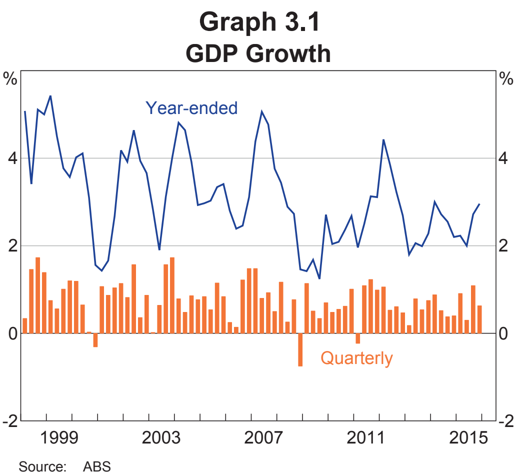
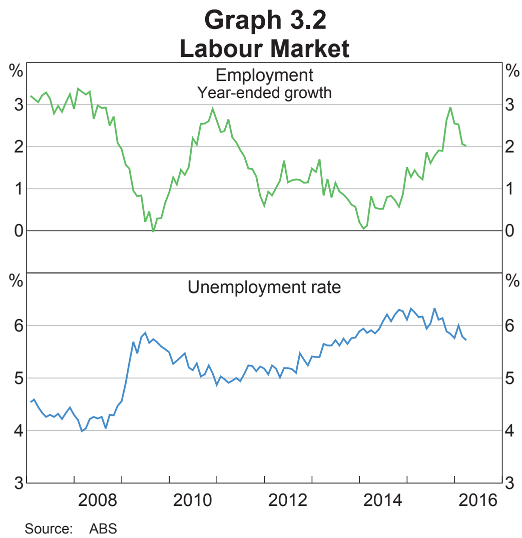
3. Domestic Economic Conditions

The Australian economy grew by 3 per cent over 2015, which is a little above central estimates of the economy's potential growth rate and was stronger than had been anticipated (Graph 3.1). In part, this reflected very strong growth in the September quarter following an upward revision to that estimate. GDP grew by 0.6 per cent in the December quarter and indications are that GDP has increased at a similar rate in early 2016.



Stronger output growth over 2015 was accompanied by a large increase in employment and a decline in the unemployment rate (Graph 3.2). After particularly strong outcomes in late 2015, employment growth has moderated over the past few months, and forward-looking indicators provide mixed signals about the underlying pace of improvement in the labour market. The unemployment rate has continued to edge down, to be about ½ percentage point below its peak in 2015. Nevertheless, there is still evidence



of spare capacity in the labour market, with wage growth remaining very low. While the protracted period of low wage growth has allowed for more employment than otherwise, it has also constrained growth in nominal household income in recent years. At the same time, gains in asset prices have supported increases in household wealth.

The rebalancing of economic activity away from the resources sector towards other sectors has continued. Activity in the non-resource sectors of the economy increased at an above-average rate over 2015, with output expanding fastest in industries that provide services to households and businesses. Growth in household consumption picked up in the second half of the year to be around average and dwelling investment continued to strengthen, supported by the very low level of interest rates (Table 3.1). Demand for

Table 3.1: Demand and Output Growth
Per cent

	December quarter 2015	September quarter 2015	Year to December quarter 2015
GDP	0.6	1.1	3.0
Consumption	0.8	0.9	2.9
Dwelling investment	2.2	1.9	9.8
Business investment	–2.7	–4.5	–12.0
Public demand	1.4	–0.8	3.5
Exports	0.6	5.4	5.7
Imports	0.6	–2.3	1.2
Nominal GDP	0.4	1.1	2.4
Real gross domestic income	0.0	0.5	0.3

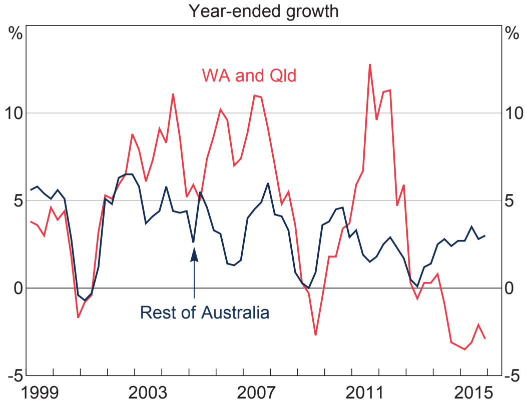
Sources: ABS; RBA

Australian production in trade-exposed industries continued to be boosted by the depreciation of the exchange rate since early 2013. Exports of services, in particular, increased noticeably over 2015 and imports of services have declined. Public demand contributed to growth over the year, while non-mining business investment remained subdued and has been little changed for several years.

In contrast, activity in the resources sector looks to have declined slightly over 2015. Mining investment continued to decline sharply, as more projects reach completion. This was partly offset by significant increases in the volume of resource exports. Mining activity is expected to pick up over the period ahead, reflecting further increases in resource exports – particularly liquefied natural gas (LNG) – and smaller declines in mining investment.

There continue to be significant differences in economic conditions across the country, consistent with the rebalancing of economic activity. Outside the resource-rich states of Queensland and Western Australia, growth has picked up over recent years (Graph 3.3). Unemployment rates have fallen noticeably in the eastern states, supported by an increase in demand, particularly for services. Overall, economic conditions in Queensland have improved a little of late, with weakness in the mining sector offset by improvements in construction and tourism

Graph 3.3
State Final Demand
Year-ended growth



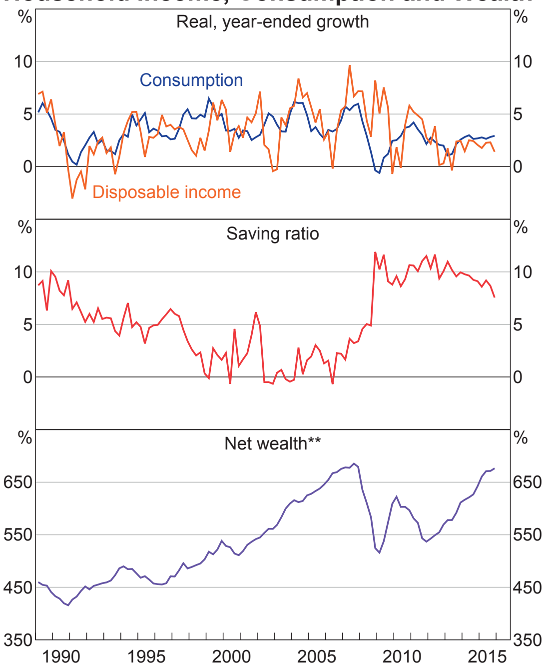
Sources: ABS; RBA

activity. In contrast, activity remains weak in Western Australia as investment and employment in the mining sector have fallen, and the unemployment rate has risen over the past few years.

Household Sector

Household consumption growth increased in the second half of 2015 to around its decade average in year-ended terms, driven by relatively strong growth in New South Wales and Victoria. Factors supporting the pick-up in consumption growth include solid employment growth and low interest rates, as well as the ongoing effects of lower petrol prices and a further increase in household wealth. With growth in household disposable income remaining below average, the saving ratio has continued to decline (Graph 3.4).

Graph 3.4
Household Income, Consumption and Wealth*



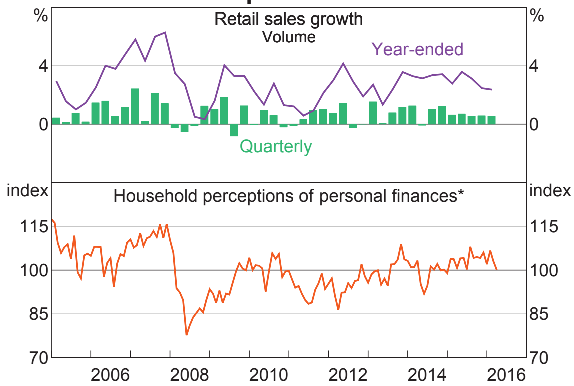
* Household sector includes unincorporated enterprises; disposable income is after tax and interest payments; income level smoothed with a two-quarter moving average between March quarter 2000 and March quarter 2002; saving ratio is net of depreciation

** Per cent of annual household disposable income, before the deduction of interest payments

Sources: ABS; RBA

Retail sales volumes grew at a similar pace in the March quarter as in late 2015, although other timely indicators of household consumption have eased of late (Graph 3.5). Motor vehicle sales to households have continued to decline in early 2016, though at a slower pace than in late 2015, and households' perceptions of their own finances have declined of late, although they remain around their long-run average. However, in the past these indicators have had only a modest correlation with quarterly aggregate consumption growth. Liaison suggests that trading conditions in the retail sector have softened in recent months, but remain generally positive.

Graph 3.5
Consumption Indicators



* Average of the ANZ-Roy Morgan and Westpac-Melbourne Institute consumer sentiment measures of respondents' perceptions of their personal finances relative to the previous year; average since 1980 = 100

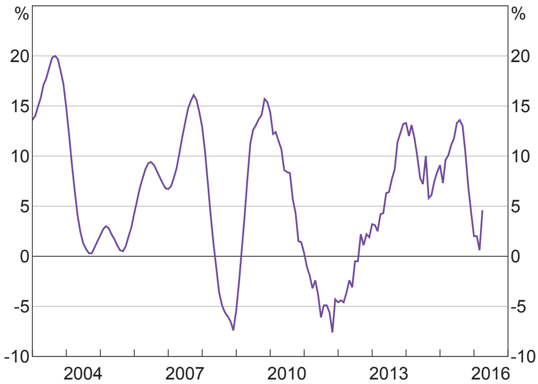
Sources: ABS; ANZ-Roy Morgan; RBA; Westpac and Melbourne Institute

Conditions in the established housing market have stabilised somewhat over the past two quarters or so. Housing prices increased in the early months of 2016, after easing slightly in the December quarter of 2015 (Graph 3.6). Auction clearance rates are above average in Sydney and Melbourne, although they remain lower than a year ago (Graph 3.7). The average number of days that a property is on the market is a little higher than the lows of last year, while the eventual discount on vendor asking prices is little changed. Housing turnover rates are below average.

Housing credit growth has eased a little in recent months, after stabilising in the second half of 2015. This follows an earlier period of rising credit growth, driven in large part by investor lending. This moderation has been consistent with the increases in mortgage interest rates implemented by most lenders towards the end of 2015 and the tightening of lending standards (see 'Domestic Financial Markets' chapter for further details on the developments in housing finance).

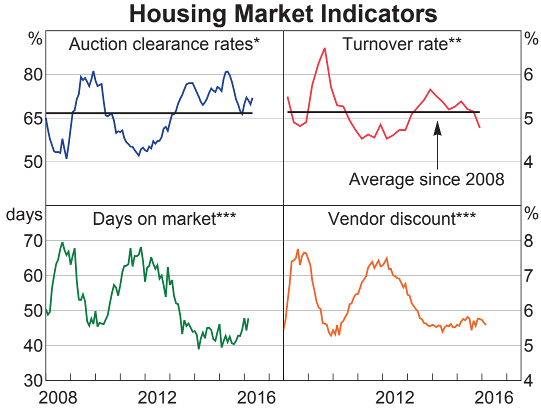
Conditions in the rental market have continued to soften. Growth in rents has declined and the aggregate rental vacancy rate has increased to around its average since 1990. While the recent increase in the national vacancy rate mainly reflects

Graph 3.6
Housing Price Growth
Six-month-ended annualised



Sources: CoreLogic RP Data; RBA

Graph 3.7
Housing Market Indicators



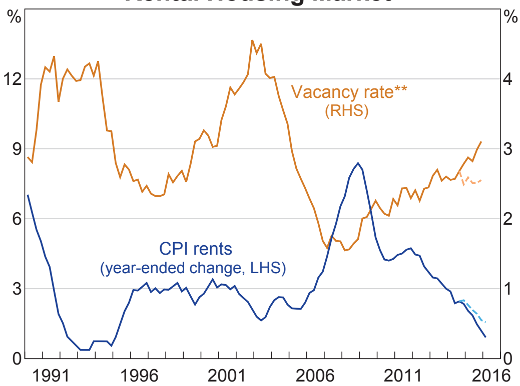
* Average of Melbourne and Sydney
** Share of dwelling stock, annualised
*** Capital city dwelling stock weighted median for private treaty sales only; vendor discounts reflect average difference between the original listing price and the final selling price

Sources: Australian Property Monitors; CoreLogic RP Data; RBA; Real Estate Institute of Victoria

developments in the Perth rental market, growth in rents has eased in most capital cities (Graph 3.8).

Dwelling investment has continued to grow strongly, supported by low interest rates and the significant increase in housing prices in recent years. Investment in higher-density housing grew at close to 30 per cent over 2015, accounting for most of dwelling investment growth over that period. More recently, the amount of residential construction work still in the pipeline has continued to rise and points to further strong growth in dwelling investment. The pace of growth is likely to moderate, however, consistent with the decline in building approvals since last year (Graph 3.9).

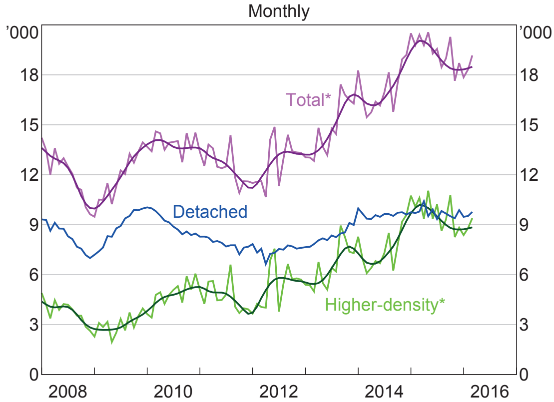
Graph 3.8
Rental Housing Market*



* Dotted lines exclude Perth
** Excludes Adelaide from March quarter 2015

Sources: ABS; RBA; Real Estate Institute of Australia

Graph 3.9
Private Residential Building Approvals
Monthly



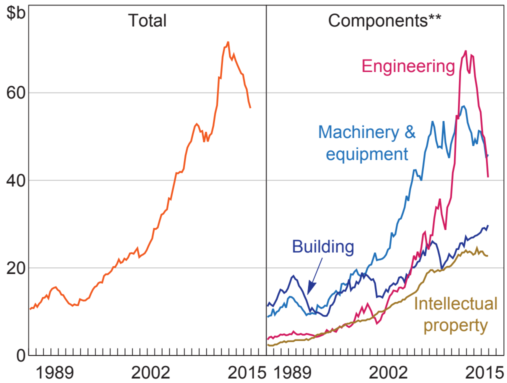
* Smoothed lines are ABS trends

Source: ABS

Business Sector

Private business investment fell by 3 per cent in the December quarter and by 12 per cent over 2015 (Graph 3.10). The annual decline was led by a sharp fall in mining investment. Non-mining investment has been little changed for several years in real terms, notwithstanding a pick-up in profits in the non-mining sector in 2015 and above-average business conditions.

Graph 3.10
Private Business Investment
Chain volume*

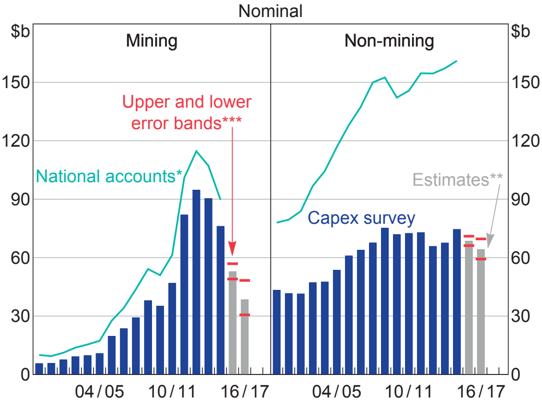


* Adjusted for second-hand asset transfers between the private and other sectors; reference year is 2013/14

** Excluding cultivated biological resources

Sources: ABS; RBA

Graph 3.11
Measures of Private Business Investment
Nominal



* Adjusted for second-hand asset transfers between the private and other sectors; excluding cultivated biological resources

** Estimates are firms' expected capital expenditure, adjusted for the past average difference between expected and realised spending

*** Error bands are based on the root mean square error of each adjusted estimate compared with the final outcome for investment in each year

Sources: ABS; RBA

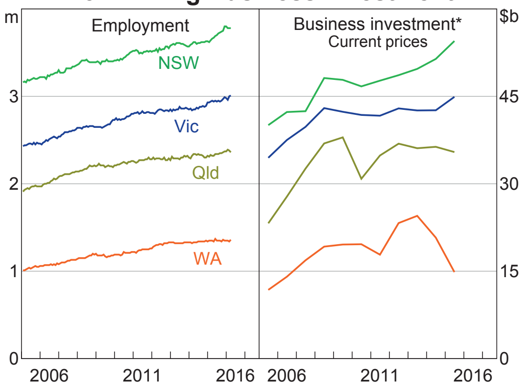
The decline in mining investment is expected to continue over coming years. Few new projects are expected to commence as the global supply of commodities has increased markedly, resulting in a significant fall in bulk commodity prices over recent years and a decline in mining sector profits. The recent rise in commodity prices, even if sustained, is unlikely to lead to additional mining investment over the next two years or so. The ABS capital expenditure (Capex) survey, along with Bank liaison, suggests that the decline in mining investment is likely to continue, although the largest subtraction from GDP growth is expected to be in the current financial year (Graph 3.11). It is likely that, by the end of 2016, the bulk of the decline in mining investment will have occurred; mining investment is currently 4 per cent of nominal GDP, down from its peak of 8 per cent in 2012.

Indicators of investment intentions suggest that non-mining investment will remain subdued for at least the next few quarters. The latest Capex survey continues to imply that a recovery in non-mining investment will not occur in either 2015/16 or 2016/17. Consistent with this, non-residential building approvals remain at relatively low levels, in part reflecting weak underlying conditions in the commercial property market. The estimates from the Capex survey are, however, subject to considerable uncertainty. Moreover, the survey does not cover a large share of non-mining investment that is captured in the national accounts, such as investment in agriculture, education, healthcare or intangible items.

Patterns in non-mining investment spending across the states appear to have varied considerably (Graph 3.12).[1] The direct and indirect effects of conditions in the mining sector on activity in the non-mining sector appear to be quite significant for the resource-rich states of Western Australia and Queensland. The direct effect arises because many non-mining firms provide inputs and support to firms involved in mining investment or resource extraction. There is also an indirect effect, whereby conditions in the mining sector affect economic conditions more broadly, for example via spending of profits, wages and tax revenues

1 Measurement issues suggest that the state-level estimates should be regarded as indicative. For each state, private non-mining business investment is estimated as total private business investment (excluding second-hand asset transfers) less mining investment. Mining investment by state is estimated as the sum of mining capital expenditure on machinery & equipment and buildings & structures (sourced from the Capex survey) and mining exploration expenditure (sourced from the ABS Mineral and Petroleum Exploration survey).

Graph 3.12
Employment and Non-mining Business Investment



* Refer to footnote 1 in the text
Sources: ABS; RBA

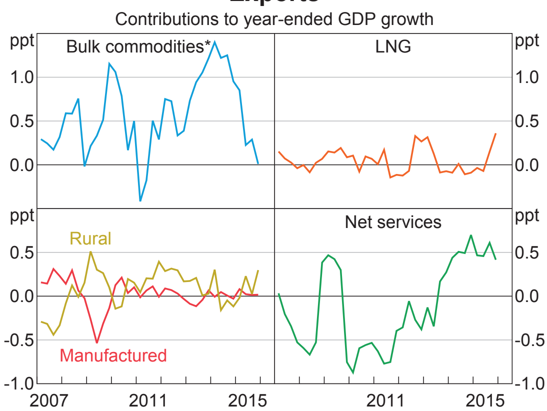
generated in mining and mining-related activities. Hence, declines in commodity prices and mining investment are likely to have had a larger 'knock-on' effect on employment and investment in Western Australia and Queensland. In contrast, in New South Wales and Victoria, which are less resource intensive, the recovery in non-mining business investment appears to have begun, supported by stronger demand growth due to very low interest rates and the depreciation of the Australian dollar over the past few years. Consistent with this, survey measures of business conditions in New South Wales and Victoria are clearly above average, while those in the resource-related states are more subdued.

External Sector

Export volumes rose by 6 per cent over 2015, with strength in resource, service and rural exports. Much of the strength in resource exports was driven by exports of LNG, which are expected to continue to increase substantially over the next couple of years as a number of LNG projects are completed and production capacity increases. Exports of iron ore grew at a more moderate pace over 2015 than they had previously. Iron ore exports are expected to continue to grow over the next couple of years, as production from the large, low-cost producers continues to expand. The recent weakness in coal exports is expected to continue, reflecting weak global demand and the relatively high cost of some Australian production.

Net service exports contributed more to GDP growth over 2015 than exports of bulk commodities, which is the first time this has happened since 2008 (Graph 3.13). This was assisted by the improved competitiveness associated with the depreciation of the Australian dollar. Tourism, education and business service exports have all expanded, while service imports have declined noticeably over the past couple of years, particularly for travel and business services (for more detail, see 'Box A: Australian Services Trade').

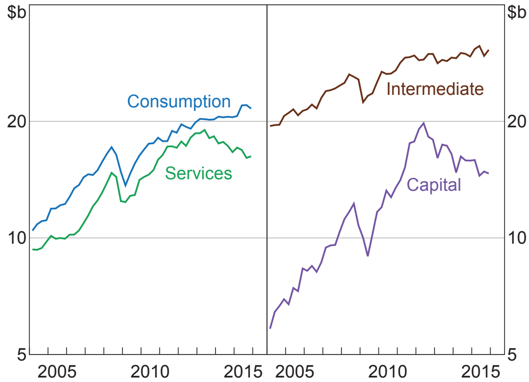
Graph 3.13
Exports



* Iron ore and coal
Sources: ABS; RBA

Overall import volumes increased modestly over 2015, reflecting growth in consumption and intermediate imports (Graph 3.14). The increase in intermediate imports was led by higher fuel import volumes, consistent with the substantial decline in oil prices over 2015. These increases were partly offset by a decline in service import volumes and the downward trend in capital goods imports associated with the decline in mining investment over recent years.

Graph 3.14
Import Volumes*
Log scale, quarterly

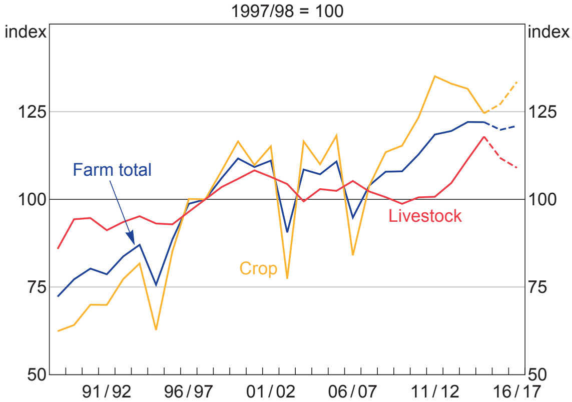


* Reference year is 2013/14
Source: ABS

Farm Sector

The Australian Bureau of Agricultural and Resource Economics and Sciences expects the volume of farm production to decline modestly in 2015/16 (Graph 3.15). Farm production has been supported in recent years by high levels of production from livestock, but these are expected to moderate in 2015/16 as herds are rebuilt; crop production is expected to grow modestly.

Graph 3.15
Farm Production Volumes*
1997/98 = 100

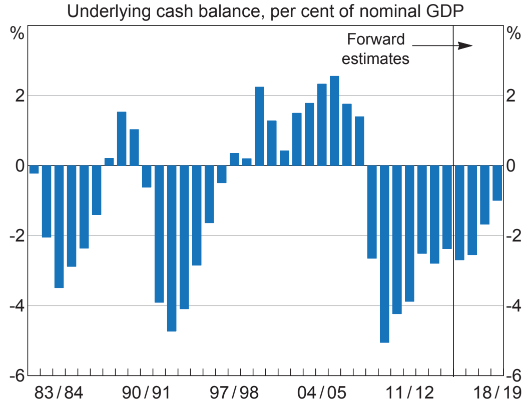


* Dotted lines represents 2015/16 and 2016/17 forecasts
Source: ABARES

Government Sector

Recent federal and state government budgets suggest there will be fiscal consolidation over coming years. Lower-than-expected growth of labour income has led to downward revisions to revenue growth in 2015/16, although this has been offset in part by higher-than-expected growth in stamp duty revenue in some states. The consolidated deficit is projected to be little changed from previous forecasts. In 2016/17, the consolidated deficit is expected to narrow to around 2½ per cent of GDP, and progressively lower deficits are expected in subsequent years (Graph 3.16).

Graph 3.16
Consolidated Budget Balance*
Underlying cash balance, per cent of nominal GDP

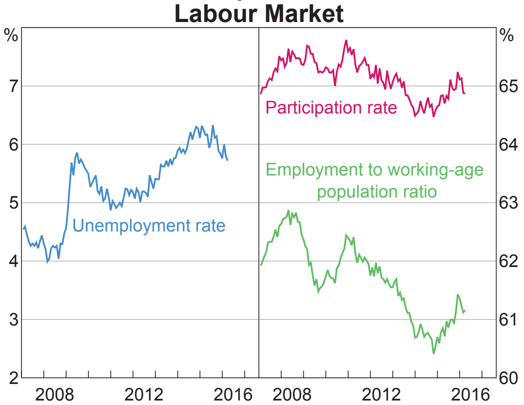


* Based on the 2016/17 Australian Government and Victorian budgets and 2015/16 mid-year updates for the other States and Territories; excludes the effect of the federal grant to the RBA in 2013/14
Sources: ABS; Australian Treasury; State and Territory Treasuries

Labour Market

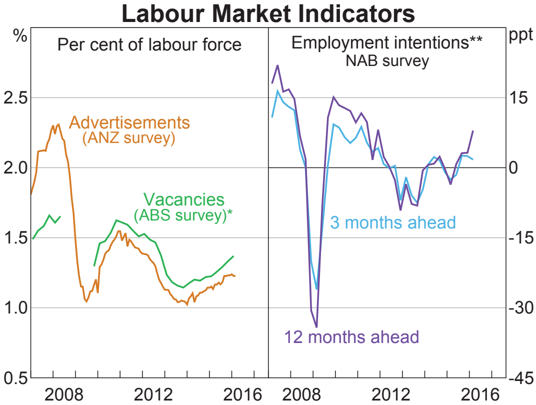
Labour market conditions are noticeably stronger than a year ago, although momentum has eased of late. Employment growth has been a little above its long-run average in year-ended terms, the unemployment rate has been on a downward trend since around mid 2015, and the employment-to-population ratio and participation rate have been on upward trends over the past year or so (Graph 3.17). This improvement has been broad based across part-time and full-time employment. Average hours

Graph 3.17
Labour Market



Source: ABS

Graph 3.18
Labour Market Indicators

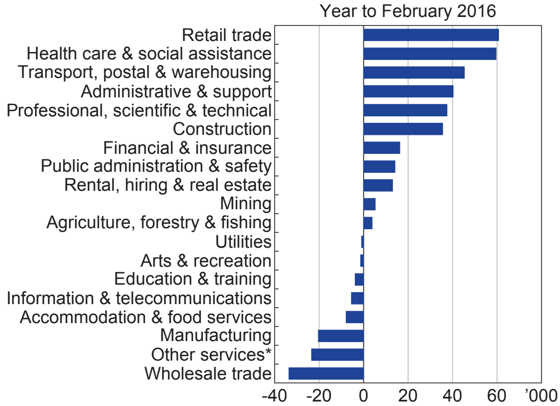


* This survey was suspended between May 2008 and November 2009

** Net balance of employment intentions for the following period; deviation from average; 12-months-ahead measure seasonally adjusted by the RBA

Sources: ABS; ANZ; NAB; RBA

Graph 3.19
Employment Growth
Year to February 2016



* Includes personal services; religious, civic, professional and other interest group services; repair and maintenance activities; and private households employing staff

Source: ABS

worked have been little changed. As expected, there has been some moderation in employment growth in early 2016, following very strong employment growth in late 2015. The unemployment rate has remained around 5¾ per cent, about ½ percentage point below its peak in 2015.

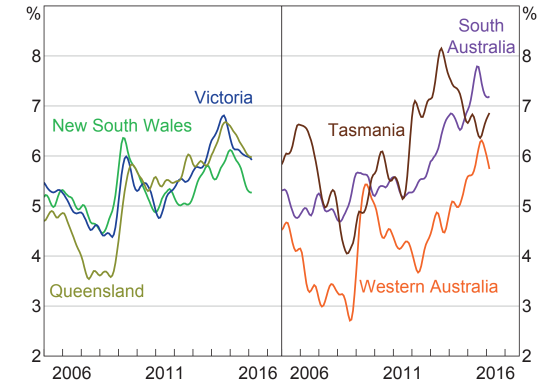
Other labour market indicators also suggest that conditions are better than a year ago, but provide mixed signals about how labour market conditions are likely to evolve in the near term. The NAB survey measures of businesses' hiring intentions remain above their long-run averages and job vacancies have continued to increase as a share of the labour force (Graph 3.18). However, the number of unemployment benefit recipients as a share of the labour force increased slightly in March, after having declined since mid 2015, and job advertisements have levelled out in recent months after a period of relatively consistent increases.

In recent years, the household and business services sectors have made the largest contributions to employment growth. This trend was somewhat reversed in the March quarter, although health & social assistance employment remains much higher than a year ago (Graph 3.19). Employment in a number of business services industries is also higher than a year ago, supported by a range of activities, including strong growth in residential building activity, public infrastructure spending in some states and the increase in service exports following the depreciation of the Australian dollar since 2013. Employment has risen in retail trade, transport, postal & warehousing and construction in recent quarters, consistent with the increased pace of consumption growth and continued dwelling investment.

The improvement in labour market conditions over the past year or so has been concentrated in the eastern states, consistent with other economic activity indicators. Unemployment rates have fallen in New South Wales, Victoria and Queensland (Graph 3.20). In contrast, the unemployment rate in Western Australia has risen over the past few years to be close to the national average in trend terms, after having been well below average during the mining investment boom. The strong growth in services employment over the past year or so has also been concentrated in the eastern states (Graph 3.21). Services employment has declined in Western Australia, reflecting the exposure of business services there to mining investment-related activity. Similarly, goods-related employment has increased a little in New South Wales and Victoria over the past year or so, while it has fallen in Western Australia and Queensland as a result of declining mining and mining-related employment.

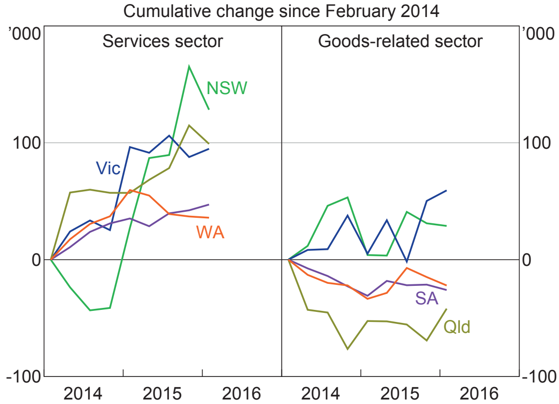
Notwithstanding the improvement in labour market conditions over the past year, there is still evidence of spare capacity. In all states, unemployment rates remain above the lows of recent years and wage growth is still very low (see 'Price and Wage Developments' chapter). ✠

Graph 3.20
Unemployment Rates by State
Trend



Source: ABS

Graph 3.21
Employment by State and Sector*
Cumulative change since February 2014



* Seasonally adjusted using ABS state seasonal factors; does not remove sectoral seasonal patterns

Sources: ABS; RBA