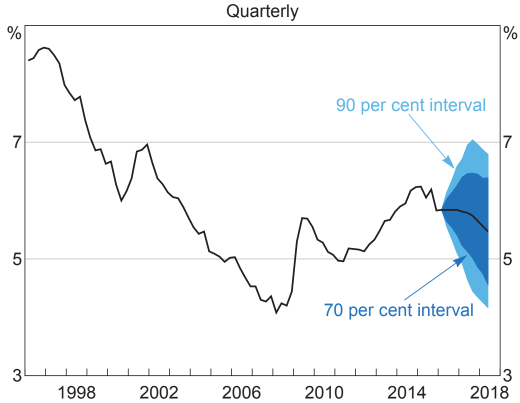
## Graph 6.3
**GDP Growth Forecast***
Year-ended




* Confidence intervals reflect RBA forecast errors since 1993

Sources: ABS; RBA

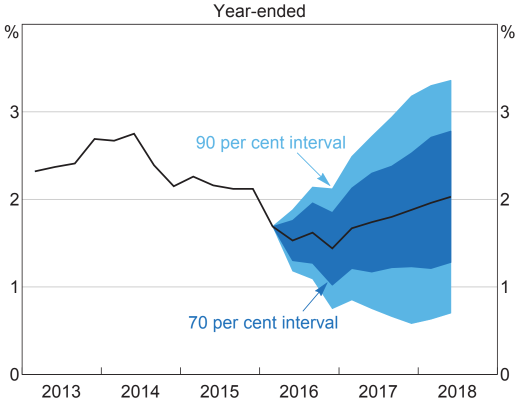
## Graph 6.5
**Unemployment Rate Forecast***
Quarterly




* Confidence intervals reflect RBA forecast errors since 1993

Sources: ABS; RBA

## Graph 6.4
**Trimmed Mean Inflation Forecast***
Year-ended




* Confidence intervals reflect RBA forecast errors since 1993

Sources: ABS; RBA

that has implications for commodity demand and ultimately for the forecasts for the terms of trade. The outlook for commodities also depends on the responsiveness of supply to price movements seen to date. Another uncertainty arising from the international environment is the extent to which labour market tightness in a number of advanced economies will affect wage growth and, ultimately, inflation.

Developments in both commodity prices and the expected path of monetary policy in major advanced economies (based on changes in their outlook for inflation) will have potential implications for the Australian dollar. Based on a number of estimates produced by Reserve Bank staff and academic researchers, a useful rule of thumb is that, all else constant, an exchange rate appreciation of 10 per cent reduces the level of GDP by between ½ and 1½ per cent, generally within two years. However, an exchange rate appreciation caused by a sustained increase in commodity prices may even be associated with a modest increase in economic activity, particularly if higher prices allow some of the smaller Australian resource firms to remain in the market. Domestically, there is also considerable uncertainty about the extent to which wage growth and domestic inflationary pressures more broadly will pick up over the next few years. This raises uncertainty about the outlook for inflation and activity.

## The Chinese economy

China's growth outlook continues to represent a considerable source of uncertainty for the Australian economy. The recent improvement in Chinese property market conditions appears to reflect policy efforts to support the sector over the past year. Stronger property prices and activity could assist the process of reducing China's large stock of unsold residential property and could, for a time, underpin more resilient demand in a range of upstream industries, including the steel industry. However, the sustainability of the present improvement in property markets is uncertain and it appears that substantial excess capacity persists in the manufacturing sector, including the steel industry. More generally, the outcomes of the March political meetings suggest that the Chinese Government is, for the time being, prioritising short-term growth over its longer-term objectives of achieving deleveraging and growth that is less reliant on investment and heavy industry. On the one hand, an increase in debt-funded growth, including a strong pick-up in public spending on infrastructure, may lead to stronger growth in overall activity than otherwise in 2016. On the other hand, this growth would be likely to be achieved by adding to the already substantial stock of debt, potentially delaying efforts to reduce excess capacity in the manufacturing and resources sectors. Declining industrial profits and deteriorating economic conditions in the north-east of the country have the potential to cause financial distress. This poses risks for financial institutions with sizeable on- and off-balance sheet exposures to affected industries and regions, and to China's growth trajectory more broadly.

## Commodity prices and trade

The outlook for commodity prices is sensitive to demand, particularly from the Chinese industrial and construction sectors. The current forecasts assume that the level of Chinese steel demand continues to decline over the forecast period, albeit at a slower rate in the near term than assumed in the previous *Statement*. The medium-term trajectory is underpinned by lower steel demand from construction and manufacturing and, more generally, a gradual shift away from investment-led growth, which is relatively steel intensive, toward a more consumption-led growth path. However, recent signs of a pick-up in construction activity and increased policy support for growth may mitigate or even temporarily reverse the expected moderation in steel demand. This, in turn, would keep iron ore prices higher for longer than expected and so represents an upside risk to the forecasts for Australia's terms of trade.

## Global inflation

Labour markets in a number of advanced economies have been improving over recent years. Unemployment rates have been declining, and are close to levels consistent with most estimates of full employment in the United States, the United Kingdom and Japan. Broader measures of labour underutilisation have also declined towards long-run average levels.

Despite this, nominal wage growth has remained subdued and this has contributed to low inflation outcomes. In the United States, low productivity growth has meant that growth in unit labour costs, which is what matters for inflationary pressures, has been above its long-run average. Nonetheless, there is uncertainty about the extent to which the increasing tightness of labour markets will feed through to growth in wages and unit labour costs, and subsequently to inflation. In some advanced economies, some measures of inflation expectations have declined further, and this has increased the uncertainty about the outlook for inflation.

Concerns about the prospects for a sustained pick-up in inflation have contributed to expectations of easier monetary policy in the major advanced economies. Should inflationary pressures build more rapidly in some advanced economies than currently expected, this could imply a significant change in the expected path of monetary policy, which would have implications for exchange rates. This could be expected to lead to a depreciation of the Australian dollar.

## Domestic cost pressures

There is also considerable uncertainty about the extent to which wage growth, and domestic inflationary pressures more broadly, will pick up over the next few years in Australia. The forecasts for wage growth and inflation have been revised lower to take into account recent data, which suggest that domestic cost pressures have been lower than previously anticipated. However, despite above-trend growth in economic activity and improvements in labour market conditions over the past year or so, it is possible that domestic cost pressures will be weaker than reflected in the forecasts, and so inflation may not pick up as expected. It is possible, for example, that inflation expectations will be persistently lower for longer than currently anticipated, given the forecast of a period of low inflation, which could weigh on wage outcomes.

It is also possible, however, that wage growth will pick up more quickly than forecast. In particular, some of the explanations for why wage growth has been much lower than suggested by its historical relationship with the unemployment rate, such as increased flexibility in the labour market, would be consistent with wage growth picking up quite quickly as spare capacity in the labour market diminishes. For instance, employees may demand larger-than-forecast wage increases to compensate for the prolonged period of unusually low wage growth. Also, the compositional change associated with labour moving from mining and mining-related industries to the non-mining economy is likely to have lowered growth in average earnings per hour. As this process of structural change slows, it is possible that the downward pressure on earnings growth in the non-mining economy will diminish more quickly than expected. Moreover, the unemployment rate may decline more rapidly than anticipated, which would allow wage and earnings growth to pick up by more than currently forecast.

## Consumption and income growth

The outlook for wage growth has implications for household consumption growth. The forecasts assume that households will respond to near-term weakness in income growth by reducing their rate of saving to sustain their consumption growth. This is likely to be a reasonable assumption if households expect the weakness in income growth to be temporary, especially given relatively high rates of saving and gains to household wealth over recent years. If, however, a longer period of low wage growth leads households to lower their expectations for income growth over the longer term, household consumption may not increase to the extent forecast. It is also worth considering alternative explanations for lower wage growth. For example, if wage growth is currently lower than expected because of a rise in the effective supply of labour, the effect on household income is likely to be mitigated by higher-than-expected employment growth.