Overview

Growth of Australia's major trading partners was around its long-run average in 2014. It appears to have eased slightly in the early months of 2015. Commodity prices have been quite volatile over recent months, notably iron ore and oil prices, which have rebounded somewhat from recent lows. Even so, prices of Australia's key commodity exports overall have declined since the beginning of 2015 and are well down on levels of a year ago. In large part, the declines reflect growth in the supply of commodities globally, although an easing of growth in China's demand for some key commodities has also played a role. While there has been a further fall in Australia's terms of trade, the Australian dollar has appreciated by around 3 per cent against the US dollar and in trade-weighted terms since the previous *Statement*.

In China, economic growth has eased further. The Chinese property market remains a source of weakness in the economy and this is flowing through to weaker demand for steel and other construction-related products. Indicators for Japanese economic activity have been somewhat mixed early this year, though labour market conditions remain tight and there are tentative signs that wage growth will rise, which is expected to underpin a pick-up in domestic price pressures. Economic growth in the rest of east Asia looks to have slowed a little in the March quarter. Growth in the US economy moderated in the March quarter, largely reflecting the temporary effects of disruptions related to severe weather and industrial action in West Coast ports. Meanwhile, the US labour market has continued to improve and wage growth has picked up. Economic activity in the euro area is recovering at a gradual pace.

Despite slightly weaker-than-expected conditions early in 2015, growth of Australia's major trading partners is expected to remain around its long-run average pace in 2015 and 2016. Growth will continue to be supported by very stimulatory monetary policies in most parts of the world. Core inflation rates are below many central banks' targets. The Federal Open Market Committee is not expected to start increasing the US policy rate until the second half of 2015, while the People's Bank of China has recently taken steps to boost liquidity and has adopted a more accommodative monetary policy stance more generally. The European Central Bank and the Bank of Japan continue to expand their balance sheets in line with their previously announced policies. Accordingly, finance remains readily available amid very favourable pricing conditions, notwithstanding the sharp rise in sovereign yields in recent days. Also, the low oil price is providing support to Australia's trading partners, most of which are net oil importers.

The available data suggest that the domestic economy continued to grow at a below-trend pace in the March quarter. Dwelling investment and resource exports appear to have continued growing strongly and there is evidence that the growth of household consumption has been gaining some momentum over the past six months or so. However, investment in the mining sector is declining noticeably and non-mining business investment remains subdued. Moreover, indicators of non-mining business investment intentions suggest that a significant pick-up is not in prospect over the next year or so.

Conditions in the established housing market remain strong, especially in Sydney and to a lesser extent in Melbourne. Outside these cities, however, housing price growth has declined. Forward-looking indicators, including building approvals, suggest that dwelling investment overall will continue to grow strongly over coming quarters. Housing credit growth has been little changed at a pace that is around the long-term growth of household income. Growth of housing credit for investors remains close to 10 per cent on an annual basis, with no sign of growth either increasing or decreasing in the period ahead.

Very low interest rates and increasing housing prices helped to support a pick-up in the growth of household consumption over 2014. More recent retail sales data suggest that consumption growth maintained its pace into the early months of 2015. Measures of consumer sentiment remain a little below average.

Export volumes continue to increase, aided in the March quarter by the absence of substantial weather-related disruptions to mining and shipping operations across the country. Resource export volumes are expected to continue growing as new production capacity for iron ore and liquefied natural gas comes on line over 2015. However, the decline in commodity prices in recent quarters has put pressure on higher-cost producers in the iron ore and coal sectors. While the substantial declines recorded in mining investment have been much as expected, producers have responded to lower commodity prices with further cost-cutting. Some smaller, higher-cost producers of iron ore and coal in Australia have announced the curtailment of production, although the affected mines accounted for only a relatively small share of Australian production in 2014.

Non-mining business investment has remained subdued even though many of the conditions for a recovery have been in place for some time. Access to funding does not appear to be constraining business decisions; lending rates on the outstanding stock of business (and housing) loans have continued to edge lower and business credit growth has been picking up. Also, surveys suggest that business conditions in the non-mining sector are close to average. However, forward-looking measures of business confidence remain a bit below average and non-residential building approvals are relatively subdued. Business liaison suggests that firms have spare capacity and are still waiting to see a more substantial improvement in demand conditions before they commit to major new investment projects. In line with that, surveys of investment intentions do not indicate that there will be much of a pick-up in non-mining capital investment over the next year or so.

There continues to be excess capacity in the labour market, though the most recent labour force data suggest that employment growth has increased over the past six months or more, to be above the rate of population growth. The participation rate has picked up slightly, and the unemployment rate has been stable at about 6¼ per cent since mid 2014. Forward-looking indicators of labour demand, which had picked up somewhat over the past year, have been little changed over recent months and point to modest growth of employment over coming months.

Consumer price inflation declined over the past year, reflecting substantial falls in fuel prices and the repeal of the carbon price, although the recent rebound in fuel prices should add to headline inflation somewhat in the near term. Measures of underlying inflation remained around ½–¾ per cent in the March quarter and 2¼–2½ per cent over the past year. Domestic cost pressures are generally well contained, partly because of the extended period of low growth of wages, with the result that non-tradables inflation was about 1 percentage point below its decade average over the year to March. Consumer prices related to housing increased by marginally more than their historical average, driven by inflation in new dwelling costs, which in turn reflects the strength of dwelling investment. Tradables inflation (excluding volatile items and tobacco) has picked up in response to the depreciation of the Australian dollar over the past two years or so.

Growth in the Australian economy is expected to continue at a below-average pace for a little longer than earlier anticipated and to pick up gradually to an above-average pace over 2016/17. The key forces shaping the outlook are much as they have been for some time. Recent data suggest that consumption growth has continued to pick up gradually, supported by very low interest rates and relatively strong population growth. Forward-looking indicators continue to suggest that dwelling investment will continue to grow strongly in the near term. The momentum building in household demand will, in time, provide some impetus to non-mining business investment, even though indicators of investment intentions suggest that non-mining business investment is not likely to pick up over coming quarters, as had been expected at the time of the February *Statement*. Export growth is also expected to continue making a substantial contribution to GDP growth. Mining investment, fiscal consolidation and the falling terms of trade are expected to impart an offsetting restraint on growth over the next couple of years at least.

The profile for GDP growth implies that there will be excess capacity in the labour market for longer than previously thought. The unemployment rate is expected to rise gradually and peak a little later than envisaged in the February *Statement*, before gradually declining towards the end of the forecast period. Wage growth is not expected to increase much from its current low levels over the next two years or so. As a result, domestic labour cost pressures are likely to remain well contained and underlying inflation is expected to be consistent with the inflation target throughout the forecast period.

The risks to the outlook for the global economy appear roughly balanced, other than for China where risks remain tilted to the downside. Weakness in the Chinese property market and constraints on the ability of local governments to fund infrastructure projects continue to represent key sources of uncertainty for China's economic growth and its demand for commodities. Any significant change in the demand for steel in China would affect the prices of iron ore and coking coal. Also, if high-cost producers of iron ore in China were to curtail production significantly, this would place upward pressure on prices. Developments in China and their impact on commodity prices are also likely to affect the outlook for the exchange rate, which is another important consideration for the forecasts for the domestic economy. Further depreciation of the exchange rate seems both likely and necessary, particularly given the significant declines in key commodity prices, although increasingly divergent monetary policies in the major economies are also likely to have an important bearing on exchange rate developments.

Domestically, the forecasts embody a further gradual pick-up in consumption growth and decline in the saving ratio. However, if households respond to changes in interest rates and asset prices to the same degree as they did prior to the global financial crisis, this would support higher consumption growth and imply a lower saving ratio than embodied in the forecasts. Alternatively, if households are less inclined to bring forward their consumption than has been factored into the forecasts, perhaps because they do not wish to increase their leverage, consumption growth would be weaker and the saving ratio higher than forecast.

Business investment remains a significant source of uncertainty. Mining investment is expected to fall significantly, but the size of the fall and the impact of lower-than-expected commodity prices remain uncertain. There are also significant risks to the forecasts for non-mining investment. While the latest capital expenditure survey implies a weaker profile for non-mining business investment over the next year than currently forecast, the first estimate of investment intentions for 2015/16 is subject to considerable uncertainty and the survey covers only about half of actual non-mining business investment. Moreover, many of the preconditions for a recovery in non-mining business investment are in place, so it is possible that the recovery could begin earlier or be stronger than currently forecast.

The adjustment to the decline in the terms of trade and mining investment over recent years has resulted in a rise in the unemployment rate and a pronounced decline in wage growth in the economy. The unemployment rate is expected to rise a little further from here, before it begins to decline. It is possible that employment growth will be stronger than expected and the unemployment rate will not increase to the extent anticipated, although this could probably only be achieved with ongoing moderation in wage growth.

The Reserve Bank Board reduced the cash rate by 25 basis points at its February meeting. At its March and April meetings, the Board kept the cash rate steady, but indicated that further easing may be appropriate. Over that period, incoming data have generally provided more confidence that growth in household expenditure is gaining some momentum, consistent with the forecasts presented in the February *Statement*. However, other information, including the forward-looking indicators of investment, suggested that overall growth will remain below trend for longer than had previously been expected. Accordingly, the economy is likely to be operating with a degree of spare capacity for some time yet and domestic cost pressures are expected to remain subdued and inflation well contained.

The Board noted that although financial conditions are very accommodative, the exchange rate continues to offer less assistance than would normally be expected in achieving balanced growth in the economy. It also noted that while housing price growth is very strong in Sydney, it has declined across much of the rest of the country, and there has been little change to the growth of housing credit in recent months. The Bank is working with other regulators to assess and contain risks that may arise from the housing market.

At its May meeting the Board judged that, under these circumstances, it was appropriate to reduce the cash rate by a further 25 basis points to provide some additional support to economic activity. This could be expected to reinforce recent encouraging trends in household demand and is consistent with achieving the inflation target.

The Board will continue to assess the outlook and adjust policy as needed to foster sustainable growth in demand and inflation outcomes consistent with the inflation target over time.