5. Economic Outlook

Domestic economic conditions have been a bit stronger than were expected at the time of the August *Statement on Monetary Policy*. As a result, the forecast for GDP growth has been revised a little higher and the unemployment rate forecast has been revised a little lower. Consistent with this, the forecasts for wages growth and inflation have also been revised slightly higher. In summary, GDP growth is expected to be above trend over the forecast period and inflation is expected to pick up to 2¼ per cent by late 2019 and to be a little higher in the following year.

GDP growth in Australia's major trading partners is expected to be above trend over the forecast period, although a modest slowing is anticipated. In the major advanced economies, GDP growth is likely to remain above potential next year, supported by accommodative financial conditions and the US fiscal stimulus. As spare capacity diminishes, inflation is expected to increase across the advanced economies. There has been a slight downward revision to the outlook for US growth. This reflects the escalation of trade tensions over recent months, which still represents a material downside risk to the global outlook. GDP growth in the euro area and Japan has also been revised a bit lower, reflecting weakness in export orders.

Economic growth in China remains firm relative to other economies, but is slowing. The recent targeted fiscal and monetary stimulus will partly offset the slowing in growth coming from tighter financial regulation and the escalation of trade tensions. Structural factors, such as the declining working-age population and subdued productivity growth, continue to weigh on medium-term growth prospects. In east Asia (excluding China and Japan), GDP growth is also expected to moderate from the strong rates recorded last year. Some of the more trade-exposed economies in the region – such as Korea and Taiwan – are likely to be affected by the rise in trade tensions because of their integration in global supply chains. Growth in India and New Zealand is expected to be higher in 2018 than previously forecast, reflecting stronger-than-expected GDP growth in the first half of the year.

Domestic GDP growth is expected to remain above trend over the forecast period

GDP growth over the year to the June quarter was stronger than previously anticipated. This mostly reflected some large revisions to previous quarters, especially for dwelling investment, business investment and exports. Consumption growth was also revised higher, reflecting stronger growth in household expenditure on overseas travel services. However, there was no net effect on GDP because this spending is also recorded as imports. Recent partial indicators point to slightly stronger GDP growth in the September quarter than previously expected, resulting in year-ended growth of around 3½ per cent. This is above estimates of potential and consistent with further declines in the unemployment rate.

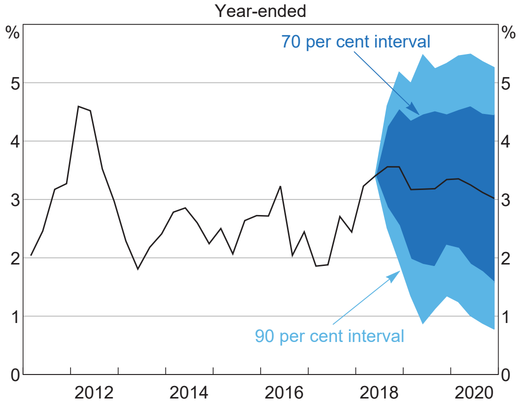
GDP growth is expected to be around 3½ per cent on average over 2018 and 2019, which is a little stronger than previously expected (Table 5.1; Graph 5.1). Growth is expected to ease in the latter

Table 5.1: Output Growth and Inflation Forecasts[(a)]
Per cent

	Year-ended					
	Jun 2018	Dec 2018	Jun 2019	Dec 2019	Jun 2020	Dec 2020
GDP growth	3.4	3½	3¼	3¼	3¼	3
(previous)	(3)	(3¼)	(3¼)	(3¼)	(3)	(3)
Unemployment rate[(b)]	5.4	5	5	5	4¾	4¾
(previous)	(5.5)	(5½)	(5¼)	(5¼)	(5¼)	(5)
CPI inflation	2.1	2	2	2¼	2¼	2¼
(previous)	(2.1)	(1¾)	(2)	(2¼)	(2¼)	(2¼)
Underlying inflation	1¾	1¾	2	2¼	2¼	2¼
(previous)	(2)	(1¾)	(2)	(2)	(2¼)	(2¼)
	Year-average					
	2017/18	2018	2018/19	2019	2019/20	2020
GDP growth	2.8	3½	3¼	3¼	3¼	3¼
(previous)	(2¾)	(3¼)	(3¼)	(3¼)	(3¼)	(3)

(a) Technical assumptions include A$ at US$0.73, TWI at 63 and Brent crude oil price at US$72 per barrel; shaded regions are historical data; figures in parentheses show the corresponding forecasts in the August 2018 *Statement on Monetary Policy*
(b) Average rate in the quarter
Sources: ABS; RBA

Graph 5.1
GDP Growth Forecast*
Year-ended



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

part of the forecast period, as the contribution from liquefied natural gas (LNG) exports diminishes. The stronger near-term outlook mainly reflects the recent GDP data (including revisions), as well as indicators for the September quarter. Accommodative monetary policy and tighter-than-anticipated labour market conditions are expected to provide ongoing support to growth in household income, consumption and business investment throughout the forecast period. Mining investment is close to its trough, and sustaining investment has started to increase and is expected to contribute to growth throughout the forecast period. Dwelling investment is expected to decline gradually but remain at a high level over the next year or so, supported by a significant amount of work in the pipeline. Public infrastructure investment growth is expected to remain high. Although liaison contacts indicate that capacity constraints are affecting residential and infrastructure-related construction activity, particularly in Sydney, the economy is not expected to encounter broad-based capacity constraints for some time. The implementation of the National Disability Insurance Scheme (NDIS) is also expected to continue to boost public demand, though growth in public demand is expected to slow a little over the forecast period. LNG exports are likely to reach their targeted production levels by the end of 2019, after which they will no longer contribute materially to growth.

The domestic forecasts are conditioned on the technical assumption that the cash rate evolves broadly in line with market expectations, which is for no change until at least the end of next year. The exchange rate and oil prices are assumed to remain around their current levels. This implies a trade-weighted exchange rate that is around 1 per cent lower than was assumed in the August *Statement*, and a US dollar price of Brent crude oil that is little changed. The population aged 15 years and over is assumed to grow by 1.6 per cent per annum over the next few years.

The current rate of consumption growth is forecast to continue, but there are downside risks

To date, household consumption growth has been fairly stable at around 3 per cent in year-ended terms and is expected to continue at around this rate. Consumption growth is expected to be supported by ongoing growth in employment and a modest pick-up in wages growth. The outlook for household consumption growth continues to represent a significant uncertainty for the forecasts. This derives from uncertainty about the outlook for household income growth as well as uncertainty about how households may respond to significant housing price declines (see below).

Household disposable income will be supported by ongoing labour income growth along with changes to income taxes announced in the 2018/19 federal budget. Growth in household disposable income is expected to pick up to about the same rate as consumption growth; the household saving ratio is expected to stabilise towards the end of the forecast period.

Dwelling approvals have moderated in recent months, but are still high by historical standards, and a significant pipeline of residential building work remains to be done in New South Wales and Victoria. In addition, capacity constraints are reported to be limiting the rate at which this pipeline can be worked through. Accordingly, dwelling investment is expected to decline gradually but remain at a high level for the next year or so. Liaison contacts report that off-the-plan sales have slowed significantly, which suggests that dwelling investment could slow sharply in the future. Were this to eventuate it would likely be after the forecast period, given the usual lags from off-the-plan sales to building approvals and from approvals to construction, and would be preceded by a sharper slowdown in approvals than has been seen to date. Liaison with developers suggests that their financial conditions have tightened further over the past six to twelve months. As a result, some developers are obtaining financing from alternative sources, though at a higher cost.

Growth in non-mining business investment is expected to become more broadly based

Non-mining investment growth was 9 per cent over the year to the June quarter, led by strength in non-residential construction. Indications are that growth in construction has slowed a little recently, and will be more moderate for the next few quarters. However, the pipeline of building and infrastructure work yet to be done, as well as liaison reports of continued underlying demand, suggest that construction activity will pick up through the forecast period. Machinery & equipment investment is also expected to pick up, consistent with an ongoing economic expansion. The outlook for non-mining investment is also supported by the high level of surveyed business conditions, rising measures of capacity utilisation and solid growth in business profits.

Mining investment is expected to start rising

The overall outlook for mining investment remains little changed: the trough in mining investment is still expected to occur in late 2018 or early 2019, as the construction of the remaining LNG projects reaches completion. Over the past year or so, firms have been investing to sustain production. This investment is expected to increase steadily over the forecast period, contributing to a modest pick-up in overall mining investment.

Solid growth in public demand is anticipated

Public demand is expected to provide an ongoing impetus to growth, but to ease modestly from its current fast rate. Growth in public consumption is currently being supported by the rollout of the NDIS, which is due to be completed by mid 2020. Liaison contacts continue to report that private sector activity is being boosted by strong growth in public infrastructure investment. State and federal budgets indicate that public investment will remain at a high level for at least the next couple of years, though growth is expected to moderate.

On a consolidated basis, state and federal government budgets are expected to return to surplus over coming years. Public demand is likely to be supported by additional revenues associated with a stronger terms of trade and ongoing employment and profit growth. This may be offset to some extent by lower stamp duty revenues associated with easing housing market conditions, especially in New South Wales and Victoria.

Export growth will be supported by services

The outlook for export growth remains little changed overall. LNG exports are due to continue ramping up through to the end of 2019, after which resource exports are expected to be at historically high levels but contributing little to GDP growth. Rural exports are being affected by drought conditions in some areas: in the near term there is likely to be a boost from meat exports as producers cut herd sizes, while over the coming year smaller harvests will weigh on grain exports. Exports of services and manufactures are expected to continue growing steadily, supported by ongoing trading partner growth and the depreciation of the exchange rate since the start of 2018.

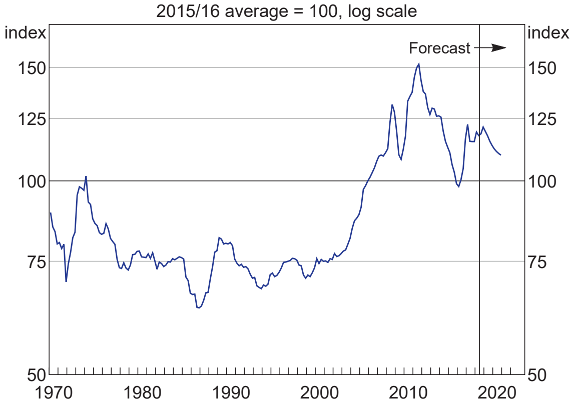
Growth in imports is likely to be slower over the remainder of 2018, reflecting the recent moderation in public and private investment (which are more import intensive than other types of spending), as well as higher import prices resulting from the earlier depreciation of the exchange rate. Further into the forecast period, import volumes should continue growing as the economy expands.

The terms of trade are still forecast to moderate

Australia's terms of trade have been revised higher relative to the August *Statement*. Higher export prices look to have offset higher import prices over recent months, and the forecast for coal prices has increased in light of ongoing strong global demand. The terms of trade are expected to remain around these higher levels for the next few quarters or so before gradually declining (Graph 5.2); Chinese demand for bulk commodities is still expected to moderate over time and global supply from low-cost producers is still expected to increase. The terms of trade are expected to remain above their trough in early 2016.

As a result of increased LNG and condensate production and related exports, Australia now earns more income from oil-related exports than it

Graph 5.2
Terms of Trade
2015/16 average = 100, log scale



Sources: ABS; RBA

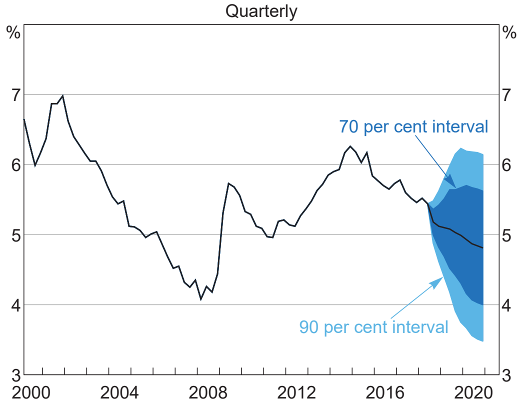
spends on oil-related imports. This means that an increase in oil prices will now boost the terms of trade, whereas in previous years an increase in oil prices would have weighed on the terms of trade.

Coal prices continue to present an upside risk to the terms of trade. Demand for premium thermal coal remains strong and growth in global supply has been limited. Coking coal prices have been affected by recent supply disruptions, and continue to be supported by ongoing strength in steel production. Despite ongoing uncertainty about the outlook for steel demand in China, the outlook for steel production in India is positive and coking coal exports to India have increased strongly over the past year.

The unemployment rate is expected to decline further

Labour market outcomes in the September quarter were better than expected at the time of the August *Statement*. Near-term indicators of labour demand continue to suggest that employment growth will remain above growth in the working-age population over the next six months. Further out, employment growth has been revised up a little, consistent with the slightly stronger outlook for GDP growth. Positive labour market conditions are expected to encourage more people to either enter or delay leaving the labour force, and the participation rate is expected to rise a little further to a record high. The unemployment rate is expected to decline gradually over the forecast period to 4¾ per cent (Graph 5.3). This amounts to more of a decline in the unemployment rate than expected at the time of the August *Statement*, reflecting the lower starting point and the slightly stronger forecast for GDP growth. However, there continues to be considerable uncertainty around how much spare capacity there is in the labour market (see below).

Graph 5.3
Unemployment Rate Forecast*
Quarterly



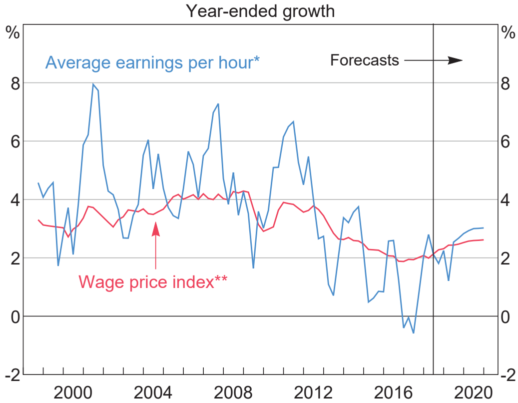
* Confidence intervals reflect RBA forecast errors since 1993
Sources: ABS; RBA

Wages growth is anticipated to pick up gradually

The decline in the unemployment rate is also expected to flow through to slightly higher wages growth than previously forecast. In addition, growth in the wage price index (WPI) in the June quarter was slightly stronger than had been expected in the August *Statement*. Wages growth is expected to be boosted a little in the September quarter as a result of the 3.5 per cent increase in award and minimum wages from 1 July. Further out, the pick-up in wages growth is still expected to be gradual, consistent with information from the Bank's liaison program and the expectation of a steady decline in labour market spare capacity (Graph 5.4).

Wage outcomes from enterprise bargaining agreements are likely to remain a drag on overall wages growth, despite picking up recently. Average earnings from the national accounts – which is a broader measure of labour costs and incorporates compositional change in the labour force – is expected to grow at a slightly faster pace than the WPI over the next few years.

Graph 5.4
Labour Costs
Year-ended growth



* Non-farm
** Excluding bonuses
Sources: ABS; RBA

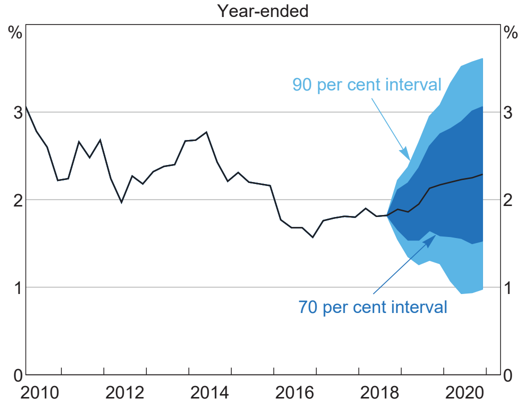
Underlying inflation is expected to pick up to above 2 per cent in 2019

The September quarter inflation outcomes were broadly in line with the forecasts in the August *Statement*. Both headline and underlying inflation moderated in the quarter as a result of sizeable declines in the prices of child care and utilities.

The inflation forecasts have been revised up a little. Underlying inflation is expected to increase in the December quarter, and then pick up to 2¼ per cent by late 2019, a little earlier than expected at the time of the August *Statement* (Graph 5.5). The upward revision reflects the faster-than-expected decline in spare capacity in the economy. Headline inflation is expected to be boosted a little in the December quarter by an increase in fuel prices. Headline inflation is expected to be a bit above underlying inflation over the forecast period as a result of the legislated tobacco excise increases.

In terms of the outlook for components of inflation, a key area of uncertainty is how long the structural changes in the retail sector will put downward pressure on retail prices. Some retail firms had indicated that they expected price competition to ease this financial year, although the arrival of new foreign entrants over the coming years may also increase retail competition. Retail prices will also be influenced by any sustained movements in the exchange rate. The outlook for rent growth, given the construction activity already underway, will partly depend on the effect of population growth on housing demand. Uncertainties specific to the outlook for utilities inflation and other administered price inflation are discussed below.

Graph 5.5
Trimmed Mean Inflation Forecast*
Year-ended



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

There are several risks to the economic outlook

The risks to global growth from trade protectionism have intensified. In light of this, and the ongoing efforts of Chinese authorities to manage slowing growth without exacerbating financial risks, there is considerable uncertainty about the outlook for China, which is a key trading partner for Australia. Another important external risk is that inflation in advanced economies, especially in the United States, could pick up faster than expected. This could lead to adjustments in financial prices, including exchange rates. Any depreciation of the Australian dollar at a time of stronger-than-expected global inflation and/or demand would be positive for the outlook for domestic growth and inflation.

In addition to risks from the global economy, there are a number of domestically sourced uncertainties for the growth and inflation outlook. On the upside, strong business profitability as a result of higher-than-expected commodity prices and generally strong domestic demand conditions could support a stronger outlook for investment, employment and wages growth than currently forecast. There continues to be uncertainty about how quickly the unemployment rate will decline and how quickly that will feed into wage pressures and inflation. The outlook for inflation also depends on how competitive pressures in the retail sector evolve, and how much downward pressure utilities and administered price changes put on overall inflation. As has been the case for some time, uncertainty about wages growth also translates into uncertainty about the outlook for household disposable income, which has a direct bearing on consumption growth, as does the evolution of housing prices through household wealth.

Escalating trade tensions are a material risk to global growth

The global growth forecasts reflect only the direct effects of tariff rate increases that have been implemented so far by the United States and China. These tariffs directly affect only a small part of global trade, so the effects on import prices, US and Chinese import demand and the related demand for the exports of other economies are expected to be relatively small. It is possible that trade tensions will escalate either through further increases in tariff rates or the imposition of higher non-tariff trade barriers. This would have further direct effects on trade, but may also affect investment and confidence, which could have more negative consequences for global growth.

Another potential source of escalation is a broadening of the trade tensions to other economies. The US administration has previously indicated its concerns about automotive imports and the possibility of increasing tariffs on such imports from a number of economies, particularly the European Union and Japan. Failure of the trade negotiations currently underway between the United States and these two economies may see an increase in tariffs, which would weaken the global growth outlook.

Chinese authorities continue to balance the need to address financial risks while maintaining growth

Chinese policymakers face several trade-offs that create uncertainty around the trajectory for the Chinese economy, demand for bulk commodities and Australia's terms of trade. Measures to restrict the growth of shadow banking activity over the past couple of years have helped lower risks to financial stability, but at the cost of weaker growth in some sectors of the economy. So far, efforts to ease fiscal and monetary policy to avert a sharper-than-desired slowing in momentum have had a modest impact, but there is a chance they could lead to growth being higher than projected. On the other hand, if these policies prove less stimulatory, or the effect of the earlier efforts to tighten shadow finance is longer lived than expected, Chinese growth could be lower than forecast.

Conditions in China's property markets pose risks in both directions to the outlook for Chinese steel demand and growth more broadly. Authorities have persisted with highly restrictive policies that may, in time, place more acute downward pressure on property prices and activity than they have to date. But any significant deterioration in conditions could lead policymakers to ease these policies. A separate, additional risk is that an entrenched trade conflict with the United States would have significant medium-term effects on China's manufacturing export sector. The impact could, however, be dampened by a further depreciation of the renminbi (should authorities allow that to occur) or policy actions that facilitate switching from external to domestic demand for the affected products.

Rising capacity constraints could result in a faster pick-up in global inflation

Spare capacity in many advanced economies has been absorbed and GDP growth is expected to remain above potential next year. Unemployment rates are unusually low in a number of economies, including the United States, Germany and Japan. Against this backdrop, it is possible that wages growth and inflation could pick up faster than expected. This risk seems especially prominent for the United States given the size of the recent fiscal stimulus and because growth in the United States could be even higher than expected if fiscal policy is expanded further, particularly in 2020.

The prices of many financial market assets imply that inflationary pressures are not expected to build up significantly. Therefore a sharp rise in inflation or inflation expectations could lead to a reassessment of the speed and extent of monetary policy tightening and prompt a significant adjustment in many asset prices, including exchange rates. A further depreciation of the Australian dollar would increase the international competitiveness of domestically produced goods and services, contributing to greater demand for Australian exports and causing some substitution away from imports towards goods and services produced domestically. The resulting increase in domestic income and employment would also support growth in business investment and consumption. Inflation would also be likely to increase by more than currently forecast, because of stronger domestic economic conditions and the increase in the prices of imported goods and services.

Domestically, strong profitability could support a stronger outlook for investment and wages

Higher commodity prices over the past one to two years have led to strong growth in mining profits, which is supporting investment in that sector. If the strength in commodity prices persists, there may be some upside risk to mining investment: mining firms may look at new plans to expand production capacity or to bring mothballed mines back on line; exploration activity may increase further; and smaller (more cash-flow sensitive) producers may increase sustaining investment. Information from liaison suggests that the increase in mining profit growth to date has already allowed for a modest pick-up in wages growth by removing wage freezes that had been in place for a number of years. Along with some reports of specialised-labour shortages, it is possible that sustained higher profitability and investment intentions over the next few years will lead to higher wages growth in mining-exposed industries. This could lead to a further reduction in the drag on overall wages growth from the decline in mining wages growth seen in recent years.

Non-mining profits have been growing steadily against the backdrop of stronger overall demand, after tracking sideways during the middle part of the decade. It is possible that the ongoing strength in the economy, and thus profits, will support stronger growth in non-mining investment than has been currently built into the forecasts.

Uncertainty remains about the amount of labour market spare capacity …

The unemployment rate has declined over the past year and is expected to decline further over the next couple of years as a result of above-trend GDP growth. Leading indicators of labour demand suggest the unemployment rate may fall faster than expected in the near term, though it is also possible that there will be a stabilisation or retracement in the unemployment rate over that period given its recent sharp decline. More broadly, the decline in the unemployment rate will depend, in part, on how much of the increase in labour demand is met by increased hours and a higher participation rate.

As spare capacity in the labour market declines, wages growth is expected to increase. How much and how quickly wages growth picks up will depend, in part, on how much labour market spare capacity has been absorbed. However, there is always uncertainty around the measurement of spare capacity. One measure the Bank uses to estimate spare capacity is the 'non-accelerating inflation rate of unemployment' (NAIRU). There is considerable uncertainty about the NAIRU estimate because it cannot be observed directly and must be inferred from other information. To complement this measure, the Bank also monitors information from business surveys and the liaison program, as well as other measures of labour market underutilisation, such as underemployment and the duration of unemployment. Despite the uncertainty about the degree of spare capacity, collectively this information suggests there is still spare capacity in the labour market.

… and how this will translate into wages growth and inflation

It is important to note that the dynamics in the labour market and wage setting do not change suddenly when the unemployment rate falls below the NAIRU, even if it was known with some certainty. The recent international experience indicates that the unemployment rate could decline well below estimates of the NAIRU based on historical experience before there is a material increase in wages growth. This suggests there are either considerable lags in the relationship between labour market strength and wages growth or that other factors have been weighing on wages growth in many economies.

Analysis at the Bank suggests that wages growth has been lower than can be explained by measures of labour market spare capacity, inflation expectations and output price inflation, and the usual lags between these variables and wages growth. It is likely that changes in competitive dynamics owing to globalisation and technological change, and changes in relative bargaining power, have played some role in lower wages growth over recent years. The central forecast for a moderate increase in wages growth over the next couple of years assumes that some of these factors will continue to weigh on wages growth for a while yet. However, the recent increases in wages growth in other advanced economies may indicate that some of these 'global' factors are starting to abate, or can be offset by sufficiently tight labour market conditions.

Any pick-up in wages growth would place upward pressure on consumer price inflation, because labour costs are the major component of business costs. However, inflation also depends on a range of other factors, such as the size and speed of the pass-through from exchange rate movements and the process of adjustment in retail margins following changes in the industry. As was flagged in the August *Statement*, there is also a risk of further declines in administered prices in the year ahead because of government initiatives to reduce cost-of-living pressures. Similarly, utilities prices could decline or remain fairly steady over the forecast period as a result of government policy changes and the large volume of renewable energy generation coming on line. However, there is sufficient uncertainty about other possible offsetting movements in prices over the forecast period that this downside risk has not been incorporated into the central forecasts.

Household consumption depends on the outlook for income growth, particularly in the context of high debt

Uncertainty about the outlook for household income and wealth gives rise to uncertainty about consumption growth.

Household income growth has increased of late and is expected to pick up further, given the outlook for employment and wages growth. Disposable income will also be supported by income tax cuts announced in the 2018/19 budget. However, if household income growth does not increase as expected, then consumption growth could be weaker. Consumption has thus far been resilient to low income growth, which has been absorbed through a lower rate of saving. Changes in the prices of goods and services that households buy – including prices administered by governments – also affect the purchasing power of household income, and therefore could affect consumption growth.

Household consumption may also be affected by declines in housing prices. While there is uncertainty about how much the earlier upswing in housing prices boosted household consumption, there is limited evidence that housing price declines have weighed on overall consumption to date. Consumption growth has been strongest in New South Wales and Victoria, where recent declines in housing prices have been the largest, although income growth has also been relatively strong in these states. It is possible that the consumption decisions of highly indebted and/or credit-constrained households could be more sensitive to an easing in housing price growth than to the previous strength, especially if income growth were to soften at the same time.

The high level of household debt remains a key consideration for household consumption. Household debt levels relative to income have continued to edge higher. A highly indebted household facing weaker-than-expected growth in income or wealth is more likely to respond by lowering consumption. Consumption growth may also be weaker for a time if households become concerned about their debt levels and choose to pay down debt more quickly. Steps taken by regulators to strengthen lending standards have led to a moderation in the growth in riskier types of lending to households, but risks remain. The ongoing high level of public scrutiny of lending decisions could see some further tightening in the supply of credit.

Household consumption accounts for just over half of nominal GDP, so if consumption growth were to be materially higher or lower than currently forecast, it would have implications for the forecasts for overall GDP growth, employment growth and inflation.