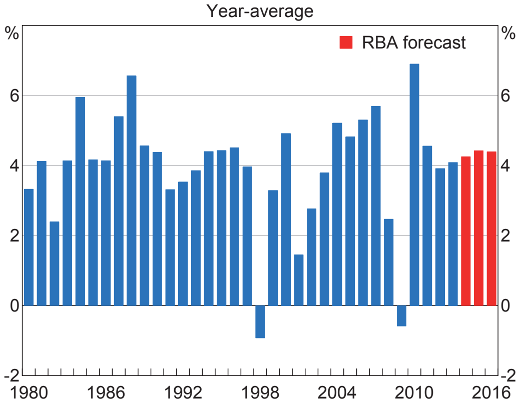
6. Economic Outlook

The International Economy

Overall, growth of Australia's major trading partners (MTPs) is expected to be around its long-run average pace in 2015 and 2016 (Graph 6.1). This forecast is little changed relative to the November *Statement*. Commodity prices have fallen in the past three months. These price declines, particularly for oil, largely reflect supply-side factors, although weaker-than-expected growth of global demand for commodities has contributed. Most of Australia's MTPs are likely to benefit from lower oil prices because they are net oil and energy importers. However, this positive effect has been largely offset by other factors, most notably slower growth in China.

In China, the authorities are widely expected to revise down their growth target in 2015. GDP growth in 2015 is projected to be at or slightly below 7 per cent. This represents a modest downward revision to the previous projection, and largely reflects a weaker-than-expected quarterly growth rate for the December quarter 2014. In the near term, weakness in the property market and parts of the manufacturing industry are likely to dampen growth, although the rollout of new infrastructure investment projects and the positive impact of lower oil prices should provide some offsetting support for demand. GDP growth is expected to moderate further in 2016, consistent with developments in supply-side factors (such as the declining working-age population) and policymakers' willingness to accommodate slower growth to prevent an unsustainable build-up in leverage.

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

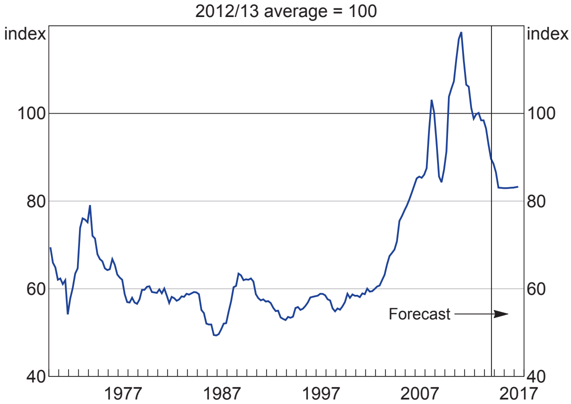


* Aggregated using total export shares
Sources: ABS; CEIC Data; RBA; Thomson Reuters

In Japan, growth appears to have resumed towards the end of 2014. Growth is expected to be stronger in 2015 than previously expected because of the postponement of a further planned consumption tax increase to April 2017, additional temporary fiscal stimulus and the positive effects of lower oil prices. In the rest of east Asia, the economic outlook is little changed and growth is expected to remain at around its decade average. Growth in the US economy in 2015 is expected to be stronger than forecast three months ago, reflecting the boost to consumer spending resulting from lower energy prices. The recovery in the euro area is still expected to be modest.

In aggregate, developments in commodity markets have lowered the outlook for Australia's terms of trade (Graph 6.2). This largely reflects the net effect of lower prices for iron ore and oil. The Bank's forecast for the iron ore price is a little below the Consensus Economics forecast over the next two and a half years. The Bank's forecast assumes that reductions in supply from higher-cost iron ore producers globally will be limited, partly because there has been little meaningful response from these producers to date, but also because the decline in oil prices will reduce the costs of extracting and transporting iron ore. The direct effect of lower oil prices is to raise the terms of trade given that Australia is a net oil importer. This is estimated to be offset in part by the fact that lower oil prices will lead to a decline in prices for liquefied natural gas (LNG), given that Australia's export prices for LNG are linked to oil prices.

Graph 6.2
Terms of Trade
2012/13 average = 100



Sources: ABS; RBA

The downward revisions to the terms of trade would normally be expected to lead to lower growth of real economic activity. However, falling iron ore and oil prices operate through different channels, so an estimate of the net effect on GDP, or on specific elements of GDP, needs to consider each factor separately.

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 64 and A$ at US$0.78). The TWI is around 7 per cent lower than the assumption underlying the forecasts in the November *Statement*. The forecasts are based on the price of Brent oil remaining at US$59 per barrel, which is more than 30 per cent lower than the assumption used in November. This is in line with near-term futures pricing. Similar to the previous *Statement*, the working-age population is assumed to grow by 1.8 per cent over each year, drawing on forecasts by the Department of Immigration and Border Protection.

The starting point for the forecasts is that over the second half of 2014 the Australian economy grew at a bit below its average rate. Falls in mining investment detracted significantly from overall growth, although this was offset by a strong increase in resource exports. While growth in non-mining activity has picked up a little over the past two years, all components except dwelling investment look to have grown at a below-average pace over the past year.

While the key forces shaping the forecasts remain much as they were, the forecasts for GDP growth over the coming quarters are a bit lower than those presented in the November *Statement* (Table 6.1). GDP growth is now expected to remain below trend over the course of this year and then to pick up to an above-trend pace in the latter part of the forecast period, in response to rapid growth in LNG exports and the lower exchange rate and interest rates.

The revisions to GDP growth in the near term take account of the net effect of a number of recent developments, which suggest that consumption will continue to grow at a below-average pace for a time and non-mining investment will remain subdued until at least mid 2015. LNG exports are also expected to increase less rapidly in the near term. These revisions have been offset to some extent by the net positive effect on growth of lower commodity prices and the depreciation of the exchange rate, which – together

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

	Year-ended					
	Dec 2014	June 2015	Dec 2015	June 2016	Dec 2016	June 2017
GDP growth	2½	2¼	2¼–3¼	2¾–3¾	3–4	3–4½
Non-farm GDP growth	2¾	2¼	2¼–3¼	2¾–3¾	3–4	3–4½
CPI inflation[(b)]	1.7	1¼	2–3	2¼–3¼	2¼–3¼	2¼–3¼
Underlying inflation[(b)]	2¼	2¼	2–3	2–3	2–3	2–3
	Year-average					
	2014	2014/15	2015	2015/16	2016	2016/17
GDP growth	2¾	2¼	1¾–2¾	2½–3½	2¾–3¾	2¾–4¼

(a) Technical assumptions include A$ at US$0.78, TWI at 64 and Brent crude oil price at US$59 per barrel
(b) Based on current legislation
Sources: ABS; RBA

with low interest rates – are expected to impart a sustained stimulus to the economy over the forecast period.

The lower level of interest rates than was assumed in the November *Statement* and strong population growth will support household demand. The lower oil prices seen to date can be expected to boost consumption by contributing about ¾ percentage point to real disposable income. However, this effect is expected to be offset by somewhat lower growth of labour incomes than had been expected. Consumption growth is still expected to pick up over the forecast period. The saving ratio is forecast to decline gradually, continuing its trend of the past couple of years. Leading indicators suggest that dwelling investment will continue to contribute to GDP growth over coming quarters. The Bank's forecast is for dwelling investment growth to ease gradually from the end of 2015.

In time, growth of household demand and the impetus to domestic production provided by the exchange rate depreciation since early 2013 are expected to increase capacity utilisation and spur non-mining business investment (although this will be offset to some extent by the higher cost of imported investment goods). However, the expected recovery in non-mining investment has been pushed out to later in 2015, reflecting new information from a number of leading indicators. In particular, the ABS capital expenditure (Capex) survey suggests that there will be only very modest growth in non-mining investment in 2014/15, and survey measures of business conditions and capacity utilisation (which both tend to lead investment by up to a few quarters) were little changed in the December quarter at close to long-run average levels. Non-residential building approvals remain relatively low in trend terms and demand for commercial property remains relatively weak. The pace of the recovery in non-mining business investment is forecast to be around the average pace of growth in previous expansions, as a lower exchange rate and very accommodative monetary conditions help to support the recovery.

Mining investment is expected to fall sharply over the next two years as a number of large-scale projects come to completion and few new projects are expected to start. The lack of a pipeline of new projects has been factored into the outlook for some time and predates the recent declines in commodity prices. Given this, the additional effect of lower commodity prices on near-term mining investment is likely to be modest. There have been indications that some capital expenditure to maintain the existing mining capital stock has been deferred and that there will be less spending on exploration activity. This has led to a marginal downward revision to the outlook for mining investment. As a result, the main channel through which lower bulk commodity prices are expected to affect activity is via lower returns to domestic shareholders and lower tax revenues, although the recent depreciation is likely to dampen this effect somewhat.

In contrast to mining investment, export growth is expected to continue to make a sizeable contribution to GDP growth, particularly towards the end of the forecast period, when LNG exports are expected to be growing strongly and to contribute ¾ percentage point to GDP growth over 2016/17. While the ramp-up in LNG production is expected to proceed a little more slowly than had previously been expected, the effect of this on exports is expected to be offset by the modest boost to manufactured and service exports provided by the depreciation of the exchange rate. Iron ore exports are expected to continue to rise as more production comes on line.

Reflecting the depreciation of the Australian dollar and a downward revision to domestic demand, import volumes are expected to be lower in the near term than previously forecast. Growth in imports related to the non-mining sector are expected to pick up in line with non-mining activity, while imports related to mining activity are expected to continue falling over the next couple of years.

Public demand is still expected to grow at a below-average pace over much of the forecast period. Growth has been revised down a little from the November *Statement*, largely reflecting weaker-than-expected growth in the September quarter. Large falls in commodity prices have not affected the forecast extent of fiscal consolidation materially, since governments have generally chosen not to respond to the most recent reduction in tax and royalty revenue implied by lower commodity prices, and have left spending plans unchanged. The exception is Western Australia, where expenditure has been cut noticeably, although this makes only a small difference to aggregate public expenditure.

While employment growth picked up a bit over the past year, a number of indicators suggest that spare capacity in the labour market has increased, consistent with below-trend growth in the economy. The labour market forecasts have been revised to be a little weaker than in the previous *Statement*, owing to the softer outlook for activity in the near term. The unemployment rate is now expected to rise a little further and peak a little later than earlier anticipated, although there is a degree of uncertainty around this forecast (see 'Box E: Unemployment Rate Forecasts and Confidence Intervals'). This is in line with forward-looking indicators of labour demand, which suggest only modest employment growth in the near term, below the rate of growth in the working-age population. The unemployment rate is expected to decline towards the latter part of the forecast period, once growth picks up to an above-trend pace.

Consistent with subdued labour market conditions, wage growth remains weak. According to the Bank's business liaison, many firms expect to see a period of low and stable wage growth ahead. Wage growth is not expected to decline further, although pressure on public and private sector employers to contain costs means that wage growth is likely to remain low for some time and pick up only gradually towards the end of the forecast period. Meanwhile, labour productivity growth is expected to remain a little above its pace of much of the past decade. Combined, these forces imply that unit labour costs will remain well contained, helping to improve the competitiveness of Australian producers.

Inflation

The inflation forecast has been revised down a little since the previous *Statement*, reflecting the fall in oil prices and the slightly weaker near-term outlook for product and labour markets, which more than offset the upward price pressures from further exchange rate depreciation.

Headline inflation has declined over the past year. In part, this reflects the repeal of the carbon price mid last year, which lowered utility prices, as well as the initial effects of lower automotive fuel prices. Headline inflation was 0.3 per cent (in seasonally adjusted terms) in the December quarter and 1.7 per cent over the year. Headline inflation is expected to remain below the 2 to 3 per cent target in year-ended terms over much of 2015, before picking up a bit to be consistent with the inflation target.

The measures of underlying inflation were around 0.7 per cent in the December quarter, after an unusually low reading in the previous quarter. In year-ended terms, the underlying measures have declined to around 2¼ per cent. Underlying inflation is expected to remain well contained and consistent with the inflation target throughout the forecast period.

The fall in automotive fuel prices, as a result of lower oil prices, subtracted around ¼ percentage point from headline inflation in the September and December quarters combined. It is expected to subtract a further ½ percentage point in the March quarter. By contributing to lower input costs for a range of businesses, lower oil prices will also have some effect on the prices of other goods and services. This indirect effect will take some time to pass through to consumer prices and is more difficult to gauge. While estimates are quite uncertain, the central forecast assumes that this indirect effect will subtract a little less than ¼ percentage point per year from underlying inflation over most of the forecast period.

The depreciation of the exchange rate since early 2013 has led to increases in import prices. Final consumer prices for tradable items (excluding automotive fuel) are likely to increase over the next few years, reflecting the pass-through of these higher import prices. Altogether, the direct effects of the exchange rate depreciation since early 2013 are expected to add a little under ½ percentage point to underlying inflation over each year of the forecast period.

Domestic inflationary pressures are expected to remain moderate. In particular, spare capacity in the labour market is expected to contain labour costs, spare capacity in product markets is likely to constrain firms' ability to expand margins, and inflation expectations remain anchored. As a result, inflation for many non-tradable items, whose prices are primarily determined by domestic factors, is expected to remain low. An exception to this is the new dwelling price component of the CPI, which has continued to record higher inflation for the past year or so, reflecting strong conditions in the housing sector, and this dynamic is likely to continue.

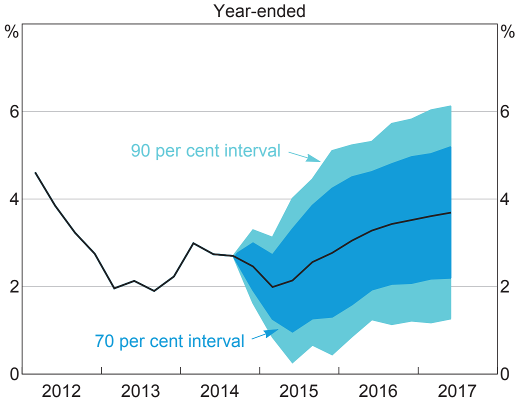
Government policy measures that have affected inflation of late will continue to do so over the forecast period. The further staged increase in tobacco excise in 2015 and 2016 is expected to contribute around ¼ percentage point each year to the rate of headline inflation, but to have little effect on underlying inflation. The effect of the recent increase in the fuel excise is expected to be small compared with the effect of lower crude oil prices.

Uncertainties

The forecasts are based on a range of assumptions about the evolution of important variables, such as the exchange rate, and judgements about how developments in one part of the economy will affect others. One way of demonstrating the uncertainty surrounding the central forecasts is to present confidence intervals based on historical forecast errors (Graph 6.3 and Graph 6.4).

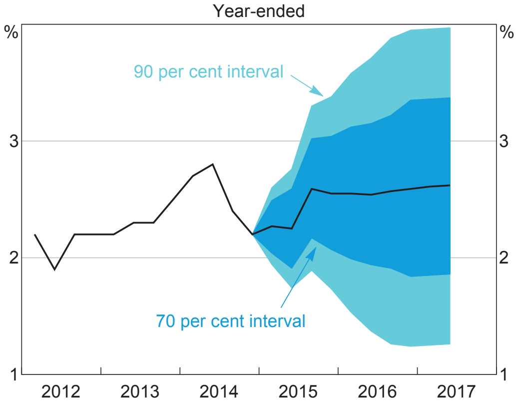
Uncertainty about the effects of changes in global macroeconomic policy is a key consideration. For example, forecasts for growth in Japan and the euro area depend crucially on assumptions about how effective monetary policy easing announced by the Bank of Japan and the European Central Bank will be in reviving growth in these regions. It is also worth considering the consequences that different assumptions and judgements might have on the forecasts and to consider the possibility of events occurring that are not part of the central forecast. Some considerations that are likely to have an important bearing on whether events unfold as forecast include uncertainty about: the implications of weakness in Chinese property markets; the outlook for commodity prices and their effects on global and domestic growth as well as the assumption of no change in the exchange rate; the extent to which households are likely to save or consume any increases in their real disposable income or wealth; and the timing and speed of the recovery in non-mining investment.

Graph 6.3
GDP Growth Forecast*
Year-ended



* 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

Chinese property market

Weakness in the Chinese property market represents an ongoing source of uncertainty for the prospects for growth in overall demand in China and for its demand for commodities. While the authorities have taken measures to support residential real estate activity, property prices have continued to decline (albeit at a slower rate than was the case earlier) and growth of investment has fallen. Real estate developers remain highly leveraged and it may take some time before existing inventories held by developers can be sold off. Slower growth of residential construction is likely to exert downward pressure on the growth of activity and profits in a range of industries that supply inputs to construction, including the steel industry. The related slowing in land price growth – and, in some cases, actual falls in land prices – also has the potential to weaken the revenue streams of local governments that rely heavily on land sales to raise funds. In some areas, this could slow local implementation of recently announced infrastructure investment plans and make it harder for policymakers to support overall economic activity without an acceleration of bank and non-bank financing. However, policymakers do have the scope to provide stimulus to the economy via fiscal and monetary policies, should they deem it necessary.

Commodity prices and the exchange rate

The large falls in both iron ore and oil prices over the past year largely reflect additional supply coming on line, although weaker-than-expected growth in demand for these commodities is also pushing down prices. The outlook for commodity prices is sensitive to assumptions about the responsiveness of supply to the decline in prices seen to date. The current forecasts assume that oil prices remain unchanged around current levels, with growth in supply and demand roughly in balance over the forecast period, and only a limited reduction in supply from higher-cost producers. However, it is possible that there is a more substantial response of supply to the sharp fall in prices, particularly from unconventional oil production. The potential for a sizeable decline in higher-cost production of bulk commodities also provides some upside risk to commodity prices more generally.

There is also uncertainty around the extent to which lower oil prices will boost global economic activity. A positive global supply shock such as this is unambiguously positive for global growth, but the size of this stimulus will depend on factors such as the persistence of the positive oil supply shock and the extent and speed of its pass-through to broader economic activity. The importance of the stimulus will also vary across economies, making it hard to assess the aggregate boost to growth of Australia's MTPs.

As usual, the path of the exchange rate remains a key source of uncertainty for the forecasts. Most estimates suggest that the exchange rate remains above its fundamental value, given the substantial decline in commodity prices over the past year. This raises the possibility of further depreciation, which by itself represents an upside risk to the forecasts for growth and inflation. The increasingly divergent monetary policies in the major economies also have uncertain implications for capital flows, exchange rates and financial markets more broadly.

There is considerable uncertainty about the combined effects of the fall in oil prices and the depreciation of the exchange rate on domestic inflation and inflation expectations. The lower oil price reduces firms' costs of production, whereas the depreciation of the exchange rate increases the costs of imported inputs. The forecasts assume that the degree of pass-through of these price changes is consistent with historical relationships, although the speed of pass-through could be slower or faster than expected depending on the strength of trading conditions.

Large changes in oil prices may have an effect on inflation expectations. Automotive fuel prices are a particularly salient price for many households, despite fuel's relatively small share of the overall consumption basket. The large fall in these prices, as well as the prospect of modest overall inflation outcomes, could have a long-lived feedback effect through inflation expectations. However, inflation expectations have remained well anchored in the face of significant relative price adjustments, including large exchange rate movements, over the inflation-targeting period.

Household sector

The forecasts for consumption assume that wealth effects continue to operate as they have done in the past and that there will be a further gradual decline in the household saving ratio. Consumption growth could be stronger than anticipated if conditions in housing markets strengthen, particularly in parts of the country that have seen less growth in house prices of late. If this is associated with a significant increase in leverage or a decline in lending standards, it could pose some risk to macroeconomic stability. However, another possibility is that ongoing buoyant conditions in housing markets will have less of an effect on consumption than previously. In particular, in recent years fewer households appear to have been utilising the increase in the value of their dwelling to increase their leverage or trade up. This possibility would imply that the saving ratio will be higher and consumption growth a little lower than expected based on historical experience. In addition, there is significant uncertainty around the size of the effect that the large changes in commodity prices, particularly oil prices, will have on household saving and consumption behaviour.

Business investment

Total business investment is expected to fall over the next two years as the large decline in mining investment offsets a recovery in non-mining investment. As has been noted previously, there is uncertainty about the timing and pace of the expected decline in mining investment. Given the size of the decline in mining investment already factored into the updated forecasts, it has been assessed that the most recent step-down in commodity prices will not lead to a significant additional fall. However, mining investment would be weaker than expected if this is not the case and/or if commodity prices decline much further.

The timing of the recovery in non-mining business investment has been pushed out until later in 2015 partly because there has not yet been convincing evidence of a turning point in the forward-looking indicators. There continues to be significant uncertainty around the timing and strength of the expected pick-up in non-mining business investment growth. However, many of the preconditions are in place for a recovery in non-mining investment and the longer investment remains weak, the more potential there is for the eventual recovery to be stronger than expected.