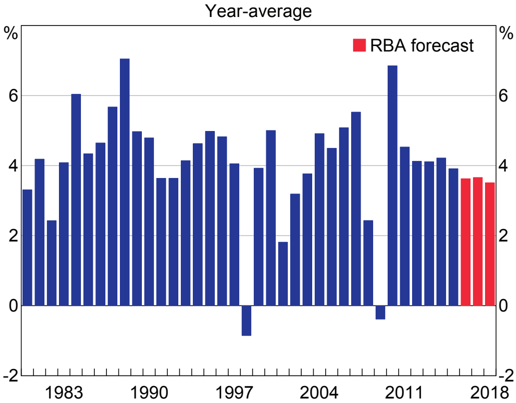
6. Economic Outlook

The International Economy

The GDP growth of Australia's major trading partners overall is expected to be a bit below average over the next few years, which is unchanged from the May *Statement* (Graph 6.1).

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



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

Growth in China is expected to moderate gradually over the next few years, largely as forecast previously. Weakness in the growth of private investment is expected to be partly offset by the effects of recent policy stimulus aimed at achieving the authorities' economic growth targets. Japanese GDP growth is expected to pick up to be slightly above its potential growth rate over the next couple of years. This is slightly stronger in the near term than previously expected given that the next consumption tax increase has been postponed from early 2017 to late 2019 and additional fiscal stimulus has been announced. However, there has been no change to the longer-term outlook for the Japanese economy, which is facing a significant drag on growth associated with population ageing.

In other east Asian economies, the ongoing weakness in external demand conditions is likely to continue to dampen export and investment growth for a time. Consumption growth, especially in the high-income economies, is also likely to be more subdued than in recent years. Accommodative monetary policies and supportive fiscal policies in some of these economies, together with some recovery in external demand conditions from commodity-exporting emerging economies, are expected to see GDP growth in the region recover to around estimates of the potential growth rate by 2018.

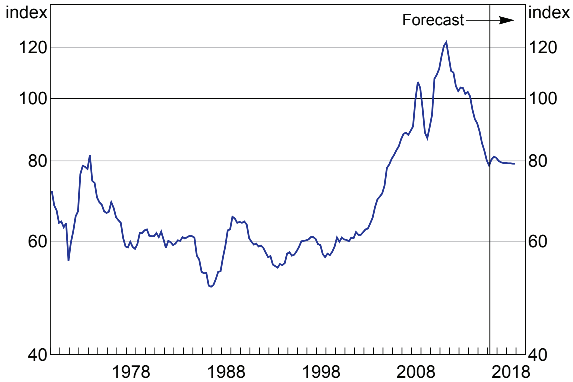
The US economy is expected to grow at an above-trend rate over the next couple of years. US monetary policy remains very accommodative and, after a few years of consolidation, fiscal policy has become less of a drag on growth. Conditions in the US labour market remain strong and should continue to support growth of consumption. This is likely to offset the ongoing weakness in overall business investment, much of which reflects the decline in oil-related investment.

There is considerable uncertainty around how the outcome of the UK referendum will affect the UK economy, although it is expected to restrain UK business investment in the near term. At this stage, the effect of these developments on Australia's major trading partners as a group is expected to be limited. Outside the United Kingdom itself, the largest impact, although still relatively small, is expected to be on growth in the rest of the European Union. GDP growth in the euro area over the next 2–3 years has been revised slightly lower but is still expected to remain above trend, supported by accommodative monetary policy, less drag from fiscal consolidation and further gradual improvements in labour market conditions.

Globally, core inflation has been low for some time, reflecting spare capacity in many labour, product and commodity markets. However, the ongoing decline in spare capacity in the major advanced economies, particularly in labour markets, is expected to place some upward pressure on core inflation over time. While headline inflation rates are likely to remain below central bank targets for some time yet, the drag from the earlier fall in oil prices should dissipate. On the other hand, there are indications that inflation expectations have declined in some advanced economies since late 2014, which could dampen inflationary pressures.

Australia's terms of trade have declined by about 35 per cent since their peak in late 2011 but remain well above levels that prevailed prior to the mining boom (Graph 6.2). They are forecast to remain close to current levels over the course of the forecast period. This outlook is little changed from that presented three months ago. The outlook for coal prices is slightly more positive than previously thought, reflecting supply cuts in China and elsewhere. Iron ore prices are still expected to fall from current levels over the forecast period. Chinese steel demand is projected to ease over the next few years, largely as previously forecast, and the total supply of iron ore is expected to increase, despite a rapid reduction in supply from high-cost producers, particularly those in China.

Graph 6.2
Terms of Trade
2013/14 average = 100, log scale



Sources: ABS; RBA

Domestic Activity

The domestic forecasts are conditioned on a number of technical assumptions. The cash rate is assumed to move broadly in line with market pricing as at the time of writing. This assumption does not represent a commitment by the Reserve Bank Board to any particular path for policy. The exchange rate is assumed to remain at its current level over the forecast period (trade-weighted index (TWI) at 63 and A$ at US$0.76). The TWI is 1½ per cent higher than the assumption underlying the forecasts in the May *Statement*. The forecasts are based on the price of Brent crude oil being US$45 per barrel over the forecast period, which is 3 per cent lower than the assumption used in May and in line with futures pricing for the near term. The working-age population is still assumed to grow by 1.5 per cent over 2016 and by 1.6 per cent over 2017 and 2018, drawing on forecasts from the Department of Immigration and Border Protection.

Overall, the forecasts for GDP growth are little changed from those presented in the May *Statement*. The year-ended growth rate in the near term is slightly higher given the unexpected strength in the March quarter data, but recent indicators are consistent with a more moderate pace of growth in the June quarter 2016. Growth is forecast to be around 2½–3½ per cent over the year to the December quarter 2016, before increasing to around 3–4 per cent over the year to the December quarter 2018, which is above estimates of potential growth in the Australian economy (Table 6.1).

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

Per cent

	Year-ended					
	Jun 2016	Dec 2016	Jun 2017	Dec 2017	Jun 2018	Dec 2018
GDP growth	3¼	2½–3½	2½–3½	2½–3½	3–4	3–4
CPI inflation	1.0	1½	1½–2½	1½–2½	1½–2½	1½–2½
Underlying inflation	1½	1½	1½–2½	1½–2½	1½–2½	1½–2½
	Year-average					
	2015/16	2016	2016/17	2017	2017/18	2018
GDP growth	3	2½–3½	2½–3½	2½–3½	2½–3½	3–4

(a) Data are quarterly; technical assumptions include A$ at US$0.76, TWI at 63.5 and Brent crude oil price at US$45 per barrel; shaded regions are historical data

Sources: ABS; RBA

The starting point for the forecasts is that the Australian economy grew by more than estimates of potential over the year to the March quarter 2016. This was stronger than expected at the time of the May *Statement* and was largely the result of a significant expansion in the volume of resource exports due to unusually favourable weather conditions. At the same time, there were further large falls in mining investment, such that mining activity overall was little changed over the year. Meanwhile, the non-mining sectors of the economy grew at an above-average pace over the year to the March quarter 2016, supported by low interest rates and the ongoing effects of the exchange rate depreciation since early 2013. Solid growth was evident in consumption, dwelling investment and most export categories. Public demand grew at close to its average pace, while non-mining business investment declined over the year.

Low interest rates and gains to employment are expected to continue supporting household demand, despite relatively modest growth in household income over the next year or so. Consumption growth is projected to remain close to its long-term average over the forecast period, consistent with the forecasts in the May *Statement*. Meanwhile, growth in real household disposable income is expected to gradually increase to around average levels by the end of the forecast period. Together, these forecasts imply that the household saving ratio will decline gradually for a time, extending the downward trend of the past few years.

The outlook for dwelling investment is little changed. The substantial amount of residential construction work in the pipeline increased a little further in the March quarter, and it is sufficient to underpin dwelling investment growth for the next year or so. However, the modest decline in dwelling approvals from the high levels observed at the beginning of 2015 is consistent with the pace of growth in dwelling investment moderating towards the end of the forecast period.

The outlook for the level of resource exports is a little higher than previously expected by the end of the forecast period. The liquefied natural gas (LNG) export profile has been revised higher, reflecting a modest increase in capacity at some LNG projects. Coking coal exports are also expected to be slightly higher as Australian miners respond to the improvement in coking coal prices. However, the scope for additional growth in thermal coal exports appears to be limited given weak global demand and the relatively high cost of some Australian production. More generally, the depreciation of the Australian dollar over the past few years is assisting domestic producers of tradable items, and net service exports are forecast to continue growing.

As before, mining investment is expected to continue to fall over the forecast period, as large resource-related projects are completed and few new projects are expected to commence. This forecast reflects existing capacity in conjunction with expectations for some moderation in growth in global demand for commodities. However, the subtraction from GDP growth from lower mining investment looks to have peaked in the 2015/16 financial year.

The outlook for non-mining business investment remains subdued in the near term, consistent with the ABS capital expenditure survey of firms' investment intentions and the low level of non-residential building approvals. However, investment is being supported, especially in non-resource-rich states, by very low interest rates, the gradual pick-up in demand growth and the depreciation of the Australian dollar over the past few years. Moreover, survey measures of capacity utilisation have been increasing over the past couple of years and are currently above their long-term averages. Stronger growth in public investment is expected to support public demand over the forecast period.

Consistent with the outlook for output, the labour market forecasts are little changed from the May *Statement*. Following strong growth in late 2015, employment growth has moderated over the first half of the year, which had been expected. Near-term indicators, such as job advertisements and job vacancies, suggest continued modest employment growth over the second half of 2016. Employment growth is then expected to pick up over the forecast period, supported by rising GDP growth and relatively subdued wage growth. The participation rate is expected to increase as more people enter the labour force in response to the improvement in employment growth. In combination, this implies that the unemployment rate will move only a little lower over the forecast period, and that there is likely to be a degree of spare capacity in the labour market for some time.

Inflation

The June quarter underlying inflation outcome was broadly in line with expectations at the time of the May *Statement*. As a result, there has been little change to the forecast that underlying inflation will remain around 1½ per cent in year-ended terms over 2016 and pick up to around 1½–2½ per cent by the end of the forecast period.

The large exchange rate depreciation since early 2013 is likely to continue boosting the prices of tradable items as increases in import prices are gradually passed through to the prices paid by consumers. However, domestic factors, such as heightened competitive pressure in retail markets and low wage growth, have put downward pressure on retail inflation over recent years and are expected to persist for some time.

Wage growth is low, reflecting spare capacity in the labour market, a decline in near-term inflation expectations and downward pressure on firms' profits as a result of the decline in the terms of trade. Growth in the wage price index (WPI) is expected to remain around its current levels over the rest of the year and to pick up gradually over the forecast period as labour market conditions improve and firms' output prices rise. However, broader measures of labour costs also influence inflation. One such measure is average earnings per hour from the national accounts, which captures the effects of non-wage costs, such as allowances, as well as changes in the composition of the labour force. Growth in average earnings per hour has been weaker than growth in the WPI over the past year or so, reflecting, in part, the usual cyclical effects arising from spare capacity in the labour market that lead to subdued growth in non-wage costs and enable firms to hire new workers on lower wages. In addition, average earnings appear to have been affected by workers moving from high-paying mining jobs to similar types of work at lower levels of pay, as mining investment and the terms of trade decline. The combination of these effects is expected to wane over the forecast period because the transition from mining employment is well advanced and labour market conditions are expected to improve. As a result, the national accounts measure of average earnings is expected to grow at a faster pace than the WPI towards the end of the forecast period.

When considering labour cost pressures, the output that can be produced for each additional hour worked also matters. Unit labour costs, which combine average earnings with labour productivity, are expected to rise gradually over the next few years. This will contribute to a pick-up in non-tradable inflation. Working in the opposite direction, further additions to housing supply are expected to keep rental growth low over the next few years.

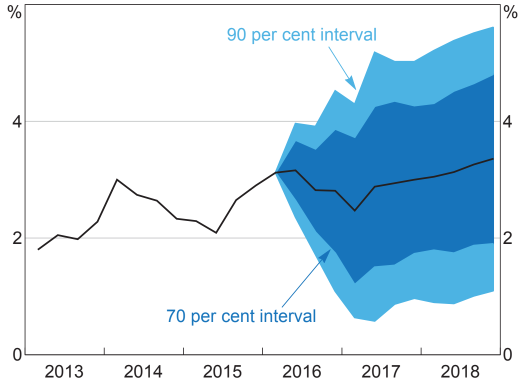
There have also been a number of temporary factors that have subtracted from headline inflation that are expected to dissipate, such as the sharp decline in fuel prices over recent years and the effects of regulatory changes to some utilities prices. In addition, the tobacco excise is scheduled to rise by 12.5 per cent in September 2016. As a result, headline inflation, which has been lower than underlying inflation over the past two years, is expected to pick up to be around 1½–2½ per cent by early 2017.

Key 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; Graph 6.5).

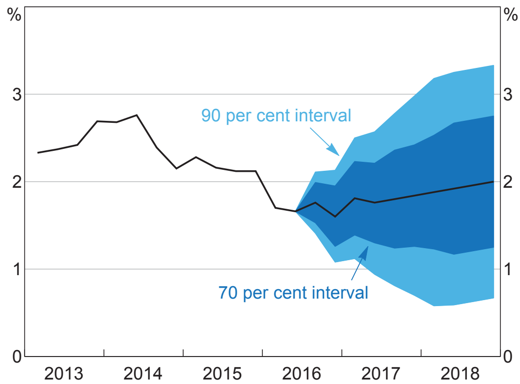
It is also worth considering the consequences that different assumptions and judgements might have on the forecasts and the possibility of events occurring that are not part of the central forecast. There continue to be a number of geopolitical and economic risks that could materialise in the global economy for which the consequences are difficult

Graph 6.3
GDP Growth Forecast*
Year-ended



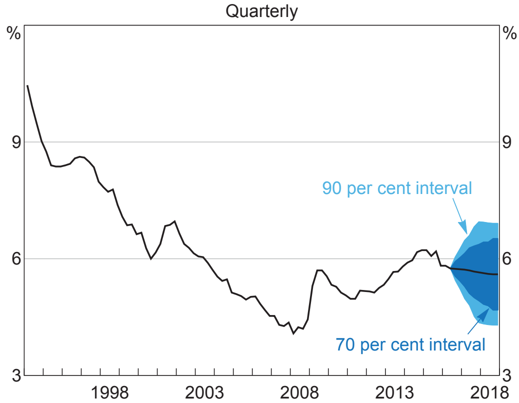
* Confidence intervals reflect RBA forecast errors since 1993
Sources: ABS; RBA

Graph 6.4
Trimmed Mean Inflation Forecast*
Year-ended



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

Graph 6.5
Unemployment Rate Forecast*
Quarterly



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

to predict. For example, there may be a larger-than-expected increase in inflation in the United States, which could lead the Federal Reserve to tighten monetary policy by more than market participants expect. In that case, a range of financial prices are likely to respond, including the Australian dollar, which would be likely to depreciate. Relative to the constant exchange rate assumption that underlies the forecasts, this would imply a boost to domestic activity and a pick-up in tradable price inflation in Australia.

Another key source of uncertainty for the central forecasts continues to be the outlook for the Chinese economy, the reaction of Chinese policymakers to slowing growth and the risks created by high and rising levels of debt. In turn, uncertainty about the outlook for China has implications for commodity demand and ultimately for the forecasts for Australia's terms of trade. Domestically, there is considerable uncertainty about the degree of spare capacity in the labour market currently and over the forecast period, and the extent to which wage growth will pick up over the next few years. The underlying balance of demand and supply in the housing market are also difficult to project. Both of these raise uncertainty about the outlook for inflation and activity.

The Chinese economy

The outlook for commodity prices and resource exports continues to be sensitive to demand fluctuations in the Chinese construction and manufacturing sectors. Accordingly, China's growth outlook remains an important source of uncertainty for the Australian economy. A key uncertainty is the sustainability of the recovery in the Chinese property market, which has provided considerable support to upstream suppliers of construction-related manufacturing items and raw materials (see 'Box A: The Pick-up in the Chinese Housing Market'). Recent falls in residential floor space sold and the slowing in residential construction investment raise some doubts about the durability of the pick-up in demand earlier in the year. A substantial slowing in demand would pose risks for property developers and related industries, including the steel industry.

There is also uncertainty related to how policymakers will respond to the continued rise in corporate and local government debt amid deteriorating conditions in some industries and regions. Chinese financial conditions have been accommodative so far this year, but recent data indicate a modest slowing in broad credit growth. Moreover, the authorities have expressed concern regarding the build-up in leverage in the economy, which may foreshadow greater caution in the application of stimulus policies. The authorities face a difficult trade-off between supporting growth and avoiding financial disruption in the near term, while achieving more financial discipline and broader economic reforms over the longer term.

Momentum in the labour market

It is currently difficult to gauge the momentum in the labour market. A decline in employment growth over 2016 was expected and followed particularly strong growth in employment late last year. Leading indicators of employment, such as job advertisements, vacancies and hiring intentions, have been mixed of late. It is possible that the recent decline in employment growth was temporary, in which case, employment growth would recover more quickly than is currently forecast. However, to the extent that gains in employment continue to be mostly in part-time employment and among workers who would like more hours, there could be more spare capacity in the labour market than implied by the forecast for the unemployment rate. In addition, the past relationship between employment and GDP growth may be less useful as a guide in the coming years because an increasing share of GDP growth is expected to come from LNG production, which is less labour intensive than most other activities. While the forecasts take this into account, it is possible that a given rate of GDP growth will generate less employment growth than currently anticipated.

The participation rate is currently forecast to increase as the labour market recovers. However, there is some uncertainty around whether the recent fall in the participation rate primarily occurred for cyclical reasons, such as an increase in discouraged workers (who have given up searching for work due to perceived poor employment prospects), or owed more to structural factors, such as the ageing of the population. If the decline in the participation rate has been driven by structural factors, it may not increase over the forecast period, and rising demand for workers may lead to a more pronounced decline in the unemployment rate than is currently forecast.

Domestic cost pressures

As has been the case for some time, there is considerable uncertainty around the extent to which domestic inflationary pressures will pick up over the next few years. Wage growth has been lower than implied by historical relationships between wage growth and measures of spare capacity in the labour market. One explanation is that the low growth of labour costs, and low inflation more generally, has been a more important part of the economy's adjustment to large swings in the terms of trade than in the past. During the large run-up in commodity prices and mining investment, growth in Australian unit labour costs outpaced that in many comparable economies, resulting in a decline in the international competitiveness of Australian labour. However, since the terms of trade have been declining, low growth of unit labour costs has played the reverse role of improving international competitiveness, in conjunction with the depreciation of the exchange rate. It is also likely that relatively low wage growth has assisted the transition of workers from the mining sector as the mining boom moves to the relatively capital-intensive production phase. The forecast for a pick-up in wage growth is based on the observation that the rebalancing of the economy is already well advanced and so these downward pressures will gradually ease, but there is significant uncertainty around how long this process will take.

The forecast rise in wage growth and inflation implicitly assumes an increase in expectations of future inflation. Various measures of inflation expectations are lower than their long-run averages, but most are still consistent with the medium-term inflation target. It is possible that inflation expectations will be lower for longer than is currently anticipated. On the other hand, wage growth may pick up more quickly than anticipated in response to an improvement in labour market conditions, particularly if employees demand wage increases to compensate for the period of low wage growth over the past few years.

The uncertain outlook for wage growth also has implications for household income and therefore consumption growth. The forecasts assume that households will respond to current near-term weakness in income growth by reducing their rate of saving to maintain their consumption growth. This is likely to be a reasonable assumption if households expect income growth to be weak only temporarily, especially given relatively high rates of saving and gains to household wealth over recent years. It is also consistent with recent data on household savings and consumption decisions. However, if households were to lower their expectations for income growth over the longer term, household consumption growth may be lower than currently forecast.

Dwelling investment

Recent strength in dwelling investment, particularly the construction of high-density dwellings, has played an important role in supporting the rebalancing of economic activity away from the resources sector. Low interest rates and increases in housing prices have encouraged a substantial increase in the supply of apartments and the pipeline of work yet to be done has increased to very high levels. While this pipeline should support economic activity over the next couple of years, the outlook for dwelling investment beyond this is uncertain.

There is concern about the risk of oversupply in specific geographical areas, such as some parts of inner-city Melbourne and Brisbane. So far, outside Western Australia, the increased supply of housing has largely been absorbed by population growth. However, if growth in housing demand does not continue to keep pace with the further large increases in supply already in the pipeline, it could place downward pressure on prices and rents and increase the risk that off-the-plan purchases fail to settle.

If the housing market were to weaken substantially, consumption could be lower than currently expected due to lower growth in household wealth. Consumer price inflation could also be affected, as housing costs comprise a significant share of the CPI basket.