Overview

The Australian economy remains on track to achieve lower unemployment and higher inflation over time. Supported by accommodative domestic monetary policy and a positive international outlook, GDP growth is expected to be a little above 3 per cent in both 2018 and 2019, which will reduce spare capacity. The unemployment rate is therefore forecast to decline, reaching around 5 per cent by end 2020. As the labour market tightens, wages growth and inflation should increase gradually. Temporary factors affecting administered prices are likely to hold inflation down in the very near term. Beyond the next quarter or so, the inflation outlook is essentially unchanged from three months ago.

The global economic outlook remains positive, despite the recent increase in trade tensions. Output growth has been quite strong in a number of key trading partners in the June quarter. Global growth is expected to slow a little, but remain above trend, over coming years. At present, central banks in the major advanced economies are at different stages of their monetary policy cycles, with some reducing policy accommodation and others adding to it.

The major advanced economies continue to grow above trend. Labour markets are tight, especially in the United States and Japan. Unemployment rates have reached multi-decade lows in some countries. As spare capacity has continued to be absorbed, wages growth has been picking up. However, the increase in wages growth to date has been modest compared with past experience. Tight labour market conditions have contributed to higher inflation in the United States, where it is now close to the central bank's policy target. In the euro area and Japan, the rise in inflation has been largely driven by oil prices.

Tax cuts and higher government spending are contributing to the strong growth outcomes in the United States. Fiscal stimulus of this magnitude is unusual in times of limited spare capacity. It is therefore possible that both growth and inflation in the United States could pick up by more than expected. In that case, US monetary accommodation might be withdrawn more quickly than currently projected. The US dollar could then be expected to appreciate against other currencies, including the Australian dollar, in an environment of strong global growth. On a trade-weighted basis, the Australian dollar remains in the range it has been in for some time.

Trade tensions between the United States and China have increased in recent months, with the US administration announcing further protectionist measures, and China and some other economies responding. The direct effects of the measures enacted or announced so far are likely to have only a minor effect on global trade and output. The risk is that uncertainty and the threat of further measures could weigh on growth through lower investment.

Financial market pricing in the major markets has been little affected by the increase in trade tensions. Strong earnings and ongoing expansionary policy settings have supported equity valuations; corporate bond spreads remain narrow and financial volatility is low. Money market rates in Australia have eased somewhat since the end of June, after having risen significantly over the previous month or so, but remain higher than last year. However, retail deposit rates are little changed, which has ameliorated the effect of higher money market rates on overall funding costs for banks.

Over the course of this year, some emerging markets have experienced capital outflows, depreciating exchange rates and widening bond spreads because of country-specific concerns about their institutional settings and economic outlook. These external pressures have continued to build in Turkey and Pakistan, but have abated across Latin America more recently.

Emerging economies in east Asia have been less affected by these financial market pressures. Growth in east Asia (excluding China and Japan) has remained broadly steady at an above-trend rate. Domestic demand has become an increasingly important driver of growth. These emerging economies could face headwinds from further trade protection measures, however, given their high trade exposure and integration with global supply chains that often include China.

Growth in China has slowed a little. The Chinese authorities have been balancing their objectives of controlling financial risk and reducing pollution against the need to support near-term growth. In doing so, they have responded to the recent weakness in some sectors with targeted easing in monetary and fiscal policy to support the economy. The Chinese renminbi has depreciated to be back around the level it was in trade-weighted terms mid last year.

Australia's terms of trade have held up a bit higher than had been expected a few quarters ago, in part because Chinese steel production has remained strong. This is likely to continue for the next couple of quarters or so as well. Beyond that, Australia's terms of trade are projected to decline moderately, as growth in Chinese steel demand slows and additional global supply of bulk commodities comes on line.

Growth in the Australian economy picked up in the March quarter. Growth is likely to have remained solid in the June quarter, despite the effect of drought conditions on the rural sector. Rural exports have been boosted in the short term because some farmers are still experiencing good conditions, while others have responded to dry weather by raising slaughter rates and thus increasing meat production.

Resource export volumes increased strongly over the first half of 2018, as new production capacity continued to come on line and previous supply disruptions were resolved. Resource exports are forecast to contribute to growth over the next two years, after which they are expected to stabilise at a high level as major projects reach their targeted production levels. Mining investment is still expected to reach its trough in late 2018 or early 2019. Further out, it should increase moderately as companies invest to sustain production at current levels.

Business conditions remain positive. Surveyed business conditions are above average, especially for goods-related sectors. Non-mining business investment increased by 10 per cent over the year to the March quarter. It is expected to continue to grow over the next few years, but at a more moderate pace. In the near term, non-residential building activity is likely to be supported by the existing pipeline of work yet to be done, even though new building approvals have trended down. Private infrastructure investment has also increased of late, led by investment in electricity projects (including renewable energy). Machinery and equipment investment is forecast to pick up as the economy continues to expand.

Spillovers from public sector infrastructure spending have contributed to the positive conditions in the private sector, especially for the construction and business services industries. More generally, public demand has supported output growth over recent quarters. State and federal budget forecasts imply that this is likely to continue over the period ahead. The rollout of the National Disability Insurance Scheme has supported growth in public sector consumption.

Dwelling investment has remained high, driven by ongoing high levels of activity in the south-eastern states. Dwelling investment is likely to remain at a high level over the next couple of years, supported by a large pipeline of work still to be done. Capacity constraints in the building industry, especially in Sydney, are likely to constrain the pace at which this pipeline can be worked through.

Conditions in the established housing markets in Sydney and Melbourne continue to ease, but the declines in prices from their peaks remain modest overall. Housing prices remain subdued in the other mainland capitals. Demand for housing credit has eased, particularly from investors, with lending to owner-occupiers slowing only slightly. Lenders continue to compete strongly for low-risk borrowers. Although a few lenders have increased advertised mortgage rates recently, citing the increase in money market rates, others have announced rate reductions on selected loan products. The average rate paid across all mortgages has drifted down over the past year.

Household consumption growth was relatively low in the March quarter, but the weakness was narrowly based; consumption is still expected to grow at a solid pace in the June quarter. Further out, consumption is expected to increase steadily, at a rate a little above the average of recent years. Weak growth in household income has posed a risk to the consumption outlook for some time. Consumption could be particularly sensitive to unexpected weakness in income given the context of high household debt. More recently, though, growth in labour income has recovered somewhat. Growth in income from other sources has remained soft.

Labour market conditions have improved. Although employment growth has not been as fast as in 2017, it exceeded growth in the working-age population over the first half of 2018 and has been sufficient to see the unemployment rate decline a touch in recent months. Labour force participation has increased and is now around its historical high. Leading indicators of employment growth point to above-average growth in the period ahead; job vacancies have reached a high level relative to the size of the labour force. Above-trend GDP growth should result in a gradual decline in the unemployment rate to 5 per cent in 2020.

As the labour market tightens, wages growth can be expected to pick up gradually from current low rates. The Fair Work Commission handed down an increase of 3.5 per cent in minimum and award wage rates from 1 July in its annual review. Average wages growth in new collective agreements has also partly recovered from its recent trough. However, the recent experience of other economies highlights the uncertainty about estimates of spare capacity and the pace of any pick-up in wages growth.

Inflation in the June quarter was as expected at the time of the May *Statement on Monetary Policy*. Both CPI and underlying inflation were around ½ per cent in the quarter. In year-ended terms, CPI inflation increased a little to 2.1 per cent, while underlying inflation was close to 2 per cent.

A number of factors have been combining to keep inflation low. Slow growth in labour costs has tended to hold down domestic price pressures across a range of items, and ongoing strong competition in the retail sector has also contributed to weakness in retail prices. Growth in rents remained around its lowest year-ended rate since the mid 1990s, consistent with the recent large expansion in rental housing supply and ongoing weak housing market conditions in Perth. In contrast, growth in the cost of building new housing has picked up a little, but by less than might have been assumed, given reported capacity pressures in the construction sector. Increases in tobacco excise have also added to headline inflation.

CPI inflation is expected to be quite low in the September quarter. Utilities prices have reversed some of the previous year's increases in some states, and a range of policy initiatives by governments are likely to reduce the effective prices of child care and some TAFE courses. The central forecast assumes that these price changes are one-offs and will not affect quarterly inflation in later quarters. These changes will reduce headline CPI inflation to a greater extent than underlying inflation.

Beyond the September quarter, the forecasts for quarterly inflation are essentially unchanged, consistent with the unchanged outlook for the real economy and labour market. The Bank's forecasts are for CPI inflation to pick up to be around 2¼ per cent in both 2019 and 2020. Underlying inflation is also expected to increase, from close to 2 per cent over the year to June 2018 to around 2¼ per cent in 2020.

Overall, the Australian economy remains on the path it has been for at least the past year and a half. Although inflation is likely to be a bit lower in the near term, this is expected to be temporary. Further gradual progress on both lowering unemployment and bringing inflation closer to the midpoint of the target is expected over coming years. The current accommodative stance of monetary policy will assist this outcome.

The Reserve Bank Board has for some time been of the view that holding the cash rate steady at 1½ per cent would support the gradual progress being made on unemployment and inflation, with steady monetary policy promoting stability and confidence. Higher interest rates are likely to be appropriate at some point, if the economy continues to evolve as expected. Given the gradual nature of the improvement, however, the Board does not see a strong case to adjust the cash rate in the near term.