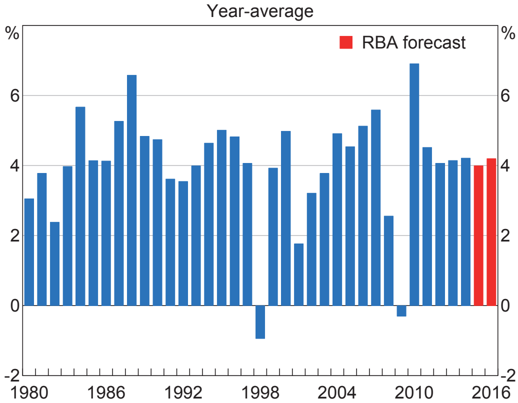
# 6. Economic Outlook

## The International Economy

Growth of Australia's major trading partners is expected to be around its long-run average in 2015 and 2016 (Graph 6.1). Forecasts for 2015 have been revised down slightly since the May *Statement*, largely reflecting somewhat weaker-than-expected growth in east Asia in the first half of 2015. Growth will continue to be supported by generally accommodative monetary policies around the globe and oil prices that remain well below their level of a year ago.

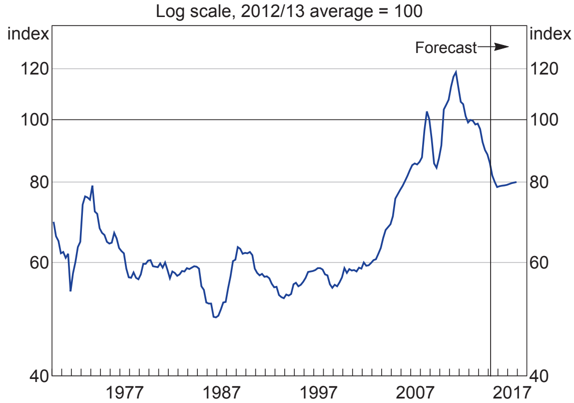
**Graph 6.1**
**Australia's Trading Partner Growth***
Year-average




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

The outlook for Australia's terms of trade has been revised down by 4 per cent since the previous *Statement* as a result of further falls in commodity prices (Graph 6.2). This is consistent with a slightly weaker demand outlook for a range of commodities, including a more subdued outlook for Chinese steel

**Graph 6.2**
**Terms of Trade**
Log scale, 2012/13 average = 100




Sources: ABS; RBA

demand. Also, expectations are that there will only be a limited reduction in global supply from high-cost producers of iron ore, including from China.

Growth in China is expected to moderate gradually over the forecast period, largely as forecast previously. Weaker growth of investment and manufacturing production is expected to be offset, in part, by the effects of more accommodative monetary and fiscal policy settings. The Japanese economy is expected to grow in 2015 and 2016 at a rate that is above its decade average, supported by accommodative monetary policy and the depreciation of the yen over the past 2½ years. In the rest of east Asia, growth in 2015 is expected to be slightly below its long-term average, reflecting weaker exports in the first half of 2015 and a more recent slowing in domestic demand growth; growth in the region is expected to return to its long-run average by 2016, aided by low interest rates and the low price of oil.

Growth in the United States is expected to continue at an above-trend rate over the forecast period, notwithstanding the moderation in growth in the first half of 2015 that was largely due to temporary factors. US growth is expected to be supported by ongoing improvements in the labour market and the stance of monetary policy, which is expected to remain accommodative for some time after the first increase in the federal funds rate. In the euro area, the gradual recovery in economic activity is expected to continue, consistent with above-average consumer and business confidence and supported by easy monetary conditions and the depreciation of the euro.

## 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 Board to any particular path for policy. The exchange rate is assumed to remain at its current level over the forecast period (TWI at 62 and A$ at US$0.74). The TWI is around 5 per cent lower than the assumption underlying the forecasts in the May *Statement*. The forecasts are based on the price of Brent oil remaining at US$53 per barrel, which is around 25 per cent lower than the assumption used in May, and in line with near-term futures pricing.

The forecasts assume a lower rate of population growth than in the previous *Statement*. Recent data indicate that population growth has been declining for some time because net immigration has been lower than expected. This is discussed in greater detail in 'Box D: Implications of Lower Population Growth for the Australian Economy'. The forecasts assume that the lower level of net immigration will persist for the next two years, in part because labour market conditions in Australia are expected to remain weaker than those in countries that have traditionally been a source of skilled, prime-age immigrants, such as New Zealand. Accordingly, the working-age population is assumed to grow at an annual rate of about 1½ per cent over the next two and a half years, which is around ¼ percentage point lower each year than assumed in the previous *Statement*.[1]

The key forces shaping the forecasts remain much as they have been for some time. Below-average growth in the near term reflects the large falls in mining investment, which are offset by continued growth in resource exports. Consumption growth is expected to rise and dwelling investment is forecast to remain strong. This increase in household demand, as well as the response of net exports to the exchange rate depreciation, is expected to support a pick-up in non-mining business investment from 2016/17.

The net result of these forces is that GDP growth is expected to be between 2 and 3 per cent over the year to June 2016 and to pick up to above 3 per cent over the year to June 2017 (Table 6.1). Revisions since the previous *Statement* are relatively minor compared with the usual range of uncertainty.

The assumption of lower population growth leads to lower growth for some elements of expenditure, most notably consumption and non-mining business investment. Growth of public demand and of non-mining business investment have also been revised lower in light of other new data. These effects have been partly offset by the stimulatory impact of the recent exchange rate depreciation.

The unemployment rate is anticipated to be lower than previously forecast. In part, this reflects the generally better-than-expected labour market conditions of late. Moreover, the unemployment rate is expected to remain little changed from recent levels for some time. This is despite the change to the forecast for aggregate demand, which is likely to be broadly matched by lower growth of the economy's productive capacity, owing to lower population growth. Accordingly, the unemployment

1 These assumptions have been developed by the Bank. Updated projections from the Department of Immigration and Border Protection have not yet been released.

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

| | Year-ended | | | | | |
|---|---|---|---|---|---|---|
| | June 2015 | Dec 2015 | June 2016 | Dec 2016 | June 2017 | Dec 2017 |
| GDP growth | 2 | 2½ | 2–3 | 2½–3½ | 3–4 | 3–4½ |
| CPI inflation[(b)] | 1.5 | 2½ | 2–3 | 2–3 | 2–3 | 2–3 |
| Underlying inflation[(b)] | 2¼ | 2½ | 2–3 | 2–3 | 2–3 | 2–3 |
| | Year-average | | | | | |
| | 2014/15 | 2015 | 2015/16 | 2016 | 2016/17 | 2017 |
| GDP growth | 2¼ | 2¼ | 2–3 | 2–3 | 2½–3½ | 2½–4 |

(a) Technical assumptions include A$ at US$0.74, TWI at 62 and Brent crude oil price at US$53 per barrel
(b) Based on current legislation
Sources: ABS; RBA

rate is now forecast to remain little changed over the next 18 months or so from recent levels, before declining over 2017.

As has been the case for some time, low interest rates are expected to support a pick-up in consumption growth over the forecast period, despite expectations that income growth will remain low. Accordingly, the household saving ratio is expected to decline further. Household credit growth has also been stronger than income growth, although it remains relatively moderate by historical standards, and the debt-to-income ratio is expected to increase gradually. Low interest rates and rising housing prices are expected to continue to support dwelling investment over the next couple of years.

Forecasts for non-mining investment have been revised lower, consistent with weaker indications from both the ABS capital expenditure survey of investment intentions for 2015/16 and the low level of non-residential building approvals. The revisions to the population projections also imply somewhat lower growth in non-mining business investment because the investment in capital required for employees to be productive is growing by less, as is household demand. The downward revision in non-mining business investment in the near term is also consistent with information from the Bank's liaison, which suggests that firms are still waiting to see a sustained pick-up in demand before increasing their capital expenditure. The depreciation of the Australian dollar is supporting demand and investment in service sectors with an export focus, such as tourism, although these sectors account for a relatively small share of non-mining investment.

Mining investment is expected to continue to fall over the next two and a half years as large iron ore, coal and liquefied natural gas (LNG) projects are completed, and few new projects commence. The lack of a pipeline of new projects has been factored into the outlook for some time and, given this, declines in commodity prices since the beginning of this year have not resulted in a significant further reduction in planned investment.

Export growth is expected to continue to make a sizeable contribution to GDP growth over the forecast period. LNG exports are expected to grow strongly as a number of projects currently under construction begin production, and exports of services are expected to benefit further from the lower exchange rate. Despite falling commodity prices, the majority of Australian production of iron ore is estimated to be profitable and low-cost producers are expected to continue to expand supply. Import volumes are estimated to be lower than previously forecast, reflecting the slight downward revision to domestic demand as well as the depreciation of the Australian dollar.

The forecast for public demand growth has been revised a little lower. This largely reflects a reassessment of the momentum in public demand, which was flat over the year to the March quarter and has grown at a below-average pace for some time.

## Inflation

Recent wage growth has been a little lower than expected. Wage growth is not expected to decline further, but neither is it expected to increase much over the next couple of years, given broad-based evidence of spare capacity in the labour market and employers in both the private and public sectors remaining under pressure to contain costs. Unit labour costs are expected to increase only gradually, having been little changed for nearly four years. This low growth of labour costs is expected to help improve the competitiveness of Australian producers and assist with a recovery in labour demand.

The inflation forecast has been revised up a little since the previous *Statement*, primarily because the Australian dollar has depreciated further. Nevertheless, domestic cost pressures are expected to remain well contained and underlying inflation is expected to be around 2½ per cent over the forecast period. Inflation expectations remain around or a little below average.

Inflation in the prices of non-tradable items is forecast to remain below its inflation-targeting average, in line with spare capacity in the labour market and low growth of labour costs. Strong demand for residential construction is likely to see inflation in new dwelling costs remain above average, although competitive pressures are likely to constrain the ability of firms more broadly to expand their margins.

The prices of tradable items are expected to rise over the next few years, given further pass-through of the exchange rate deprecation. The cumulative depreciation of the exchange rate since early 2013 has already led to an increase in import prices, which is gradually being passed through into prices for final goods. The exchange rate has depreciated further since the May *Statement* and therefore tradables inflation is expected to be somewhat higher than was forecast at that time. The direct effects of the exchange rate depreciation since early 2013 are expected to add around ½ percentage point to underlying inflation over each year of the forecast period.

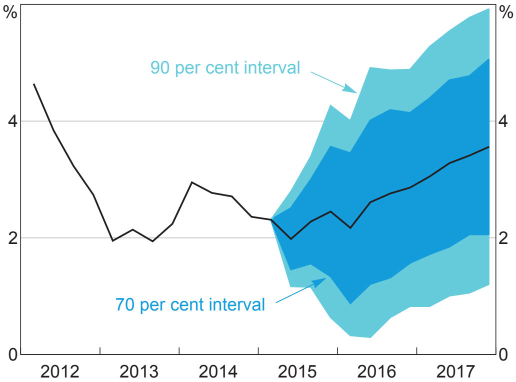
Headline inflation has declined over the past year or so in response to factors that are likely to have a temporary effect, most notably lower automotive fuel prices and the repeal of the carbon price. As the direct effects of these factors pass, headline inflation is expected to pick up. Lower fuel and oil prices have reduced input costs for a range of businesses, and these lower costs may gradually be passed on to the prices these businesses charge for their goods and services. The magnitude and timing of this indirect effect is difficult to gauge. Further increases in the tobacco excise in 2015 and 2016 are expected to contribute around ¼ percentage point in each of those years to the rate of headline inflation, but to have little effect on underlying inflation. Accordingly, headline inflation is expected to be consistent with the inflation target over the forecast period.

## Uncertainties

The forecasts are based on a range of assumptions about the evolution of some variables, such as the exchange rate and population growth, 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).

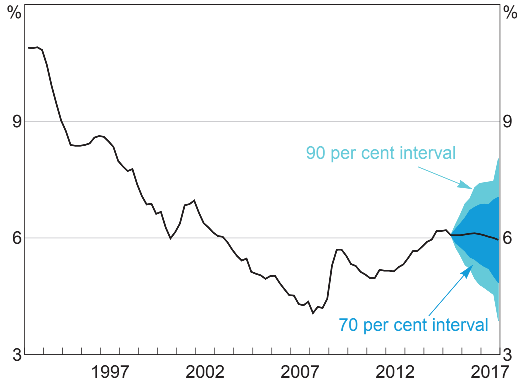
It is also worth considering the consequences that different assumptions and judgements might have on the forecasts and to consider the possible effects of events that are not part of the central forecast. There are always uncertainties about how events offshore will unfold, and how policymakers and financial markets will respond.

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



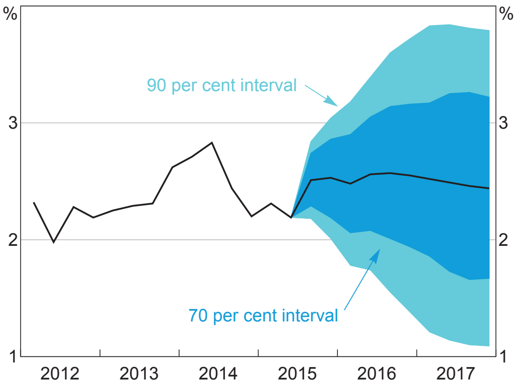

* Confidence intervals reflect RBA forecast errors since 1993
Sources: ABS; RBA

**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

One of the key sources of uncertainty for the forecasts is how policymakers in China will respond to economic and financial market developments, and how any policy actions will affect the Chinese economy. These developments will have implications for commodity prices, particularly prices for iron ore and coal, which affect Australia's terms of trade. Another key uncertainty is the way financial markets will react when the US federal funds rate starts to increase, which is expected to occur later this year.

Domestically, as always, there are uncertainties that could influence the balance between the growth of demand and supply, which, in turn, affects conditions in the labour market and the outlook for inflation. One such uncertainty relates to the effect of lower population growth. There is also uncertainty about how households will respond to the combined effects of low growth in incomes and rising wealth from the housing market, and about the outlook for business investment.

## The Chinese economy

There continues to be uncertainty surrounding the outlook for China's growth and macroeconomic policies, and the implications for commodity demand. Downside risks stemming from weakness in the property market persist but have receded somewhat, partly as a result of policy measures designed to support this part of the economy. Strong growth in property sales has reduced some of the inventory overhang, and has been associated with a rise in prices in the medium-sized and larger cities. This could boost investment growth in those cities over the coming year. However, construction activity in smaller cities, which has constituted a large share of residential investment, is likely to remain weak for some time. Policymakers have also responded to broader concerns about the momentum in activity. In particular, new infrastructure projects have been announced.

Moreover, progress is being made on the program to restructure local government debt, which is a key source of funding for infrastructure investment. Even so, the spending plans of some local governments are likely to remain under pressure from subdued proceeds from land sales.

Recent volatility in the Chinese equity market and the government's forceful policy responses may also be relevant to the economic outlook. The relatively low exposure of households to equity markets suggests that the immediate impact on domestic consumption is likely to be small and, to date, the effects on the broader financial system have been modest. However, potential confidence effects on consumption and investment are difficult to assess, and any wider implications for the reform agenda that may arise from the government's decision to intervene directly in capital markets are as yet unclear.

## Market reaction to an increase in the federal funds rate

Recent commentary from Federal Open Market Committee members and market pricing suggest that there is likely to be a policy tightening in the United States some time this year. This would see the policy rate rise from near zero for the first time in nine years. Although the prospect of this tightening has been well telegraphed for some time, there is a possibility of considerable volatility in global financial markets when it eventuates. It is also possible that there will be a further appreciation of the US dollar, including against the Australian dollar and other currencies in Asia.

A depreciation of the Australian dollar would be expected to support demand for Australian production and add to inflationary pressures for a time through higher import prices. Historical relationships suggest that a 10 per cent depreciation in the Australian dollar (that is not associated with a decline in commodity prices) would be expected to increase output by ½–1 per cent over a period of two years or so. Year-ended inflation would be higher by a little less than ½ percentage point over each of the two years or so following such a depreciation.

## The balance between demand and supply

The degree of spare capacity in the economy is not directly observable and relies on estimates of aggregate demand and the productive capacity of the economy, both of which are subject to measurement error and revision. The assumed profile for population growth affects both aggregate demand and the productive capacity of the economy. The recent revisions to population growth have increased the uncertainty about the degree of spare capacity in the economy, in part because complete information about which components of population growth have been revised is not yet available.

The downward revision to population growth to the end of 2014 is assumed to imply lower growth in the economy's productive capacity. The stabilisation of the unemployment rate over the course of the past year is consistent with this interpretation. However, it is possible that there has been an offsetting pick-up in productivity growth over this period that will persist into the future, or that the output and labour market data, on which this interpretation is based, will be revised.

## Business investment

Total business investment is expected to fall over the next two and a half years as mining investment continues to decline sharply and non-mining investment remains subdued. However, the size of the fall in overall mining investment and the impact of the declines in commodity prices remain uncertain. Given the size of the falls in mining investment already factored into the forecasts, the decline in commodity prices since the begining of the year is not expected to lead to a significant additional fall in mining investment, although there have been indications that some capital expenditure may have been deferred, especially in the coal sector.

The forecast for non-mining business investment in 2015/16 has been lowered, partly on the basis that new data on business investment intentions and non-residential building approvals over the past three months have been weaker. More generally, the revisions to population growth and consumption reduce the need for additional investment, and much of the growth in the economy is being generated by service sectors that are relatively labour intensive. However, some of the preconditions for a stronger recovery in non-mining business investment are in place, including low borrowing rates and survey measures of business conditions that are at an above-average level. In addition, the Australian dollar has depreciated significantly over the past couple of years, which has stimulated demand for domestically produced goods and services. This would be expected to continue should the dollar depreciate further. As a result, there is significant uncertainty around the timing and strength of the expected pick-up in non-mining business investment growth. The downward revisions to the non-mining business investment forecasts are assessed to have resulted in the risks to these forecasts being more balanced.

## Household sector

The forecast for a further gradual pick-up in consumption growth is associated with a further gradual decline in the saving ratio, given the low growth of household disposable income that is expected. The decline in the saving ratio is consistent with low interest rates and a forecast for continued increases in household wealth.

It is also consistent with the decline in the terms of trade, insofar as some of the increase in the saving ratio over the 2000s was a response to the temporary effect on income from the boom in the terms of trade. This possibility is supported by data that show saving ratios increasing by more for households in states that have been most directly affected by the terms of trade.

There is also uncertainty about the path of wealth and its effect on household consumption decisions. Housing prices have an important bearing on household wealth. Supply constraints, particularly in Sydney, may limit the extent to which new dwelling investment can satisfy growing demand, which raises the possibility that housing prices will grow more quickly than forecast. Also, housing prices outside Sydney and Melbourne are little changed over the past year or so and may not yet have responded fully to the very low levels of interest rates.

While higher housing prices would pose upside risk to the consumption forecasts, there is also a downside risk arising from the possibility that consumption will be less responsive to rising wealth than has been the case in the past. In recent years, fewer households appear to have been utilising the increase in the value of their dwellings to trade up or increase their leverage for the purposes of consumption or alterations and additions to housing. There is also evidence that households have revised down their expectations of their income growth, and therefore may be less willing to carry as much debt as in the past. These possibilities suggest that growth of household expenditure could be somewhat lower, and the saving ratio higher, than forecast.