3. Domestic Economic Conditions

Growth in the Australian economy slowed in the March quarter and was below estimates of trend growth, but looks to have picked up more recently (Table 3.1; Graph 3.1). Some of the slowing in the quarter was driven by temporary weakness in exports and dwelling investment, partly affected by adverse weather conditions. More recent data, though, suggest economic conditions improved in the June quarter. Retail sales have been stronger, business conditions have picked up and capacity utilisation has risen. Momentum in the labour market has improved. Strong employment growth has been recorded over recent months,

Graph 3.1
GDP Growth

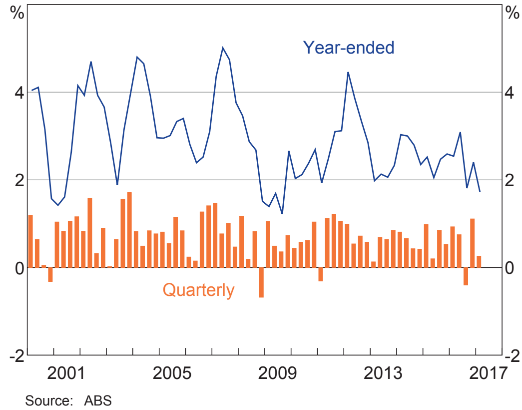


Table 3.1: Demand and Output Growth
Per cent

	March quarter 2017	December quarter 2016	Year to March quarter 2017
GDP	0.3	1.1	1.7
Domestic final demand	0.3	1.1	1.7
– Consumption	0.5	1.0	2.3
– Dwelling investment	–4.4	1.9	–2.5
– Mining investment	3.7	1.5	–17.5
– Non-mining investment	–0.4	1.4	4.3
– Public demand	0.4	1.0	4.0
Change in inventories[(a)]	0.4	–0.3	0.6
Exports	–1.6	3.7	5.6
Imports	1.6	1.9	7.9
Mining activity[(b)]	1.0	2.6	3.6
Non-mining activity[(b)]	0.1	0.9	1.5
Nominal GDP	2.3	3.2	7.7
Real gross domestic income	1.7	3.1	6.5
Terms of trade	6.6	9.6	24.8

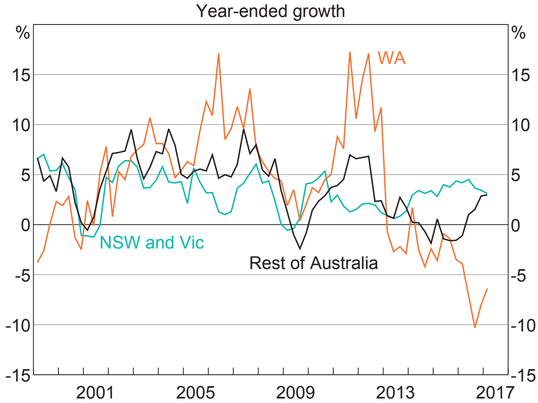
(a) Contribution to GDP growth
(b) RBA estimates
Sources: ABS; RBA

although wage growth remains low by historical standards. Looking ahead, the economy is expected to strengthen, as the drag from mining investment continues to dissipate, supported by the low level of interest rates and the ongoing recovery in the global economy. In turn, the recovery in the domestic economy is expected to reduce the spare capacity in the labour market, which should produce a gradual lift in wage growth and inflation.

Economic conditions continue to vary across the states. The New South Wales and Victorian economies have performed most strongly in recent years, and there are signs that economic conditions are starting to stabilise or improve in the mining-exposed states of Queensland and Western Australia (Graph 3.2). State final demand remains weak in Western Australia, but the pace of contraction has slowed, and demand has been recovering in Queensland since early 2016. Employment has increased in these two states and surveyed measures of business conditions and confidence have risen.

Even though growth in the domestic economy slowed somewhat in the March quarter, nominal income growth was very strong, supported by a sizeable pick-up in the terms of trade.

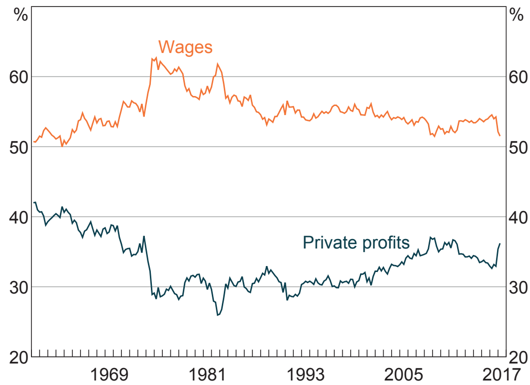
Graph 3.2
State Final Demand
Year-ended growth



Sources: ABS; RBA

Business profits increased by 25 per cent over the six months to the March quarter, largely reflecting increased profits in the mining sector. This has seen the share of national income going to profits increase sharply (Graph 3.3). On the other hand, the recent slow growth in wages has contributed to an offsetting fall in the labour share of income, which is around its lowest level in 50 years.

Graph 3.3
Wages and Profits*
Share of total factor income



* Private profits include income of unincorporated enterprises; public sector entity profits and income from ownership of dwellings not shown

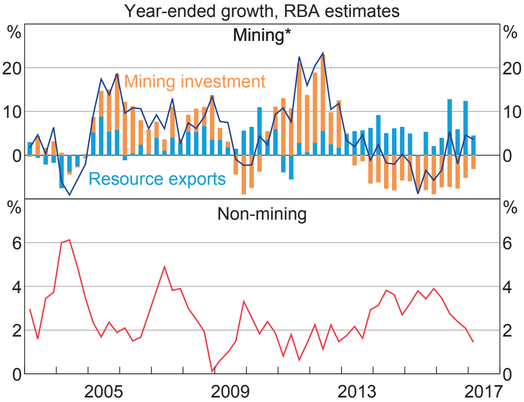
Sources: ABS; RBA

Mining Activity

The adjustment after the mining boom to a lower level of mining investment is now well advanced; mining investment is expected to fall further over the next year or so, but the largest declines are in the past (Graph 3.4). Indeed, both the ABS capital expenditure (Capex) survey of investment intentions and Bank liaison point to smaller declines in mining investment over the period ahead. Much of the remaining decline is expected to be in liquefied natural gas (LNG) investment. Mining investment is then expected to stabilise as mining firms make new investments to maintain productive capacity.

The increase in resource export volumes over the past year was largely driven by an increase in LNG production; however, growth in resource

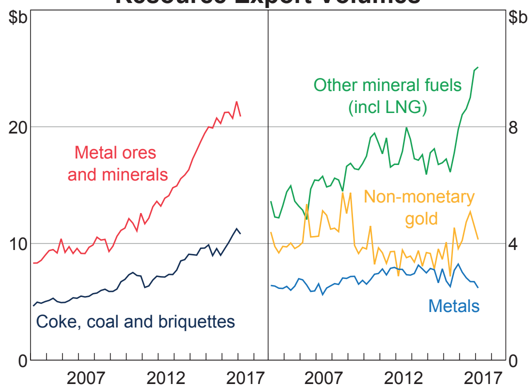
Graph 3.4
Mining and Non-mining Activity
Year-ended growth, RBA estimates



* Net of mining-related imports; components are contributions to year-ended mining activity growth; contribution from changes in inventories not shown

Sources: ABS; RBA

Graph 3.5
Resource Export Volumes



Source: ABS

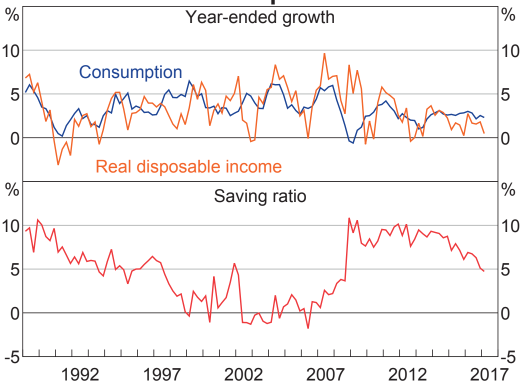
exports could be lower than previously reported because of recent revisions to trade data (Graph 3.5). LNG exports are expected to grow strongly over the next couple of years as the productive capacity of existing projects ramps up and projects currently under construction start production; LNG exports are expected to contribute almost ½ percentage point directly to annual GDP growth. This is a little lower than previously expected because some projects are experiencing delays. Iron ore export volumes are expected to rise with further incremental increases in production expected from Australia's low-cost producers over the next few years. Coal export volumes have also increased strongly over the past year or so. However, coal exports declined in the March quarter and are expected to have declined again in the June quarter after Cyclone Debbie damaged coal rail infrastructure in the Bowen Basin. The damaged infrastructure has since been restored to full capacity and coking coal exports are expected to return to pre-cyclone levels in the second half of 2017.

Although resource export volumes have risen since late 2015, the sizeable increase in bulk commodity prices has been the main driver of the significant improvement in mining profitability. Information from the Bank's liaison and company announcements has indicated that firms have generally used the additional income to pay down debt, pay dividends and increase share buybacks, rather than expand productive capacity through new investment. In part, this reflects the earlier expectation that commodity prices would not remain elevated; indeed, prices have declined from their high levels earlier in the year. At the margin, some mining firms have reportedly undertaken small-scale investments in machinery and equipment.

Household Sector

Although household consumption growth slowed over the year to the March quarter, it is likely to increase somewhat in the period ahead. The slowing was broadly consistent with subdued growth in household income, such that the household saving ratio declined a little over the year (Graph 3.6). Recent indicators suggest a positive outlook for consumption growth over coming quarters (Graph 3.7). The value of retail sales grew in April and May, both across states and categories of spending, and employment growth has picked up recently. When combined

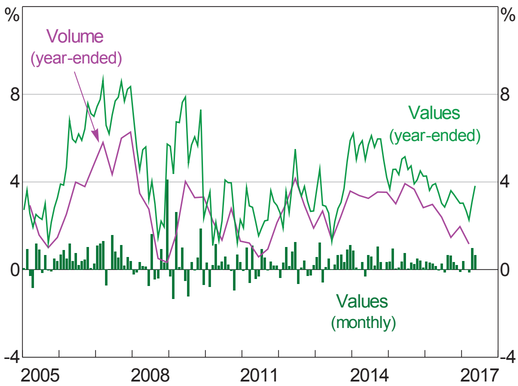
Graph 3.6
Household Consumption and Income*



* Disposable income is after tax and interest payments; saving ratio is net of depreciation

Sources: ABS; RBA

Graph 3.7
Retail Sales Growth



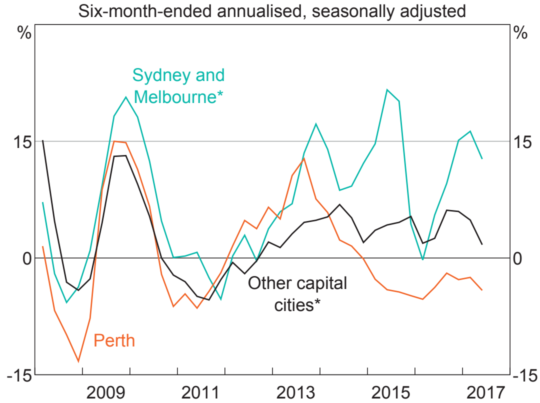
Sources: ABS; RBA

with flat retail prices in the June quarter (see the 'Inflation' chapter), this points to solid growth in the volume of retail sales. Employment growth is expected to continue at a solid pace over the forecast period, which should support household income, even if the pick-up in wage growth is as gradual as expected. Low interest rates should continue to provide an impetus for households to spend, as would any further increases in net household wealth.

Conditions in the established housing market remain strongest in Sydney and Melbourne, which is consistent with better economic growth in these states. Demand for housing in Victoria has been supported by strong migration flows, both from overseas and from interstate, particularly from New South Wales and Western Australia (Graph 3.21). Nevertheless, there have been some signs that conditions in the Sydney and Melbourne markets have eased a little of late; housing price growth and auction clearance rates have declined from their recent highs, especially in Sydney (Graph 3.8; Graph 3.9). Housing prices have declined a little further in Perth, where population and household income growth remain weak. In Brisbane, ongoing large additions

Graph 3.8
Housing Price Growth

Six-month-ended annualised, seasonally adjusted

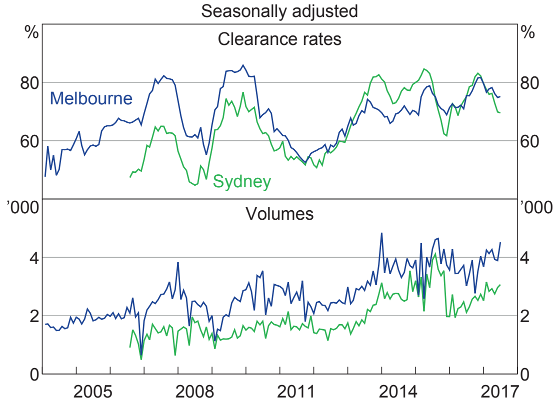


* Capital city dwelling stock weighted

Sources: ABS; APM; RBA

Graph 3.9
Auction Market Indicators

Seasonally adjusted



Sources: APM; CoreLogic; RBA; REIV

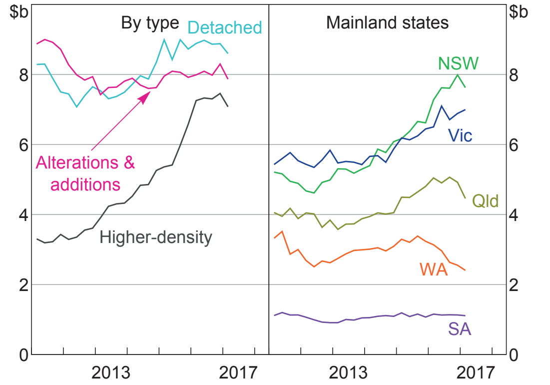
to the supply of new apartments have placed downward pressure on apartment price growth.

The value of housing loan approvals has decreased in the past few months, driven by a decline in investor approvals. The level of approvals is consistent with the easing in aggregate housing credit growth, and investor credit growth having slowed (see 'Domestic Financial Markets' chapter).

High housing prices in the largest cities have provided some impetus to both new dwelling construction and alterations and additions. Residential dwelling investment remains high, although it declined a little in the March quarter, primarily in Queensland and in New South Wales where construction activity appears to have been impeded by wet weather (Graph 3.10). High-density construction continues to account for a relatively high share of construction activity. Higher land prices have also supported the shift towards apartment construction over recent years, most notably in Sydney.

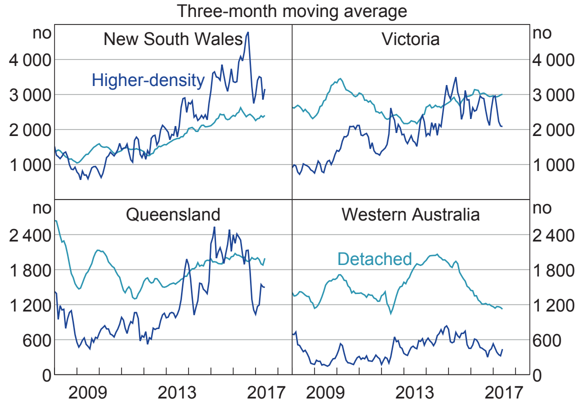
Building approvals have been significantly lower over the past nine months than they were over the preceding two years, particularly for higher-density housing in New South Wales and Queensland (Graph 3.11). The decline in building approvals is likely to reflect a number of factors. Liaison with developers indicates that demand for off-the-plan apartments in the major east-coast cities has moderated in recent months, partly reflecting weaker demand from foreign buyers. Developers' access to bank finance has also tightened over the past year or so, particularly in geographic regions at risk of oversupply, such as the Brisbane apartment market. In contrast, demand for greenfield land, which is usually used for detached housing and medium-density developments, has been robust, particularly in Melbourne. Related to this, demand for new detached homes also

Graph 3.10
Dwelling Investment
Chain volume



Source: ABS

Graph 3.11
Private Residential Building Approvals
Three-month moving average



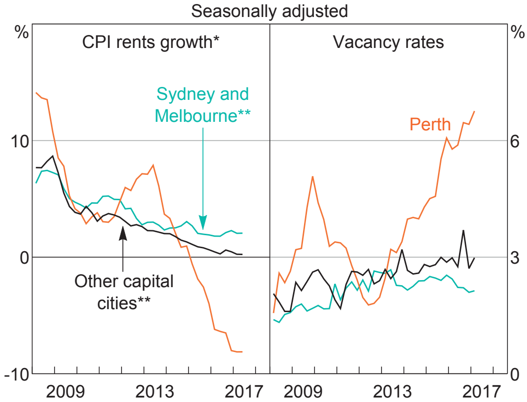
Sources: ABS; RBA

reportedly remains strong in Melbourne and Sydney; reports from Brisbane have been more mixed. In Perth, enquiries about new detached dwellings have picked up recently. Although this has not yet translated into higher sales, it suggests confidence in the Perth market for new detached houses is improving.

Despite the decline in building approvals, the pipeline of work already approved or underway remains close to historically high levels, so dwelling investment is likely to be maintained at a high level for the next year or so, before declining slowly. Assuming that approvals remain around current levels, this implies that the pipeline of work will decline over the forecast period. Given that apartment projects typically take at least three times longer to complete than detached houses, the decline in dwelling investment may be more gradual than has been the case in the past.

Rental vacancy rates in most capital cities have remained around their long-run average levels because stronger population growth has absorbed the significant increase in supply of housing in recent years (Graph 3.12). Rental inflation has stabilised at rates a little lower than suggested by the historical relationship with the vacancy rate. Conditions remain weakest in Perth, where the vacancy rate is more than double the average of other capital cities, population growth has been slow and rents have been falling for the past two years.

Graph 3.12
Rental Market
Seasonally adjusted

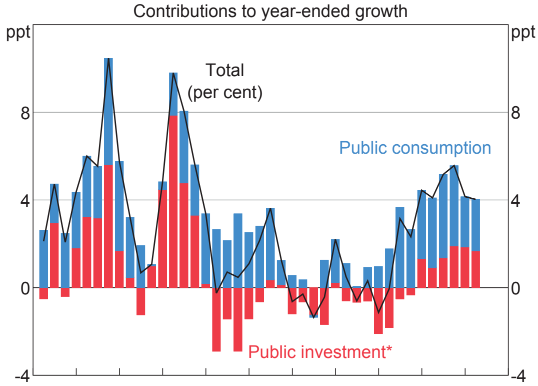


* Six-month-ended annualised
** Capital city dwelling stock weighted; vacancy rates exclude Adelaide from March 2015, Hobart and Darwin
Sources: ABS; RBA; REIA

Government Sector

Public spending has picked up in recent years, both in terms of consumption and investment expenditures, providing some support to the domestic economy (Graph 3.13). The increase in public investment growth has been relatively

Graph 3.13
Public Demand
Contributions to year-ended growth



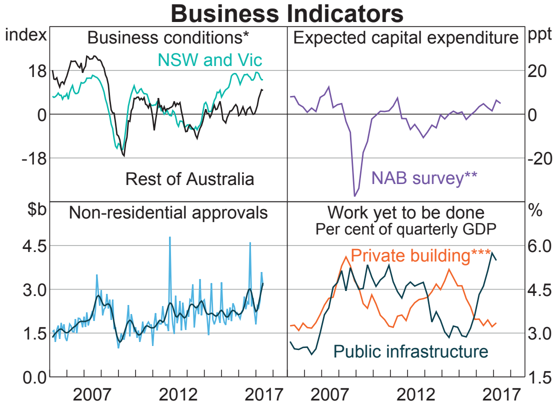
* Adjusted for second-hand asset transfers between the public and other sectors
Sources: ABS; RBA

broad based across all levels of government. This has been supported by some large infrastructure projects, most notably in New South Wales and Victoria, and these should continue to contribute to economic growth over the forecast period. The amount of work yet to be done on public infrastructure projects (which have commenced construction) has increased steadily over the past two years to be at its highest level in some time (Graph 3.14). Recently released state budgets suggest public investment will be slightly higher over the next financial year than suggested by previous estimates. On top of this, empirical evidence and information from the Bank's liaison suggests that public infrastructure spending generates positive spillovers to private investment.

Non-mining Business Sector

Non-mining business investment has been gradually trending up for a number of years, but was little changed in the March quarter. In New South Wales and Victoria, there has been reasonably robust growth in recent years, consistent with the better economic growth in these states. Economic conditions have generally improved recently in the other states, as has been reflected in a marked step-up in survey measures of business conditions (Graph 3.14). The spillover effects of falling mining investment to other sectors of the economy continue to diminish.

Graph 3.14
Business Indicators



* Net balance; three-month moving average

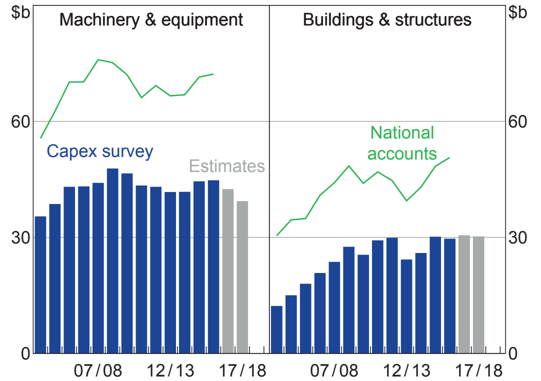
** Expectations for the year ahead; deviation from long-run average

*** Non-residential

Sources: ABS; NAB; RBA

Forward-looking indicators of non-mining business investment continue to be mixed. Investment intentions in the ABS Capex survey suggest that non-mining investment is unlikely to pick up substantially over the next year or so (Graph 3.15). The stock of private non-residential building work yet to be done also remains at a low level, following the completion of predominantly office and health-related buildings. But the Capex survey only covers around one-half of non-mining investment captured by the more comprehensive national accounts measure and investment by certain service industries that are not covered by the survey has been rising more strongly recently. In contrast to the Capex survey, survey measures of capacity utilisation have increased over the past year, particularly for goods-producing firms, which could be expected to lead investment, or even coincide with it. Non-residential building approvals have picked up

Graph 3.15
Non-mining Capital Expenditure*
Nominal



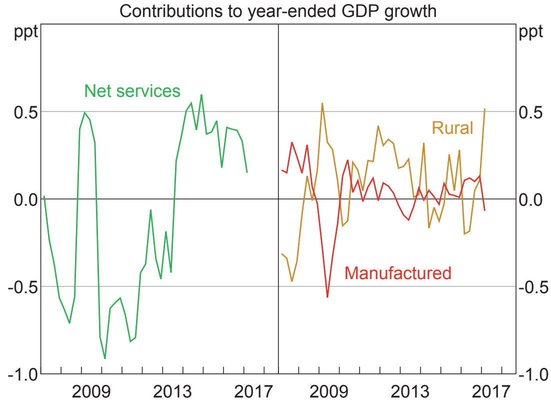
* Estimates are firms' expected capital expenditure, adjusted for past average differences between expected and realised spending

Sources: ABS; RBA

in the past few months. The NAB survey measure of investment intentions for the year ahead has also improved a little over the past year.

Non-resource exports have continued to contribute strongly to economic growth (Graph 3.16). Service exports made a significant contribution to GDP growth over the past year, largely driven by education and tourism exports. Rural exports grew strongly, following the record winter harvest, while manufactured exports declined.

Graph 3.16
Non-mining Exports
Contributions to year-ended GDP growth

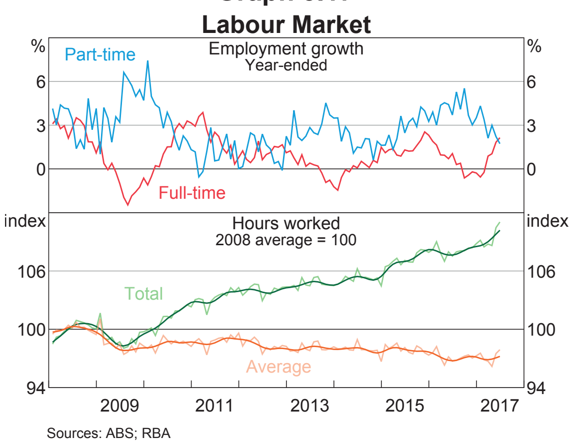


Sources: ABS; RBA

Labour Market

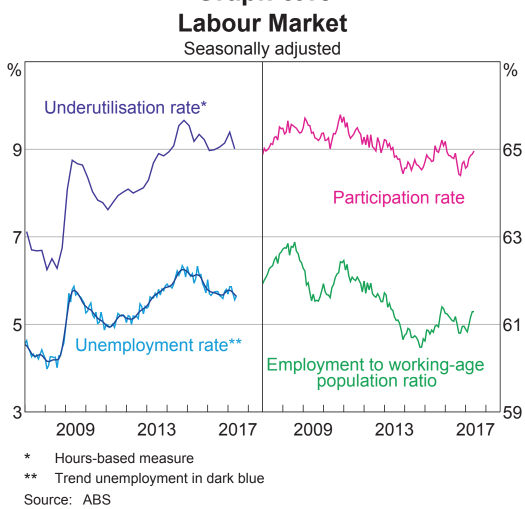
Conditions in the labour market have improved since late 2016, supporting other evidence of better economic conditions over the past few quarters and pointing to stronger growth in aggregate household incomes. A pronounced pick-up in employment growth was recorded in the June quarter and was driven entirely by full-time employment (Graph 3.17). The increase in full-time employment growth over the first half of 2017 follows no growth over 2016 and has contributed to the recent sharp increase in total and average hours worked. The participation rate has also increased since late 2016 as conditions have strengthened (Graph 3.18). The participation rate remains below its previous peaks, which is partly the result of the gradual ageing of the population.

Graph 3.17



The unemployment rate fell in the June quarter by a little more than had been anticipated at the time of the previous *Statement*, to be 5.6 per cent. Despite this improvement in conditions, there is still spare capacity in the labour market that is yet to be absorbed. The unemployment rate remains around ½–¾ percentage point above the Bank's estimate of full employment.[1] Another

Graph 3.18



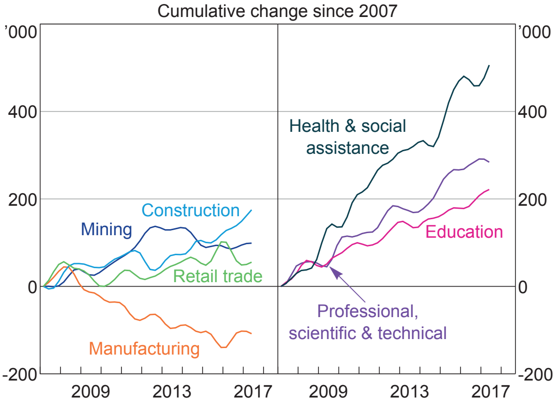
measure of spare capacity in the labour market is the hours-based underutilisation rate, which measures the additional hours sought by workers (including those currently unemployed) relative to the total number of hours that workers would like to work. This measure tends to show the same pattern as the unemployment rate, although the gap has widened recently as the share of part-time workers has increased.

Employment growth remains strongest in the service industries. In particular, health & social assistance employment has increased notably over recent years and now accounts for around 13 per cent of total employment, up by 3 percentage points from a decade ago (Graph 3.19). The strength in health employment over recent years has largely been in medical & other healthcare services and, to a lesser extent, in aged care. The rollout of the National Disability Insurance Scheme over the next few years will continue to boost employment in the health & social assistance industry. Education employment has also steadily increased in recent years. Major public infrastructure projects and the large pipeline of residential investment continue to support construction employment.

1 See Cusbert T (2017), 'Estimating the NAIRU and the Unemployment Gap', RBA *Bulletin*, June, pp 13–22.

Graph 3.19
Employment by Industry*

Cumulative change since 2007

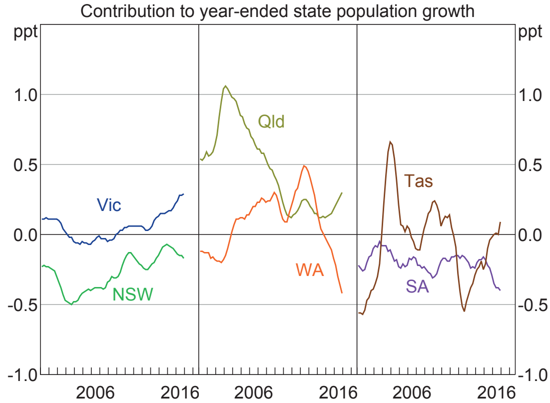


* ABS trend measure

Sources: ABS; RBA

Graph 3.21
Net Interstate Migration

Contribution to year-ended state population growth



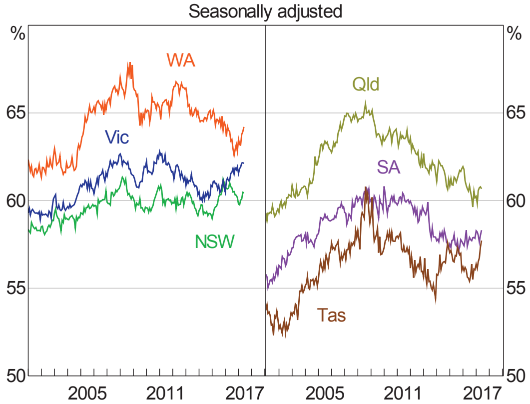
Sources: ABS; RBA

Employment growth has been strongest in Victoria over the year (Graph 3.20). However, growth in employment has picked up in New South Wales recently following subdued growth over the previous year. Dwelling and infrastructure investment have helped boost employment in these states. Higher migration flows, both from interstate and overseas, have contributed to strong population growth in Victoria (Graph 3.21). This, in turn, has contributed to higher demand for household services such as health. Employment conditions in the mining-exposed states have also improved since late 2016, with a particularly marked turnaround in full-time employment in Western Australia. As part of the adjustment following the booms in the terms of trade and mining investment, people have migrated out of Western Australia to the eastern states.

Forward-looking indicators of labour demand continue to point to solid growth in employment over the second half of 2017 (Graph 3.22). Job vacancies data suggest that labour demand is strongest in the household services sector.

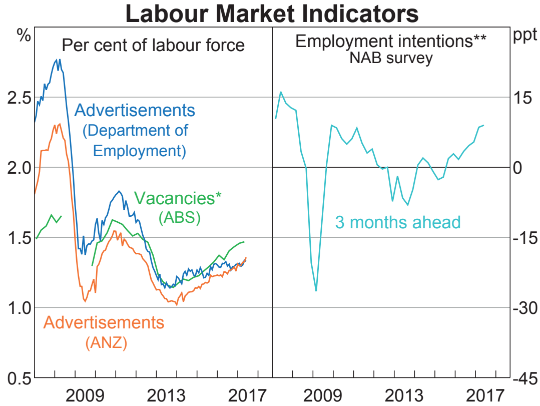
Graph 3.20
Employment-to-population Ratio by State

Seasonally adjusted



Sources: ABS; RBA

Graph 3.22
Labour Market Indicators



* This survey was suspended between May 2008 and November 2009

** Net balance of employment intentions for the following period; deviation from average

Sources: ABS; ANZ; Department of Employment; NAB; RBA

Labour Costs

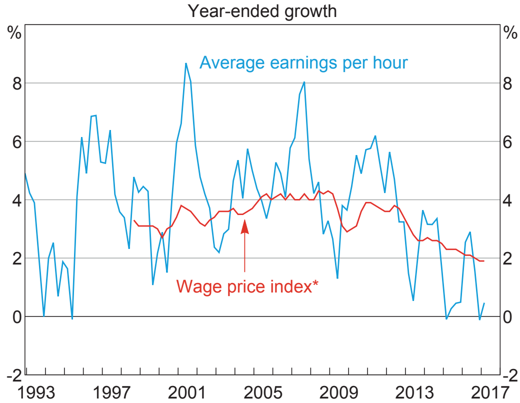
Wage growth is low across a range of measures. The wage price index (WPI) grew by a little less than 2 per cent over the year to March (Graph 3.23). Growth in average earnings from the national accounts (AENA) is around its lowest level since the early 1990s.[2] There has been modest growth in real wages over recent years. Liaison contacts suggest that low outcomes for inflation in recent years have helped employers secure lower wage outcomes. But headline inflation has picked up recently and could therefore feed into higher wage growth as spare capacity diminishes.

There are a number of potential reasons for the low wage growth in Australia. Spare capacity in the labour market may have meant that employees have been more willing to accept lower wage growth. Low wage growth, particularly in mining and mining-exposed industries, has also been part of the adjustment to the earlier decline in the terms of trade and falling mining investment. Measures of perceived job security are relatively low, which may also mean that workers are less inclined to seek larger wage increases.

Data published by the ABS suggest the share of workers changing employers has declined to around its lowest in recent decades (Graph 3.24). Less switching between employers is also likely to be related to lower wage growth. This is because when workers voluntarily move between jobs, they generally receive a higher salary in their new role; indeed, this is likely to be a motivating factor behind much switching. There is also a demand-side effect if fewer firms are attempting to attract workers from other firms. All of this is consistent with subdued wage growth. That said, business surveys point to some decline in the availability of suitable labour, and liaison evidence suggests that incidences of labour shortages, while not prevalent, are broadening out across some industries in the eastern states.

2 AENA, which is more volatile than the WPI, is also wider in scope because it includes non-wage costs and the impact of any changes to the composition of the workforce.

Graph 3.23
Labour Costs
Year-ended growth



* Total pay excluding bonuses
Sources: ABS; RBA

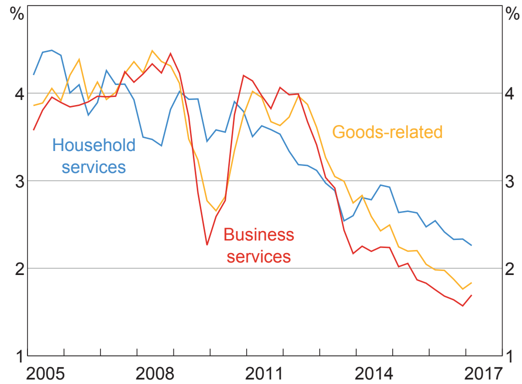
Graph 3.24
Job Mobility
Share of employed who changed employer in past year

Sources: ABS; RBA

The Australian experience of low wage growth is common with a number of advanced economies, including some with tight labour markets. This common experience could point to similar factors weighing on wage growth across a range of countries, including reduced bargaining power of workers, for example, as a result of increased global competition in labour and product markets.

Wage growth remains relatively low across all industries and states, although growth is particularly soft in business-service industries and in mining (Graph 3.25). The slowing in wage growth in business-service industries such as professional, scientific & technical and rental, hiring & real estate may partly reflect their exposure to the end of the mining investment boom. Liaison reports suggest there are some signs of stronger wage growth in some occupations within business-service industries that are experiencing labour shortages; these include selected IT roles and some construction-related engineering jobs. Household services wage growth has also slowed in recent years. A relatively large share of workers in these industries have their wages determined in enterprise bargaining agreements (EBAs); the slowing in wage growth is consistent with many of these EBAs rolling over to lower wage increases over the past couple of years, a trend that continued into the March quarter. The slower growth in public sector EBAs is also consistent with the caps placed on public sector wage growth by state governments.

Graph 3.25
Wage Price Index Growth
Year-ended



Sources: ABS; RBA

Information from the Bank's liaison program suggests that private sector wage growth will be broadly unchanged over the year ahead. The Fair Work Commission's decision to raise minimum and award wages by 3.3 per cent, effective from 1 July, will support wage growth in the September quarter and beyond (see 'Box C: Minimum Wage Decision'). ✠