# Overview

Growth in Australia's major trading partners remains a bit below average and is expected to decline a little over the forecast period, reflecting a further moderate easing in growth in China. While longer-term risks associated with high and rising debt in China remain, the downside risks to Chinese growth in the near term appear to have diminished, in large part due to strong growth of government-funded infrastructure projects and buoyant conditions in the property market. These developments have led to an increase in the demand for bulk commodities at the same time as the Chinese authorities have restricted domestic production of commodities to reduce overcapacity. This has contributed to a pick-up in bulk commodity prices and has been associated with a broad-based increase in producer prices in China.

The rise in commodity prices this year has resulted in an increase in Australia's terms of trade. This represents a marked change from the pattern of recent years, whereby the terms of trade had fallen significantly and by more than expected. Although the recent increase in the terms of trade has been associated with an appreciation of the Australian dollar, it is expected to provide some support to income growth, in contrast to the period since the peak in the terms of trade in 2011. The forecasts assume that the terms of trade will remain above the low point reached earlier this year. In part, this reflects the expectation that Chinese demand for steel will remain resilient in the near term and that Chinese production of bulk commodities will not increase substantially. However, the Chinese authorities may relax efforts to reduce overcapacity in their mining industry, in response to recent sharp increases in bulk commodity prices, and there is uncertainty about the extent to which the recovery in the Chinese property market will be sustained. Either of these factors, among other things, could affect the outlook for Australia's terms of trade.

In the major advanced economies, growth in economic activity continues to be supported by accommodative monetary policy and further improvements in labour market conditions. Output is forecast to grow at above-trend rates and a further reduction in spare capacity is expected over the forecast period. That, combined with the rise in the prices of oil and other commodities, is expected to put upward pressure on global inflation over the forecast period. While there is still a risk that low inflation expectations could become entrenched, the risks to global inflation appear to be more balanced than they have been for some time. In the United States, inflation has increased a bit since last year and is only a little below the Federal Reserve's target. Financial market pricing implies that an increase in the federal funds rate by the end of 2016 is more likely than it was at the time of the August *Statement on Monetary Policy*. While inflation remains below the European Central Bank's target, long-run inflation expectations appear to be relatively well anchored at close to 2 per cent. In contrast, inflation and inflation expectations in Japan have declined over the past year.

Any changes to the current stance of monetary policy or in the expected path of policy rates in the major advanced economies are likely to affect a range of financial market prices, including exchange rates. The depreciation of the Australian dollar since 2013 has contributed to the ongoing adjustment of the economy to the end of the resources boom; an appreciating currency could complicate that process.

As expected, the pace of growth in the Australian economy appears to have moderated around the middle of the year following strong growth in the March quarter. There has been little change to the aggregate growth forecasts. GDP growth is expected to be around potential in 2016/17 and gradually pick up thereafter to be between 3 and 4 per cent by the end of the forecast period. Resource exports are likely to make a further significant contribution to GDP growth, as exports of liquefied natural gas (LNG) continue to ramp up. Mining investment is still expected to subtract from growth for a time, albeit by less than was the case over the past year. Non-mining activity is projected to continue to grow at around its average pace over the forecast period. Low interest rates and the depreciation of the exchange rate over the past couple of years will help support household consumption, dwelling investment and exports. Ongoing growth in these areas of the economy is expected to underpin a further increase in non-mining business investment in the period ahead.

Consumption growth was below average in the June quarter, but has been above the growth in household disposable income in year-ended terms for some time – supported by low interest rates and rising household wealth, and consistent with measures of consumer sentiment remaining above average. Consumption growth has been accommodated by a gradual decline in the household saving ratio, which is expected to continue over the forecast period. Households' expectations about the likely growth in their incomes will have an important bearing on their consumption, saving and borrowing decisions. These factors, as well as future developments in the housing market, are all risks to future consumption growth.

As expected, private dwelling investment was strong over the year to the June quarter. The value of residential building approvals has reached record levels as a share of GDP and the amount of work in the pipeline has edged higher. Accordingly, dwelling investment is likely to contribute to growth for some time yet. However, the large amount of work in the pipeline raises concerns that some locations could become oversupplied, particularly in inner-city areas where a lot of high-density housing is planned. This could lead to settlement failures by off-the-plan purchasers and a general reduction in rents and prices.

Conditions in the established housing market have eased relative to a year ago, although some indicators suggest that conditions may have strengthened over recent months. In particular, housing price growth has picked up noticeably in Sydney and Melbourne, where auction clearance rates have also increased to high levels. However, the number of auctions and housing market turnover more generally are lower than they were last year and properties are, on average, taking longer to sell. While housing credit growth has also declined over the past year, loan approvals data suggest that lending to investors has increased a little over recent months. Housing market conditions remain weak in Perth, where prices of both apartments and detached dwellings have declined further over the past year.

The unemployment rate has declined over the course of this year, but so too has employment growth. Moreover, the growth in employment has been accounted for by part-time employment. Forward-looking indicators are consistent with moderate employment growth in the months ahead. The unemployment rate is expected to edge just a little lower over the next couple of years. This forecast is largely unchanged from that presented in the August *Statement* and implies that a degree of spare capacity remains in the labour market. However, there is uncertainty about how much spare capacity there is and the extent to which it will ultimately feed into inflation. One aspect of this uncertainty is that the underemployment rate remains elevated and implies more spare capacity than indicated by the unemployment rate alone. At the same time, however, there is evidence that wage growth has stabilised, in part because it appears that the drag on aggregate wage growth from the movement of workers from mining-related activities to lower-paying jobs in the non-mining sector has diminished. The growth in labour costs is expected to rise over the forecast period as labour market conditions improve and the effects of the large decline in the terms of trade and mining investment on demand wane. Even so, growth in labour costs is likely to remain low.

The September quarter inflation data were in line with expectations. Underlying inflation has been around 1½ per cent in year-ended terms over recent quarters, while headline inflation was around 1¼ per cent. Petrol prices have subtracted from year-ended headline inflation over recent years.

Domestic cost pressures remain subdued as the economy continues to rebalance following the end of the resources boom. Low growth of labour costs is clearly evident in very low inflation in prices of market services. Also, rent inflation remains very low, while growth in the cost of constructing a house has declined, which is somewhat at odds with the strength in dwelling investment across much of the country. The prices of tradable items (excluding volatile items and tobacco) fell slightly in the September quarter and were unchanged over the year. Inflation in those parts of the retail sector subject to heightened competitive pressures over recent years also remains low, but stabilised in the September quarter.

There has been no material change to the forecast for underlying inflation, which is expected to remain around current rates in the near term, before gradually picking up to around 2 per cent by the end of the forecast period. The disinflationary effects from heightened retail competition are expected to dissipate over time and gradually rising labour cost growth is forecast to add to inflation over the forecast period. Higher prices for oil over recent months and increases in the tobacco excise tax are also expected to add to headline inflation. On the other hand, low rent inflation is expected to persist, while the boost to the prices of tradable items from the earlier depreciation of the exchange rate appears to have largely run its course.

The Reserve Bank Board reduced the cash rate by 25 basis points in May, following weaker-than-expected inflationary pressures, and by the same amount again in August, when the data confirmed that inflationary pressures remained low. Those reductions in the cash rate will provide some additional support to demand and enhance the prospects of inflation returning to target over time. In August, the Board also noted that, compared with 2015, conditions in the housing market had eased and housing credit growth was lower, partly as a result of earlier actions to tighten lending standards.

The flow of data over the past few months has been consistent with the earlier forecasts. Inflation is expected to remain low for some time, before gradually returning to more normal levels. While there is uncertainty about the outlook for employment growth, it is likely that there will still be some spare capacity in the labour market over the forecast period. At the same time, housing prices are rising at a brisk rate in some locations, although overall housing credit growth and housing turnover remain lower than they were last year.

Taking all these considerations into account, at its recent meetings the Board judged that there were reasonable prospects for achieving sustainable growth in the economy with inflation returning to the medium-term target over time and, hence, it was appropriate to leave the cash rate at 1.50 per cent.