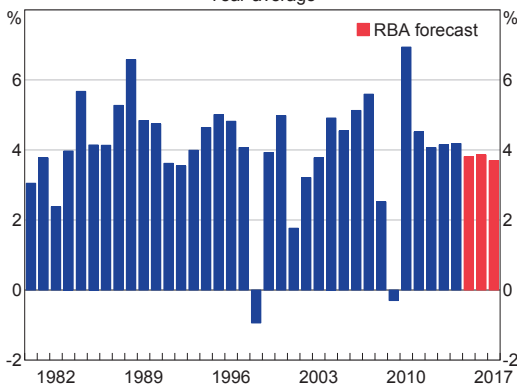


6. Economic Outlook

The International Economy

Growth in Australia's major trading partners is expected to be slightly below its decade average over the next two years or so (Graph 6.1). This reflects an unchanged expectation for a gradual easing in the growth of the Chinese economy and a more persistent slowdown in growth in the rest of the Asian region than was expected at the time of the *August Statement*. Globally, core inflation is generally stable at rates below central bank targets. In combination with the effects of the earlier decline in oil prices, this suggests that headline inflation rates will remain low for some time yet.

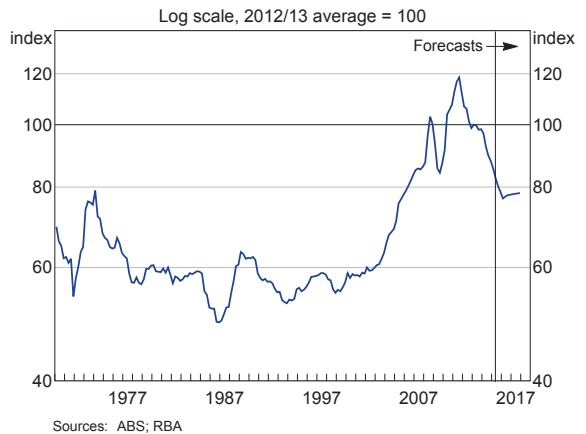
Graph 6.1
Australia's Trading Partner Growth*
Year-average



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

A further decline in commodity prices has contributed to downward revisions to the outlook for Australia's terms of trade of around 2 per cent since the previous *Statement* (Graph 6.2). The

Graph 6.2
Terms of Trade



forecast for iron ore prices has been lowered slightly, reflecting a weaker outlook for Chinese steel demand and an expectation that there will be only a limited reduction in supply from high-cost producers of iron ore, particularly those in China.

Growth in China is expected to moderate gradually over the forecast period, largely as forecast previously. Weaker growth in investment and manufacturing production is expected to be offset, in part, by the effects of accommodative monetary and fiscal policy settings.

Subdued external conditions, combined with a decline in investment, have led to downward revisions to growth in Japan in 2015. Japanese growth is likely to experience some volatility in early 2017 when the consumption tax is scheduled to increase again. In other east Asian economies, a spillover of weakness in external demand conditions

to domestic demand has also resulted in lower forecasts for economic growth in 2015. GDP growth in these economies is now expected to return to trend more gradually over 2016, and to remain around trend in 2017. Lower exchange rates in the east Asian region, together with growth in advanced economies, will provide some support to the region's exports over the period ahead. More generally, accommodative monetary policy and low oil prices are also likely to support growth in the region.

The outlook for economic growth in the United States and the euro area is little changed. Both economies are expected to grow at above-trend rates throughout the forecast period. In the United States, accommodative monetary policy and ongoing improvement in labour market conditions are expected to support strong consumption growth and above-trend growth more generally, despite the appreciation of the US dollar adversely affecting the outlook for the manufacturing sector. In the euro area, growth is expected to remain above trend, supported by accommodative monetary policy, lower oil prices, a gradually improving labour market and above-average confidence.

Domestic Activity

In preparing the domestic forecasts, a number of technical assumptions have been made. The forecasts are conditioned on the assumption that the cash rate moves broadly in line with market pricing at the time of writing. This assumption does not represent a commitment by the Board to any particular path for policy. The forecasts also take account of the fact that many banks have announced that they will increase interest rates on variable-rate mortgages by up to 20 basis points, following regulatory changes that will increase capital requirements for a number of banks. This follows earlier increases in the standard variable interest rates for investor-related housing loans of at least 20 basis points.

The exchange rate is assumed to remain at its current level over the forecast period (TWI at 61 and A\$ at US\$0.72). The TWI is around 2 per cent lower than the assumption underlying the forecasts in the

August *Statement*. The price of Brent oil is assumed to be around US\$52 per barrel, which is consistent with near-term futures pricing and close to the assumption used in August. Similar to the previous *Statement*, the working-age population is assumed to grow by 1.6 per cent over 2016 and 2017, based on updated forecasts from the Department of Immigration and Border Protection.

The starting point for the forecasts is that the Australian economy grew, as expected, at a moderate rate in 2014/15. Mining investment continued to decline sharply, although this was partly offset by the contribution from resource exports. Non-mining business investment increased a little and public demand was unchanged. Dwelling investment continued to grow strongly and while consumption growth was below average, it had picked up a little from its lows of 2013. Net service exports made a noticeable contribution to GDP growth, aided by the earlier exchange rate depreciation.

Overall, the forecasts for GDP are little changed from the August *Statement*. GDP growth has been revised down slightly towards the end of the forecast period to reflect updated forecasts for resource exports, which are still expected to make a substantial contribution to growth. Year-ended GDP growth is forecast to be 2–3 per cent in June 2016, and to pick up to 2¾–3¾ per cent by June 2017, which is around its long-run average (Table 6.1).

The changes to the outlook for resource exports reflect an assessment that some large liquefied natural gas (LNG) projects will start production a bit later than previously thought, although the anticipated magnitude of the eventual ramp-up in production has not changed. As a result of this minor delay, the expected contribution of LNG exports to GDP growth in 2017 is lower by ¼ percentage point. At the same time, despite lower commodity prices, expansions to supply by the low-cost producers of bulk commodities are likely to continue. Meanwhile, the lower exchange rate is assisting domestic producers of tradable items. The strong growth of net service exports is likely to continue.

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	2.0	2¼	2–3	2½–3½	2¾–3¾	3–4
CPI inflation	1.5	1¾	1½–2½	2–3	2–3	2–3
Underlying inflation	2¼	2	1½–2½	2–3	2–3	2–3
	Year-average					
	2014/15	2015	2015/16	2016	2016/17	2017
GDP growth	2.3	2¼	2¼	2–3	2½–3½	2¾–3¾

(a) Technical assumptions include A\$ at US\$0.72, TWI at 61 and Brent crude oil price at US\$52 per barrel
Sources: ABS; RBA

Mining investment is expected to continue to fall over the next two and a half years, as large iron ore, coal and 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, the recent declines in commodity prices are unlikely to result in a significant further reduction in planned mining investment.

Growth in household consumption is projected to increase to be a bit above average from 2016, consistent with the forecasts from the August *Statement*. Low interest rates and further growth in employment are expected to continue to support a pick-up in household demand, and the household saving ratio is expected to decline gradually. The high level of residential building approvals since the start of the year is likely to translate into further increases in dwelling investment, albeit at a gradually moderating rate.

The near-term outlook is for non-mining business investment to remain subdued, consistent with the ABS capital expenditure survey of firms' investment intentions and the low level of non-residential building approvals. However, some of the preconditions for a pick-up in investment are in place and survey measures of business conditions have increased over the past year to be clearly above average. The depreciation of the Australian dollar has added support to demand and investment in the services sector, although the labour-intensive nature of parts

of this sector means that it makes up a modest share of non-mining investment.

Employment growth is expected to be a bit stronger than had been forecast earlier. The labour force survey indicates that employment growth has been stronger than expected over the past year. This is partly because the sectoral composition of economic activity has provided more support to aggregate labour demand. In addition, the labour market has been more flexible than anticipated. In particular, wage growth has declined by more than had been expected and this appears to have helped employment to grow faster than otherwise. Leading indicators of labour demand, such as job advertisements and vacancies, have been on an upward trend and point to further employment growth over coming months.

Labour supply appears to have grown by more than previously expected, as the increase in the participation rate has more than offset lower population growth. This is expected to continue as individuals are encouraged to enter the labour market in response to the improvement in employment growth.

The net effect of the anticipated increase in labour demand and supply is that the unemployment rate forecast is little changed from the previous *Statement*. The unemployment rate is projected to remain within its recent range of 6 to 6¼ per cent over the next year and to decline only gradually toward the end of the forecast period.

Inflation

Wage growth has been broadly in line with expectations at the time of the *August Statement*. Wage growth is not expected to increase much over the next couple of years, given continued spare capacity in the labour market and liaison reports that employers remain under pressure to contain costs. Unit labour costs are expected to increase only gradually, having been little changed for around four years. This low growth of labour costs is helping to improve the competitiveness of Australian producers.

The September quarter inflation outcome was lower than expected. While quarterly inflation outcomes can be volatile, the broad-based nature of the weakness in the September quarter suggests that inflationary pressures are a bit more subdued than earlier anticipated. As a result, the inflation forecasts are lower in the near term. Underlying inflation is now expected to be around 2 per cent over most of next year before picking up to be around 2½ per cent. Inflation expectations remain a little below average.

Domestic inflationary pressures are expected to remain subdued, and inflation in the prices of non-tradable items is forecast to continue to be below its inflation-targeting average. This is consistent with the expectation that there will be spare capacity throughout the forecast period and growth of labour costs will remain low. Also, competitive pressures and below-average demand conditions in the near term are likely to constrain the ability of many firms to expand their margins, with the notable exception of residential construction where strong demand is likely to see inflation in new dwelling costs remain elevated.

The prices of tradable items are expected to rise over the next few years, as the exchange rate depreciation since early 2013 has led to increases in import prices, which will be gradually passed on to the prices paid by consumers. Based on historical relationships, 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

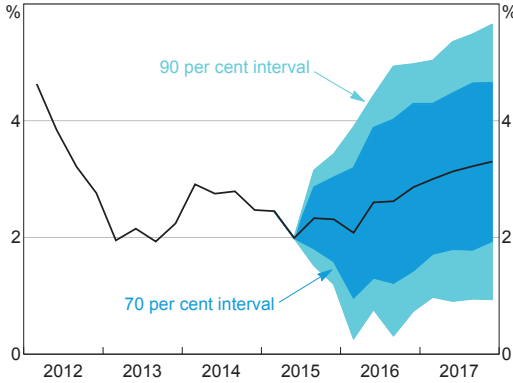
forecast period. However, it is always difficult to identify the effects and timing of exchange rate pass-through given other influences. In particular, heightened competition and improvements in supply-chain efficiency may continue to temper the effects of exchange rate pass-through to final consumer prices.

Headline inflation has been weak over the past year or so as a result of factors that are likely to have a temporary effect, most notably lower fuel prices and changes to utility prices stemming from regulatory and policy decisions. As the direct effects of these factors pass, headline inflation is expected to pick up. Lower fuel and utility 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. A further increase in the tobacco excise in 2016 is expected to contribute around ¼ percentage point to headline inflation, but to have little effect on underlying inflation. Overall, headline inflation is expected to remain subdued over most of the next year before picking up to be around the middle of the inflation target in the second half of the forecast period.

Uncertainties

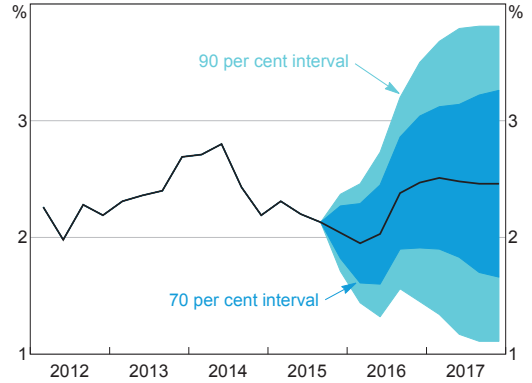
The forecasts are subject to a considerable degree of uncertainty. This is evident in the width of confidence intervals around the forecasts based on historical forecast errors (Graph 6.3, Graph 6.4 and Graph 6.5). In part, this uncertainty relates to the assumptions that underlie the forecasts. For example, the forecasts are conditioned on a range of assumptions about the evolution of key variables, such as the exchange rate. Judgements are also made about how developments in one part of the economy will affect others. Accordingly, it is worth considering the consequences that different assumptions might have on the forecasts, as well as the possibility of events occurring that are not part of the central forecast.

Graph 6.3
GDP Growth Forecast*
 Year-ended



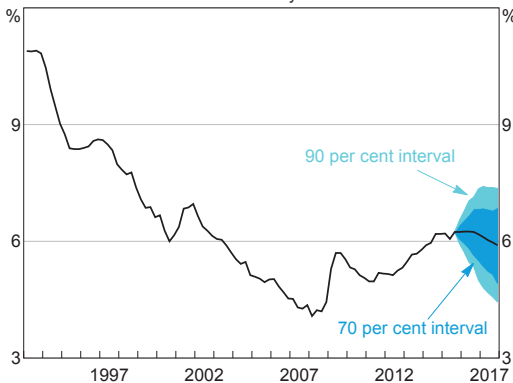
* Confidence intervals reflect RBA forecast errors since 1993
 Sources: ABS; RBA

Graph 6.5
Trimmed Mean Inflation Forecast*
 Year-ended



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

Graph 6.4
Unemployment Rate Forecast*
 Quarterly



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

The outlook for growth and trade in the Asian region, particularly China, is a key source of uncertainty that has important implications for commodity prices, particularly prices for iron ore and coal, and the forecast for the terms of trade. Another key source of uncertainty for the forecasts, particularly the assumption that the exchange rate will be unchanged, is the evolution of monetary policy in major economies. Domestically, key sources of uncertainty continue to be the outlook for business investment, the response of households to the combined effects of low growth in incomes and

wealth effects from the housing market, and the degree of spare capacity in the economy.

Growth in China, trade and commodity prices

As has been the case for some time, there is considerable uncertainty regarding the outlook for growth in China. This has contributed to uncertainty surrounding the outlook for economic growth and trade in the Asian region more generally, and has implications for commodity demand and commodity prices.

Ongoing weakness in Chinese residential and non-residential construction activity has contributed to a deterioration of conditions in the Chinese industrial sector since late 2014. This has been particularly acute in the north-eastern provinces and in the mining and manufacturing industries. Persistent weakness in these parts of the economy could increase the vulnerability of financial institutions with concentrated exposures. Policymakers have responded to concerns about lower growth in economic activity by easing monetary policy and approving additional infrastructure investment projects, and they have scope to provide further support. Even so, given the relatively muted response of investment growth so far to the range

of initiatives undertaken since late 2014, there is uncertainty about how effective current policies will be in supporting growth in the next few quarters.

Slowing Chinese domestic demand has contributed to subdued export growth in a number of Asian economies. In addition, after being flat for several years, Chinese assembly and processing trade declined in 2015, pointing to less activity in regional supply chains. As a result of these strong trade linkages, risks around Chinese growth also represent risks to growth in the rest of east Asia.

Uncertainty surrounding China's growth and the outlook for steel demand remains a key risk for commodity prices, particularly prices for iron ore and coal. The forecasts assume that there will only be a limited response of global commodity supply to the sustained period of lower commodity prices. Most Australian iron ore producers remain profitable at current prices, while many higher-cost domestic bulk commodity producers have been able to lower their production costs, although the scope for further cost reduction appears to be more modest than in the past. To date, there has also been a limited supply response to lower prices by bulk commodity producers in China, despite their higher cost base. The possibility of significant cuts to production represents an upside risk to commodity prices. The possibility of unexpected cuts to Australian production represents a downside risk to the forecast for export growth.

Central banks' policies

There are always uncertainties about how events offshore will unfold, and how policymakers and financial markets will respond. For some time there has been uncertainty around the path for monetary policy in major economies and their net effect on financial markets, particularly exchange rates. Many observers expect the European Central Bank and the Bank of Japan to announce further steps to make their monetary policy more accommodative and there is considerable uncertainty about when the US Federal Reserve will start to normalise its

policy rates. Many Federal Open Markets Committee members have indicated that they believe it will be appropriate to raise rates this year, but other members have expressed somewhat different views, and financial markets have not fully priced in a rate rise until the first quarter of 2016. Although it is hard to say how financial markets will react when policy normalisation begins in the United States, it is likely that the Australian dollar could depreciate.

Business investment

Total business investment is expected to fall over the next two years as mining investment continues to decline sharply and non-mining investment is forecast to recover only gradually and with some delay. Given the size of the falls in mining investment already factored into the forecasts, the most recent decline in commodity prices is not expected to lead to a significant additional fall in mining investment. However, there continues to be uncertainty around the size of the fall and the impact of the declines in commodity prices.

The strength and timing of the recovery in non-mining business investment remains uncertain. Indicators of investment intentions provide little, if any, evidence of a material pick-up in the near term. Indeed, the ABS capital expenditure survey implies that non-mining investment could be lower than forecast in 2015/16. However, some of the preconditions for a stronger recovery in non-mining business investment are in place: borrowing rates for businesses are currently low and have tended to fall; survey measures of business conditions are at an above-average level; and the Australian dollar has depreciated significantly over the past couple of years. Indeed, demand for domestically produced services is expected to continue to pick up and could accelerate should the Australian dollar depreciate further. The services sector, however, is generally relatively labour-intensive. Hence, the additional capital expenditure required to meet a given increase in demand is likely to be less than if other, more capital-intensive, sectors were to play a larger role in the recovery. Nonetheless,

given the significant uncertainty around the expected pick-up in non-mining business investment growth, the risks to these forecasts are assessed to be roughly balanced.

Household sector

There is still considerable uncertainty about the resilience of consumption to a period of below-average income growth. Consumption is forecast to grow at a rate that is slightly above average from 2016, consistent with a further gradual decline in the household saving ratio.

Whether this materialises will depend, in part, on the extent to which households perceive the low income growth to be temporary. This would be consistent with households judging the low wage growth of late to be associated with the rebalancing of the economy in response to the unwinding of the terms of trade and mining investment boom. If, however, households come to view lower income growth as being more persistent, consumption growth could be somewhat lower, and the saving ratio higher, than forecast.

The extent of the pick-up in consumption growth will also depend on the strength of housing price growth and its associated wealth effects. Supply constraints, particularly in Sydney, may limit the extent to which new dwelling investment can satisfy growing demand. This raises the possibility that housing prices grow more quickly than forecast. At the same time, some market segments, particularly apartments in the inner-city areas of Melbourne and Brisbane, appear to be reaching a point of oversupply. It is also unclear how households will respond to changes in housing prices. In recent

years, fewer households appear to have been using 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, which may have muted the effect of wealth increases on consumption.

Spare capacity in the economy

The elevated rate of unemployment, together with the low growth in wages and broader domestic cost pressures, suggests that the economy is currently operating with spare capacity. However, there remains considerable uncertainty about the degree of spare capacity in the economy and how it is likely to evolve over time.

Recent changes in the sectoral composition of activity are one source of uncertainty around the productive capacity of the economy and the degree of spare capacity. The change in the sectoral composition of employment has involved a shift away from mining-related jobs that have very high output per hour worked (high labour productivity), towards jobs in the services sector that tend to have lower measured output per hour worked. This switch to activity in the services sector may reduce the economy's measured potential output growth, unless it is offset by productivity improvements within industries. Compositional change could also produce a mismatch between jobs and the skills of available workers, reducing the effective amount of spare capacity in the labour market. However, there is little evidence of this to date. In particular, the relationship between the unemployment and job vacancy rates does not appear to have shifted from its historical pattern. ✎

