Overview

Conditions in the global and domestic economies remain positive and are broadly continuing on the track they have been on for the past year or so. Output growth in most of Australia's major trading partners is at or above trend and labour markets are tightening. Inflation has picked up a little in a number of these economies and is likely to increase further, after a long period at low levels. Domestically, a further gradual reduction in the unemployment rate and a rise in inflation are expected over the next couple of years. The Bank's forecasts are little changed from three months ago, as are the considerations for monetary policy.

The global economy has been expanding at a solid pace. Data available so far imply that this continued into the March quarter, including in parts of east Asia where some indicators had suggested that growth slowed late last year. In the major advanced economies, employment growth remains strong, wages growth has picked up and the outlook for investment is positive. Both the euro area and Japan are likely to expand at or above the rate of growth of productive capacity in the period ahead, as has been the case for several years. In the United States growth is likely to be boosted by a considerable fiscal stimulus in 2018 and 2019.

Capacity constraints are starting to show up in the major advanced economies. Business surveys in some economies are reporting increasing difficulty in finding suitable labour and other signs of binding capacity constraints such as production delays. Unemployment rates have reached very low levels. After a long period of slow growth in wages, a pick-up is now occurring in some economies.

Inflationary pressures globally are expected to increase further. As well as wages growth rising in response to tight labour markets, upstream price pressures are also evident. Oil prices are up by around 10 per cent since the start of the year. More recently, the prices of some base metals have been boosted by commodity-specific supply factors. Producer price inflation is generally higher than it has been for several years, although it has turned down in recent months.

In China, the authorities continue to balance their policy priorities of supporting growth, reducing financial leverage and improving environmental outcomes. The authorities' target for growth in 2018, at 6.5 per cent, is a step down from last year's outcome for GDP growth and provides scope to address their other policy priorities. Some measures of activity have eased in recent months, although the housing sector has remained resilient. This easing could prompt renewed policy stimulus to support growth at target. Any additional spending on housing or infrastructure would tend to boost demand for Australia's coal and iron ore exports, at least in the short term.

Australia's terms of trade have been a bit higher than was expected a year ago, partly because of the boost to prices from disruptions to coal supply. The prices of bulk commodities have declined over recent months as these supply disruptions have eased and concerns about future Chinese steel demand have continued.

These prices, and thus Australia's terms of trade, are expected to decline somewhat over coming years, because Chinese demand for these commodities is likely to moderate and further low-cost supply will come on line. The terms of trade are nonetheless expected to remain significantly higher than the averages of past decades.

As always, there are a number of risks to the outlook for global growth. Recent announcements of trade protectionist measures by the US and Chinese authorities involve only a small share of their total trade and are therefore unlikely to affect growth noticeably. A significant escalation in trade protectionism would, however, derail the global economic expansion.

There are also scenarios in which global demand and inflation are stronger than expected. If that occurred, it could prompt a faster tightening of monetary policy and financial conditions in the major advanced economies than many observers expect. Financial market pricing currently implies that solid global growth can continue without sparking much of an increase in inflation. A significant reappraisal of the inflation outlook could result in higher yields and affect financial market pricing.

Any increase in yields arising from increased inflation expectations would occur on top of the effects of the recent moderate tightening in money market conditions in the United States and some other markets, which has occurred for several reasons unrelated to expectations about monetary policy. This has increased the cost of funding for a range of financial institutions in Australia as well as the borrowing costs for some businesses.

More broadly, global financial conditions remain accommodative, even though credit spreads have widened a little. Financial market volatility has increased since last year but remains fairly low. The US dollar has appreciated against most currencies, including the Australian dollar. On a trade-weighted basis, the Australian dollar has depreciated a little lately but remains in the range it has been in for the past couple of years. A significant appreciation of the Australian dollar would tend to dampen future output growth and inflation.

Growth in the domestic economy is expected to have picked up in the March quarter, as coal exports recovered from disruptions to supply and liquefied natural gas (LNG) exports increased further. Recent data, including revisions to prior quarters, imply that there was a bit more momentum in domestic demand in the second half of 2017 than previously reported. Beyond that, the forecasts for GDP growth are little changed. Growth is still expected to be a bit above 3 per cent from late 2018. Growth at these rates would typically imply that spare capacity will continue to be absorbed.

Business conditions are very positive. Survey-based measures of conditions are above average in all industries, including mining and retail, which had previously been reporting much weaker conditions. Profits for both listed companies and the corporate sector generally increased over 2017. Non-mining business investment increased by 12½ per cent over the year and ongoing investment in new public infrastructure is boosting activity for some businesses.

The outlook for non-mining business investment is for continued expansion. An increasing number of firms are reporting that they face capacity constraints, and survey measures of investment intentions also suggest that further solid growth in investment is likely. Currently, investment growth is being led by construction, particularly office buildings. Growth in other types of investment, such as machinery and equipment, is expected to pick up in the period ahead.

Mining investment held up a little more over the past year than earlier expected, but is still likely to decline further in the period ahead as large LNG projects are completed. The trough in mining investment is now expected to be in late 2018 or early 2019, which is a bit later than the Bank's previous forecasts implied. Further out, a pick-up in sustaining mining investment is likely, but this will contribute much less to overall growth than the earlier boom in investment in production capacity.

Dwelling investment is expected to remain at a high level but have little effect on overall economic growth. Residential building approvals have stepped down from their peak levels in mid 2016 but remain high. Building activity has been supported by the large pipeline of work yet to be done, which has increased to reach historically high levels. Renovation activity has been lower than historical relationships with new home building would suggest.

Conditions in the Sydney and Melbourne established housing markets have eased. Nationwide measures of housing prices were little changed over the past six months, and price falls were recorded in some areas. The flow of new borrowing has slowed, especially for investors, as has housing credit growth. Credit standards have tightened a bit further recently and it is possible that they will be tightened again in the context of the current high level of public scrutiny.

Growth in household consumption has picked up since early 2017; recent data revisions imply that household consumption growth was more resilient to weak income growth than earlier reported. Indications are that consumption growth remained solid in the March quarter. Consumer sentiment also remains above average. Household income growth has been weak despite rapid growth in employment; wages growth has been low and compositional change in the labour force has weighed on average earnings per hour. This weakness in income growth has presented a risk to the consumption forecast for some time. The high level of household debt also carries certain risks, including that households' spending decisions might become more sensitive to unexpected weakness in income or wealth.

Employment growth has been very strong over the past year, although it has slowed in recent months. Labour force participation increased significantly over the past year or so, especially for females and older workers. The unemployment rate is lower than in early 2017, but has been around 5½ per cent for some months. Forward indicators point to above-average growth in employment in coming months, and a resumption of the gradual decline in the unemployment rate is expected. The unemployment rate is forecast to reach 5¼ per cent by mid 2019.

As the labour market tightens, wages growth is expected to pick up gradually. The wage price index measure of wages growth, which abstracts from compositional change, has increased a little but remains low. Broader measures of labour income growth have, as noted above, been subdued. The Bank's liaison suggests that a higher share of firms are now expecting a pick-up in wages growth over the year ahead, although most still expect little change. Also, business surveys suggest that a higher share of firms are finding it more difficult to find suitable workers.

Inflation remains low but has troughed and is expected to increase gradually over the next few years. Inflation in the March quarter was broadly in line with earlier expectations. Headline inflation was 0.5 per cent in the quarter and unchanged at 1.9 per cent over the year. Underlying inflation was about ½ per cent in the quarter and close to 2 per cent over the year. Subdued growth in labour costs and ongoing competition in retailing are weighing on inflation. Prices of durable goods and many other consumer staples have accordingly been little changed or have fallen over recent quarters. Some of this downward pressure should ease as the labour market tightens and wages growth picks up. The Bank's forecasts are for CPI inflation to be a bit above 2 per cent in both 2018 and 2019. Underlying inflation is also expected to increase from close to 2 per cent currently, to be above 2 per cent by the end of the forecast period.

Overall, the Australian economy is progressing broadly on the track the Bank has been expecting for a while. The unemployment rate is a little lower than a year ago and inflation has risen slightly. The current accommodative stance of monetary policy has assisted this outcome.

Further progress on both inflation and unemployment is expected over the period ahead, although this progress is expected to be only gradual. For some time the Reserve Bank Board's view has been that holding the cash rate steady at 1½ per cent would assist that progress, with steady monetary policy promoting stability and confidence. If the economy continues to perform as expected, higher interest rates are, however, likely to be appropriate at some point. Notwithstanding this, the Board does not see a strong case for a near-term adjustment in the cash rate.