# Overview

Globally, monetary policy remains very accommodative and is supporting economic activity, although inflation remains below most central banks' targets. The US Federal Reserve raised the federal funds rate target in December for the first time in nearly 10 years, although the stance of policy in the United States remains very accommodative and the pace of future rate increases is expected to be very gradual. In December, the European Central Bank (ECB) announced a package of measures designed to ease monetary policy further. More recently, the Bank of Japan also eased policy further by reducing the rate it pays on marginal reserves to –10 basis points while announcing that it would continue to expand its balance sheet over 2016 as planned.

The diverging monetary policy trends among the major central banks, concerns about the challenges facing the Chinese authorities and large declines in oil prices have contributed to an increase in volatility in global financial markets of late. Sovereign bond yields have declined noticeably since late last year, as have equity prices. Also, spreads on corporate bonds in the United States, euro area and Australia increased owing to sharp rises in spreads for energy and resource-related companies. Large flows associated with capital outflows from China, together with asset sales by sovereign wealth funds of oil-producing nations, also appear to have contributed to market volatility. Despite this volatility, high-quality borrowers still have access to finance at very favourable rates.

Over 2015, the US and euro area economies grew at or above trend rates, while growth in Asia moderated. Weak conditions in the industrial and construction sectors in China have affected other economies in the Asian region as well as commodity exporters, including Australia, and have been associated more generally with declining growth in global industrial production and trade volumes. At the same time, service sector activity in China and elsewhere has been relatively resilient to date. The sharp fall in oil prices over recent months, largely in response to strong supply, should continue to support growth in Australia's major trading partners, which are generally net oil importers. Other commodity prices, including prices for coal and iron ore, have also declined since the previous *Statement on Monetary Policy*, although to a lesser extent.

In China, economic growth moderated over 2015, largely reflecting a decline in investment growth associated with excess capacity in heavy industry and the large stock of unsold housing. A range of longer-term structural factors, such as declining growth in both productivity and the urban labour force, have also played a role. In contrast, conditions in the services sector have been relatively strong and growth in consumption picked up in the year. Deflationary pressures persist in the industrial sector, which is making it more difficult to service the high level of corporate debt. While housing prices increased slightly over the year, this was driven by price growth in the larger cities and sales volumes overall have declined over recent months.

In Japan, GDP looks to have grown at a moderate rate over 2015. Labour market conditions are tight and nominal wage growth remains higher than it was a couple of years ago. Inflation remains well below the Bank of Japan's target, although core inflation increased a little over 2015. In the rest of east Asia, GDP growth was below average in 2015. Industrial activity and exports have been subdued, in part reflecting the region's significant exposure to the Chinese economy. In contrast, growth in India has picked up since early 2013, reflecting stronger private consumption and public investment.

In the United States, labour market conditions continued to improve even though GDP growth declined towards the end of last year. Private consumption has been the key driver of expenditure growth, supported by further growth in employment and lower oil prices. Investment growth has also added to expenditure and business conditions have been generally positive, although the industries most exposed to oil prices and the appreciation of the exchange rate have experienced more subdued conditions.

Euro area GDP has grown at an above-trend rate over recent quarters, driven by household and government consumption, and the unemployment rate has continued to decline gradually. However, there is still considerable spare capacity in the labour market and inflation remains below the ECB's target.

Growth in Australia's major trading partners is forecast to remain around its current rate over the next two years. The US and euro area economies are expected to grow at an above-trend pace, while growth in the Asian region is expected to ease a little further, driven by a further moderation in Chinese growth.

The outlook for China continues to be a key source of uncertainty for the forecasts. While growth in China has been expected to slow gradually for some time, the recent bout of global financial market volatility has been characterised, in part, by concerns about the evolving balance of risks in China and the ability of the Chinese authorities to manage a challenging economic transition. The authorities still have scope to respond if the economy turns out to be much weaker than expected, but any sharp slowing in economic activity or increase in financial stresses in China could spill over to other economies in the region and adversely affect commodity prices, including those that are important for Australia.

Australia's terms of trade have declined substantially from their peak of around four years ago and, over the course of the past year or so, the Australian dollar has been adjusting to lower commodity prices. As a result of the decline in bulk commodity prices from late last year, the forecast for Australia's terms of trade has been revised down a little further, although the exchange rate has been little changed since then. The path for commodity prices is uncertain and will depend, in part, on the outlook for the Chinese industrial sector. It will also depend on the responsiveness of the global supply of commodities to the decline in prices seen to date. While the possibility of significant cuts to global 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.

The Australian economy has continued to grow at a moderate pace and activity is rebalancing away from the resources sector towards non-resource sectors. Even though the available data suggest that GDP continued to grow at a below-trend pace over 2015, employment growth was above average and the unemployment rate fell by around ½ percentage point. In part, employment growth appears to have reflected the relatively strong growth of output in the more labour-intensive sectors of the economy, such as household services. Growth of goods-related production has picked up more recently, but remains modest overall.

Household consumption growth increased in the September quarter, and indicators suggest that a similar pace of growth has been sustained more recently. The Bank's retail liaison suggests that trading conditions improved in the Christmas and post-Christmas sales period. This is consistent with strong employment growth and households' perceptions of their personal finances being above average.

While dwelling investment grew strongly over the year to the September quarter, conditions in the housing market more generally have eased since then. Building approvals have declined but remain at a high level, while some other indicators of dwelling investment – such as new construction loan approvals – have picked up a bit in recent months. At the same time, housing prices nationally have declined a little and auction clearance rates have fallen to be around their long-run averages. Aggregate housing credit growth has stabilised at around 7½ per cent. However, investor housing credit growth has declined, consistent with the larger increase in mortgage rates for investors and the strengthening of banks' non-price lending terms in response to supervisory actions.

As expected, there was a further sharp decline in mining investment in the September quarter, while non-mining investment was little changed over the year. Indicators of non-residential building activity, including the stock of work yet to be done and private non-residential building approvals, are at relatively low levels. In contrast, survey measures of non-mining business conditions and capacity utilisation remain above their long-run average levels and business credit growth has picked up. The depreciation of the exchange rate has been supporting activity in those parts of the economy exposed to trade. This has been most apparent in the significant contribution to growth made by net service exports. Resource exports have also continued to support growth. Iron ore exports, particularly to China, remained at a high level in 2015 while the ramp-up in liquefied natural gas exports is expected to gain pace as more projects begin production.

There has been no material change to the forecast for GDP growth since the previous *Statement*. Economic growth is expected to increase gradually over the next two years to be a bit above the decade average. A further increase in growth in household incomes and demand is anticipated, supported by rising employment, low interest rates and lower petrol prices. Growth in dwelling investment is expected to moderate gradually from its relatively rapid pace of the past year. Non-mining business investment is forecast to pick up in the second half of the forecast period, reflecting the improvement in domestic demand. Further large falls in mining investment are likely, although the largest subtraction from GDP growth is expected to occur in the current financial year. Resource exports are projected to remain a key driver of GDP growth over the period ahead. More generally, net exports will continue to be supported by the lower exchange rate, particularly in the services sector.

New data over the past three months suggest that there has been a notable improvement in labour market conditions that was not anticipated at the time of the previous *Statement*. The unemployment rate declined to 5.8 per cent in December and the participation rate has continued on an upward trend. Employment grew at an above-average rate over 2015, supported by relatively strong growth in service sector output. Also, the low growth of wages is likely to have encouraged businesses to employ more people than otherwise. Measures of job vacancies and advertisements point to further growth in employment over the coming months. In response to this flow of data, the forecast for the unemployment rate has been revised lower.

The fact that the improvement in labour market conditions has occurred against the backdrop of below-average GDP growth raises some uncertainty about the economic outlook. It is possible that the strength in the labour market data contains information about the economy not apparent in the national accounts data, or that the strong growth in employment of late will be followed by a period of weaker employment growth. Alternatively, the strength in labour market conditions relative to output growth may reflect a rebalancing of the pattern of growth towards labour intensive sectors and away from capital intensive sectors.

Inflationary pressures remain well contained overall. Underlying inflation was around ½ per cent in the December quarter, to be about 2 per cent in year-ended terms, which was much as expected. Headline inflation was 1.7 per cent over the year, partly owing to lower fuel prices as well as the decline in utilities prices in the September quarter. Domestic inflationary pressures have eased. This is consistent with heightened competitive pressures, declines in the cost of business inputs such as fuel and some regulated utilities, and the fact that spare capacity in the labour market has been contributing to low growth in labour costs. These factors are not expected to dissipate rapidly over the forecast period. Meanwhile, the prices of tradable items (excluding volatile items and tobacco) have increased to be slightly higher over the year, suggesting that some of the price increases for imported goods and services arising from the depreciation of the exchange rate have been passed on to consumers. A gradual pass-through of the exchange rate depreciation is expected to continue to place upward pressure on the prices of tradable items over the next few years. While the inflation forecasts take into account the decline in oil prices, they have not changed materially. Underlying inflation is expected to remain low over the forecast period.

The Reserve Bank Board reduced the cash rate by 50 basis points in the first half of 2015. The available data suggest that the accommodative stance of monetary policy and the depreciation of the exchange rate since 2013 have supported growth and assisted the rebalancing of economic activity towards non-resource sectors of the economy. This process has been particularly apparent in the labour market. Employment growth over 2015 was stronger than was expected a year ago and the unemployment rate fell by more than had been expected. Despite this, output growth has remained below average.

At the February meeting, the Board judged that there were reasonable prospects for continued growth in the economy, with inflation close to target. The Board therefore decided that the current setting of policy remained appropriate.

The Board will continue to assess the outlook over the period ahead. New information should allow the Board to judge whether the recent improvement in labour market conditions is continuing and whether the recent financial turbulence portends weaker global and local demand. Continued low inflation may provide scope for easier policy, should that be appropriate to lend support to demand.