Overview

The Australian economy is performing well, and a little stronger than earlier expected. GDP growth is running above 3 per cent. The unemployment rate has declined noticeably, reaching 5 per cent in the month of September. As flagged three months ago, inflation declined in the September quarter, largely because childcare prices fell and utilities price inflation moderated. More generally, inflation remains low and stable. Stronger growth and labour market conditions can be expected to generate a gradual lift in wages growth and inflation over time. The Bank's forecasts for growth and inflation have been upgraded slightly in light of recent data. GDP growth is now expected to be around 3½ per cent on average over 2018 and 2019, but to ease in the latter part of the forecast period as production of some resource commodities stabilises at high levels. Headline and underlying inflation are both expected to rise to be a little above 2¼ per cent by the end of 2020.

The global economic outlook remains positive. Although growth has slowed in some economies, it remains above trend in the major advanced economies. Spare capacity in these economies is likely to diminish further, putting upward pressure on global inflation. Rising trade tensions are expected to weigh a little on growth in the United States and a few economies in east Asia, but the US fiscal stimulus and still-accommodative monetary policy remain supportive of continued economic expansion. Growth in Australia's major trading partners is expected to slow slightly over the next couple of years.

Further US–China tariff measures came into effect in the past few months, and trade restrictions appear to be weighing on export orders for some economies. The possibility of trade protectionism escalating further presents a significant downside risk to global growth, especially if tensions spread to involve other economies or if business investment decisions are affected.

Growth in China has slowed a little over the past year. Conditions in the industrial sector, in particular, have weakened. Some of the slowing is related to measures taken by the Chinese authorities to contain financial risk and improve the transparency of local government finances. The authorities have, for some time, been balancing these objectives with the need to support growth. As such, they have eased policies in a targeted way to ensure that growth does not slow too much and to offset the effects of rising tariffs.

Elsewhere in Asia, growth has remained relatively strong in 2018 to date. Many economies in this region could be affected by rising trade tensions between the United States and China, because of their position in global supply chains. Export orders had slowed earlier in the year but have been broadly stable in recent months. Meanwhile, domestic demand has supported growth, especially in India, where growth has strengthened recently.

Growth in the major advanced economies remains above the growth in productive capacity. Spare capacity is therefore diminishing and unemployment rates have continued to decline to multi-decade lows in a number of economies. As labour market conditions have tightened, wages growth has increased. This has been contributing to increased inflationary pressures in the United States and some smaller advanced economies, but is yet to do so in the euro area or Japan. These capacity pressures could lead to a faster pick-up in global inflation, a scenario that is not currently being priced in by financial market participants.

Financial conditions in the major advanced economies have tightened somewhat recently but remain accommodative overall. Sovereign bond yields have edged up a bit from low levels. Equity prices declined across most major markets in recent weeks, though corporate earnings remained strong. Credit and money market spreads generally remain narrow, despite widening a little in October. Central banks are at different stages of their monetary policy cycles. A number of central banks in advanced economies are expected to continue to raise policy rates, most notably the US Federal Reserve. In contrast, the European Central Bank and the Bank of Japan are expected to retain their highly expansionary policy stances for some time.

Financial conditions have stabilised recently for several emerging market economies that have been experiencing difficult external financing conditions this year, including Argentina and Turkey. Nevertheless, for some emerging markets, the external financing environment is likely to remain challenging for some time.

Money market rates in Australia remain a little higher than the average in 2017. The overall effect of higher money market rates on banks' funding costs and profits has been fairly small. Rates on banks' retail deposits have not risen and banks have increased interest rates on a large share of their lending, including for mortgages. Despite these increases, lending rates are relatively low and competition by lenders for high-quality mortgage borrowers remains vigorous. In particular, the rates on offer for new home loans are typically lower than the average for outstanding loans.

On a trade-weighted basis, the Australian dollar remains in the fairly narrow range it has been in for some time. Although rising commodity prices would normally be associated with a tendency for the Australian dollar to appreciate, an offsetting development has been the decline in the yield differential between bonds in Australia and those in major markets.

Australia's terms of trade continue to exceed earlier expectations, because prices of energy and other bulk commodities have been stronger than projected over the past year. Global energy demand has supported oil, liquefied natural gas (LNG) and thermal coal prices, while ongoing strong demand for steel in China and, increasingly, India, has supported the prices of iron ore and coking coal; supply disruptions have also boosted coking coal prices in recent quarters. Beyond the next few quarters, Australia's terms of trade are still expected to decline gradually, as commodity prices moderate and global prices of imported goods pick up along with global inflation. However, this adjustment is now expected to take a bit longer than previously thought.

Domestically, growth was broad based in the June quarter. Recent indicators suggest that further solid growth is likely to have occurred in the September quarter. If so, that would continue the above-trend growth that has prevailed for the past several quarters.

Growth in household consumption has been resilient, despite ongoing slow growth in household income. Year-ended consumption growth is expected to remain around current rates over the period ahead. The outlook for household income remains a key uncertainty around this forecast, especially in the context of high household debt and a slowing housing market.

Dwelling investment has remained high and the large pipeline of work yet to be done suggests that construction should remain at a high level for the next year or so. Leading indicators of housing demand have slowed, however, implying that dwelling investment could fall more sharply beyond that. Finance has become harder to obtain for some developers. Substantial additions to the dwelling stock in the east coast capital cities is placing downward pressure on rents and prices, and rental price inflation remains soft nationwide.

Demand has clearly slowed in the established housing markets of Sydney and Melbourne, with housing prices continuing to decline steadily. Housing prices have also declined further in Perth and Darwin in recent months. Conditions have been stable, though still fairly subdued, in the other major cities. Growth in housing credit has eased over recent months, with lending to investors flat, although credit growth for owner-occupiers remains robust.

Public spending has been supporting GDP growth for some time. State and federal budgets indicate that public infrastructure investment should remain at a high level over coming years. This should, in turn, continue to have positive spillover effects on private sector investment activity and spending.

Business conditions remain positive and investment in non-mining sectors has been growing strongly in recent years. Non-residential construction has been supported by high levels of underlying demand for office space and other properties. Private sector spending on infrastructure has also been increasing of late. Non-mining investment should continue to be underpinned by the ongoing economic expansion and supportive financial conditions.

Mining investment is likely to reach its trough late this year or early next year, as the construction of remaining LNG projects is completed. Beyond that point, mining investment is expected to grow as firms continue to invest to sustain production. The scale of this increase will nonetheless remain far below that seen during the mining investment boom of prior years.

Export growth remains solid, supported by strong global demand conditions and the ongoing ramp-up of LNG production and exports. Although drought conditions have continued in some parts of the country, this has yet to reduce rural exports materially, partly because producers are increasing meat production. The near-term outlook for rural production has clearly weakened, however.

Conditions in the labour market have been stronger than earlier expected. Employment growth was strong in the September quarter, and the unemployment rate declined. Some spare capacity is likely to remain in the labour market at these unemployment rates, but less than prevailed a year ago. Leading indicators of labour demand suggest that this positive momentum could be sustained in the near term. Further out, employment is forecast to continue to increase faster than growth in the working-age population, consistent with above-trend growth in GDP. The unemployment rate is expected to decline gradually, reaching 4¾ per cent by the end of 2020.

As the labour market tightens, wages growth is likely to drift upwards. Some measures of wages growth picked up a touch in the June quarter, and a further boost could occur in the September quarter as the effects of the Fair Work Commission's minimum wage decision flow through. That said, wages growth has been slower to pick up than its historical relationship with indicators of spare capacity in the labour market would imply. The Bank's forecasts assume that this departure from past experience will persist for a while yet.

Inflation in the September quarter declined, as expected. CPI inflation was 1.9 per cent over the year, while underlying inflation was 1¾ per cent. Slow wages growth and a lack of domestic retail pricing pressures have continued to limit the overall inflation impulse in the economy. In addition, the quarterly outcome was affected by the changes to the funding of child care, as had previously been flagged. Utilities price inflation also slowed in the quarter, reversing some of the price increases that had occurred a year earlier. Housing-related price inflation was also weak, with a small increase in home building costs compounding the ongoing slow growth in rents.

Further out, inflation is still expected to increase gradually. The forecasts for inflation have been revised slightly higher, consistent with the recent stronger outcomes and upgraded forecasts for GDP growth and the labour market. Against this, there is some chance that the recent unusually slow growth in administered prices could persist if governments introduce further initiatives to reduce cost-of-living pressures.

The Reserve Bank Board has maintained the cash rate at 1½ per cent since August 2016. This stimulatory setting of monetary policy has supported the economy and resulted in progress towards full employment. Inflation has also increased over the past couple of years, although it is currently slightly below the target range. The steady setting of monetary policy has supported stability and confidence in the Australian economy.

At its recent meetings, the Board has paid close attention to trends in wages growth and household spending. A gradual pick-up in wages growth is expected as the economy continues to improve and is likely to be necessary for inflation to be sustainably within the target range. There remains considerable uncertainty about how soon and how quickly this might occur. Household spending has been growing steadily for some time and is expected to continue to do so. The Board is continuing to assess the impact of slow growth in household incomes in an environment of high debt and declines in housing prices.

The Board is expecting further progress in reducing unemployment and ensuring inflation is consistent with the target. If that progress is made, higher interest rates are likely to be appropriate at some point. However, given the expected gradual nature of that progress, the Board does not see a strong case to adjust the cash rate in the near term.