Overview

Growth in economic activity in Australia's major trading partners has remained a little below average over the first half of 2016. Despite this, commodity prices overall have increased since the beginning of the year, partly because of reductions in supply by some high-cost producers of commodities, including iron ore and coal. The outlook for overall growth in Australia's major trading partners and the outlook for the terms of trade are little changed from three months ago. The terms of trade are forecast to remain close to current levels over the next couple of years. This is around 35 per cent lower than their peak in late 2011, but still well above levels that prevailed prior to the mining boom.

In China, subdued growth in private sector investment has been only partially offset by additional policy measures to support demand. Conditions in the Chinese residential property market have eased a little recently, while growth in the services sector has remained relatively strong. The effects of the gradual easing in economic growth in China have been evident in a number of east Asian economies and emerging economies in other regions that have strong trade links to China. The outlook for the Chinese economy remains an important source of uncertainty for global growth and demand for commodities. A substantial slowing in demand in the Chinese property market would pose risks for property developers and related industries, including the steel industry. There is also uncertainty related to how the Chinese authorities will respond to the difficult trade-off involved in supporting growth and avoiding financial disruption in the near term, while achieving more financial discipline and broader reforms over the longer term.

In the major advanced economies, growth in GDP has been sufficient to drive further improvements in labour market conditions over the past year. Indeed, a number of economies are close to full employment. Despite this, wage growth remains subdued in most advanced economies.

Inflation remains below most central banks' targets. Globally, monetary policy continues to be remarkably accommodative and, for most jurisdictions, market participants generally expect it to remain so for an extended period or to become even more stimulatory. In an environment of low inflation and low inflation expectations, the Bank of Japan announced some additional stimulus measures at its July meeting. Market participants anticipate further easing by the European Central Bank and while the Bank of England left its policy rate unchanged at its July meeting, it signalled that it expects to ease policy in August. Market expectations for the US federal funds rate have declined over the past few months such that the next rate rise in the United States is not priced in until late 2017, although members of the Federal Open Market Committee have signalled that there is a reasonable likelihood of an increase before the end of 2016.

Volatility in foreign exchange and other financial markets increased significantly around the time of the UK referendum. Despite that volatility, financial markets, including those in Australia, continued to function effectively. Volatility has since declined to more normal levels. Meanwhile, funding costs for high-quality borrowers remain low. The Australian dollar has appreciated a little since the previous *Statement on Monetary Policy*.

In Australia, low interest rates and the depreciation of the Australian dollar exchange rate since early 2013 are continuing to support the rebalancing of economic activity towards non-resource sectors. Growth in GDP was stronger than expected in the March quarter, in large part because of a substantial rise in resource exports, which were boosted by unusually favourable weather conditions. More recent data suggest that real GDP growth was more moderate in the June quarter, as expected.

The unemployment rate has remained at around 5¾ per cent over 2016, which is around ½ percentage point lower than a year or so ago. Following particularly strong growth late last year, employment growth has been slower this year. While this was largely expected, recent employment growth has been concentrated in part-time employment. Forward-looking indicators of the labour market have been mixed of late. Those indicators overall are consistent with a modest pace of employment growth in the near term and little change in the unemployment rate.

There has been very little change to the outlook for economic activity since the previous *Statement*. GDP growth is expected to be around 2½–3½ per cent over 2016, before increasing to around 3–4 per cent by 2018, which is above estimates of potential growth in the Australian economy.

Consistent with the profile for economic activity, employment growth is expected to increase gradually and the unemployment rate is expected to fall a little. This would imply spare capacity remaining in the labour market throughout the forecast period. However, there is considerable uncertainty about the outlook for the labour market. In part, this reflects the recent divergence between growth in employment and hours worked. In addition, past relationships between growth in GDP and employment may be less useful as a guide in the coming years given the strong prospective contribution to GDP growth from liquefied natural gas production, which is less labour intensive than most other industries.

Household consumption growth is expected to be close to its long-run average over the next couple of years. Surveys suggest that households' perceptions of their own finances have been above average in recent months – notwithstanding relatively weak income growth – and expectations of unemployment are lower than in recent years. Income growth is expected to pick up gradually, but it is likely to remain a bit lower than consumption growth for a time. This implies that the household saving ratio will decline gradually, extending the downward trend of the past few years.

Dwelling investment has continued to grow strongly. While building approvals have declined over the past year, they remain elevated and the pipeline of dwelling construction is at very high levels. This is expected to support dwelling investment for some time, but also raises the risk of oversupply in some markets.

Conditions in the established housing market appear to have eased since last year. While one source of data recorded strong growth in housing prices in April and May, that growth appears to have been overstated and other sources suggest that housing price growth was modest over those and more recent months. Moreover, a range of other indicators are consistent with an easing in conditions. In particular, housing credit growth remains lower than a year ago, consistent with the tightening in lending standards towards the end of 2015 and the decline in turnover in the housing market to low levels this year. Also, the rental vacancy rate has drifted higher, to be close to its long-run average, and inflation in rents has eased to multi-decade lows.

Trade data indicate that net exports made a much smaller contribution to GDP growth in the June quarter than in the March quarter. Even so, net exports are expected to continue making a positive contribution to growth over the period ahead, supported by the earlier exchange rate depreciation and the ramp-up in liquefied natural gas production. Mining investment still has further to fall as projects are progressively completed, although the effect of this on GDP growth should diminish noticeably over the next year or so. While there are signs that non-mining business investment is rising in some parts of the economy, most indicators of business investment intentions and non-residential construction activity suggest that overall non-mining business investment will remain subdued in the near term. At the same time, survey measures of business conditions and capacity utilisation are noticeably above their long-run averages. Non-mining business investment is expected to pick up in the latter part of the forecast period as demand strengthens.

The latest data on inflation and labour costs confirm that domestic cost pressures remain subdued. Measures of underlying inflation picked up to ½ per cent in the June quarter, to be around 1½ per cent over the year. This outcome was in line with the forecasts in the May *Statement*. Subdued domestic cost pressures reflect a number of factors, including the effect of the decline in the terms of trade and mining investment over recent years, and spare capacity in labour and a number of product markets. Low wage growth and a decline in margins contributed to non-tradables inflation remaining around its lowest level since the late 1990s in year-ended terms, and have largely offset the significant upward pressure on the prices of tradable items arising from the depreciation of the exchange rate over the past few years.

Underlying inflation is expected to remain around current rates in the near term, before picking up gradually to around 2 per cent by the end of the forecast period. The substantial depreciation of the exchange rate over recent years is expected to continue exerting upward pressure on the prices of tradable items for some time. Wage growth is expected to remain low in the near term, before rising modestly over the forecast period as labour market conditions improve and the adverse effects of the decline in the terms of trade and mining investment wane. There is, however, considerable uncertainty about the timing and the size of these effects. The outlook for the balance of supply and demand in the housing market is also an important source of uncertainty. Among other things, this will have a bearing on inflation given that housing costs make up a significant share of the CPI basket. While the exchange rate is assumed to remain around current levels over the forecast period, it may respond to any unanticipated changes to the outlook for growth in Australia or offshore, commodity prices or monetary policy decisions in Australia or elsewhere. It therefore represents a significant source of uncertainty for the forecasts of inflation, as well as for the outlook for growth in activity.

In May, with the outlook for economic activity and the unemployment rate little changed but the inflation outlook lower than previously anticipated, the Board decided to reduce the cash rate by 25 basis points. At the same time, the Board had taken careful account of developments in the housing market, noting the effects of supervisory measures to strengthen lending standards, the easing in housing credit growth and the abatement of strong price pressures.

The data coming to hand since then have not altered the outlook for output and unemployment, and confirm that inflation is likely to remain below 2 per cent over most of the forecast period. While the prospects for growth in economic activity are positive, there is room for even stronger growth. Also, recent information implies that dwelling prices have been rising modestly over the course of this year and confirms that growth in lending for housing purposes has slowed since last year. All this suggests that the risks associated with high and rising household sector leverage and rapid gains in housing prices have diminished.

Given this background, the Board judged that prospects for sustainable growth in the economy, with inflation returning to target over time, would be improved by a further easing of monetary policy. Accordingly, the cash rate was reduced by 25 basis points at the August meeting.