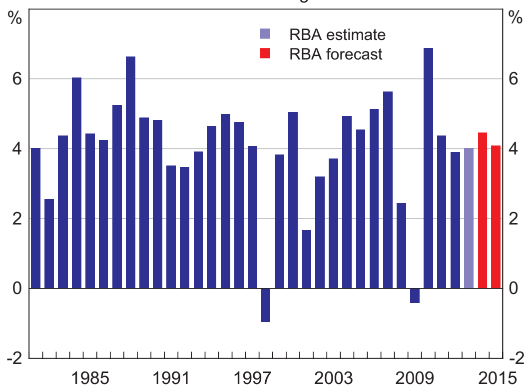
6. Economic Outlook

The International Economy

The Bank's forecast for overall growth of Australia's major trading partners is little changed from those in the November *Statement*. Year-average trading partner growth in 2014 is expected to be a little higher than in 2013 at around 4½ per cent, with a recovery in the advanced economies, before returning to its decade average of around 4 per cent in 2015 (Graph 6.1). This forecast is similar to those of most other forecasters.

Graph 6.1
Australia's Trading Partner Growth*
Year-average

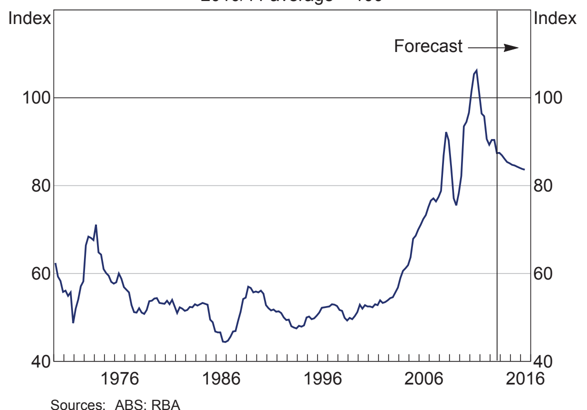


* Aggregated using Australia's export shares
Sources: ABS; CEIC Data; RBA; Thomson Reuters

Growth in the US economy in 2014 is expected to be a little stronger than earlier anticipated – reflecting stronger domestic demand – supported by stimulatory monetary policy and an easing in the extent of fiscal tightening. Chinese growth in 2014 is expected to be around 7½ per cent, similar to growth in 2013. A slight easing of growth in domestic demand, in part reflecting the government's efforts to moderate the growth of financing, is expected to be largely offset by a modest improvement in export demand from China's major trading partners. In Japan, growth in 2014 is expected to be similar to the pace seen over the past year or so, but stronger earlier in the year ahead of the rise in the consumption tax in April and lower thereafter, with only a partial offset from a temporary fiscal stimulus. In the rest of east Asia, the economic outlook is little changed, with growth expected to remain at around its decade average. In the euro area, economic conditions improved a little over the second half of 2013, and the economic recovery is expected to continue at a gradual pace.

The terms of trade are estimated to have been little changed for several quarters, and are 18 per cent lower than their late 2011 peak (Graph 6.2). They are expected to decline further in coming years as an increase in the supply of global bulk commodities, including from Australia, weighs on prices. This would still leave the terms of trade about 50 per cent higher than the long-run average up to the mid 2000s.

Graph 6.2
Terms of Trade
2010/11 average = 100



Sources: ABS; RBA

Domestic Activity

In preparing the domestic forecasts, as usual a number of technical assumptions have been employed. The exchange rate is assumed to remain at its current level over the forecast period (TWI at 69 and A$ at US$0.89, which is around 5 per cent lower than was assumed in the November *Statement*). The forecasts are based on the price for Brent oil remaining at US$104 per barrel, in line with the assumption in November. The cash rate is assumed to be unchanged over the forecast period at 2.5 per cent, which implies that borrowing rates remain at very low levels. The working-age population is assumed to grow by 1.8 per cent each year, drawing on forecasts by the Department of Immigration and Border Protection and in line with the November *Statement*.

The starting point for the forecasts of the Australian economy is below-trend growth over the year to the September quarter 2013, against the background of declining mining investment, subdued growth of consumer spending and non-mining business investment, and ongoing fiscal restraint. The available indicators suggest that growth was moderate in the December quarter. Until recently, survey measures of current business conditions have been below average, consistent with subdued non-mining business investment and the weak state of the labour market.

A number of indicators, however, suggest a gradual increase in growth over time. The depreciation of the exchange rate should provide some additional impetus to activity in the traded sectors of the economy. Survey measures of business conditions moved to above-average levels late in 2013. Retail sales and the Bank's liaison point to a pick-up in household consumption growth in the December quarter and measures of consumer sentiment remain a little above average levels, despite easing somewhat from a few months ago. Leading indicators suggest that dwelling investment is likely to have increased in the quarter and will grow further over the coming months. Strengthening conditions in the housing market more generally are evident in further increases in housing turnover and prices. Trade data imply strong growth of exports in the December quarter, boosted in part by new resource projects coming on line.

Overall, growth is thought likely to strengthen a little in 2014, though to a pace that is still a little below trend. It is then expected to pick up further to an above-trend pace by 2015/16 (Table 6.1). This outlook is a little stronger than it was at the time of the November *Statement*, primarily owing to the lower exchange rate, which is expected to boost exports and restrain imports (to the benefit of domestic production). The outlook for the various components of domestic demand is little changed.

Table 6.1: Output Growth and Inflation Forecasts[(a)]
Per cent

	Year-ended					
	Dec 2013	June 2014	Dec 2014	June 2015	Dec 2015	June 2016
GDP growth	2½	2¾	2¼–3¼	2½–3½	3–4	3–4½
Non-farm GDP growth	2½	2¾	2¼–3¼	2½–3½	3–4	3–4½
CPI inflation[(b)]	2.7	3¼	2¼–3¼	2¼–3¼	2–3	2–3
Underlying inflation[(b)]	2½	3	2¼–3¼	2¼–3¼	2–3	2–3
	Year-average					
	2013	2013/14	2014	2014/15	2015	2015/16
GDP growth	2¼	2½	2¼–3¼	2¼–3¼	2½–3½	3–4

(a) Technical assumptions include A$ at US$0.89, TWI at 69 and Brent crude oil price at US$104 per barrel
(b) Based on current legislation for the price of carbon
Sources: ABS; RBA

This outlook over the year ahead continues to be affected by the substantial fall in mining investment and planned fiscal restraint. At the same time, low interest rates are stimulating prices and turnover in the established housing market, as well as construction of new dwellings. In addition to boosting activity directly, it is likely that these trends will, in time, be associated with stronger growth in some areas of household consumption. This pick-up in domestic demand, coupled with improved economic conditions overseas, is expected to flow through to stronger non-mining business investment and employment, and therefore higher GDP growth. Over 2015/16, GDP growth is also expected to be boosted by a significant increase in liquefied natural gas (LNG) exports as a number of large plants currently being constructed commence production.

The outlook for household consumption is little changed from that outlined in the November *Statement*. Growth of consumption is expected to be below average through 2014, before gradually rising to around average by the end of the forecast period. This pick-up in growth is assisted by a gradual increase in employment and wage growth. Consumption spending is expected to grow a little faster than incomes, however, given rising wealth. This implies a modest decline in the household saving ratio toward the lower end of the range seen over recent years.

Dwelling investment is expected to grow quite strongly over the forecast period. Building approvals have increased sharply in recent months and other forward-looking indicators, such as loan approvals and first home owner grants for new construction, remain at relatively high levels. Conditions remain supportive of dwelling investment, with very low interest rates, rental yields around the average of the past decade and government incentives for first home buyers that promote the purchase of new dwellings. Stronger conditions in the established housing market, including a rise in housing turnover, are also expected to support renovation activity, which to date has been quite subdued.

With governments at both the federal and state levels planning to undertake fiscal consolidation over the next few years, the outlook for growth in public demand remains very weak relative to its historical average. Consistent with budget projections, the contribution to GDP growth from public demand over the forecast period is expected to be around half of its long-term average.

Surveys of firms' investment intentions continue to suggest that non-mining investment is likely to remain subdued over the next year. Further out, non-mining business investment is expected to recover, given the low level of interest rates, an improved competitive position, limited growth of the non-mining capital stock in recent years, and a pick-up in other parts of the economy, such as the housing sector.

At the time of the November *Statement*, the outlook for mining investment was marked down, particularly for 2014/15, following a reappraisal of the likelihood of new large projects going ahead. There has been little change to the profile since then, with mining investment expected to decline rapidly over the next few years as the investment projects now underway move into the production phase and with few new projects expected to commence. While Bank liaison suggests that the peak in mining investment has passed, the expectations component of the ABS capital expenditure survey, which tends to be a relatively imprecise guide to firms' realised spending, continues to point to some growth in mining investment in 2013/14.

Export volumes are expected to make a significant contribution to GDP growth in the forecast period. As mining projects move into the production phase, bulk commodity export volumes are forecast to continue growing strongly. Iron ore exports are expected to increase significantly in 2014, while LNG exports are likely to pick up even more noticeably from 2016 onwards as the new LNG production facilities commence production. The recent depreciation of the exchange rate should, in time, provide some support to exports of manufactured goods and services, which have been subdued in recent years.

Labour market conditions have remained weak in recent months. There has been little growth in employment, which has risen by only ½ per cent over the past year. The unemployment rate has continued to move higher and the participation rate has declined noticeably. Total hours worked have declined in recent months, reversing some of the steady growth seen earlier in 2013 (and bringing growth in total hours over the past year back into line with that of employment). Various factors have weighed on growth in labour demand: below-trend growth in output, particularly among sectors of the economy that are more labour intensive; a continued focus among firms on reducing costs and improving productivity; and a degree of uncertainty causing a general reluctance to employ new workers (consistent with subdued non-mining business investment intentions). These factors are likely to continue to weigh on employment growth in the near term, and the unemployment rate is expected to remain on an upward trend for several quarters. This outlook for the unemployment rate over the next year or so is little changed from the previous *Statement*. In 2015, the expected improvement in the non-resource sector should underpin an improvement in labour demand, with growth in employment increasing gradually and the unemployment rate declining.

The increase in spare capacity in the labour market over the past year or so has been accompanied by a decline in various measures of wage growth to historically low levels. Reflecting elevated concerns of households over job security, relatively low inflation expectations and pressures for firms to contain labour costs, the forecast profile for wages has been revised a little lower over coming quarters. In the public sector, fiscal restraint is expected to contribute to very slow growth in wages, as reflected in recent enterprise bargaining agreement outcomes. Private sector wage growth is expected to pick up somewhat from the middle of 2015 as the labour market recovers. However, it will take some time for spare capacity in the labour market to be absorbed and so wage growth is expected to remain below its decade average.

Inflation

The inflation forecasts have been revised higher in the short term, reflecting a combination of the lower exchange rate and the higher-than-expected December quarter CPI outcome, which have more than offset the effect of the softer outlook for wage growth.

The various measures of underlying inflation suggest that the quarterly pace picked up to between ¾ and 1 per cent in the quarter – around ¼ percentage point higher than the assessment of underlying inflation a quarter ago. In year-ended terms, the pace of underlying inflation increased to be a touch above 2½ per cent.

Underlying inflation is expected to reach 3 per cent over the year to June 2014, about ½ percentage point higher than forecast in November. This upward revision reflects the higher-than-expected inflation reported for the December quarter – which is assumed to persist somewhat into early this year – as well as the effect of the further depreciation of the exchange rate since November. Given the slow growth of wages and the limited extent of domestic cost pressures more generally, year-ended underlying inflation is expected to ease back later this year. Headline inflation is forecast to reach 3¼ per cent over the year to June 2014. In addition to the same factors influencing underlying inflation, the upward revision to headline inflation reflects the increase in the price of tobacco in December. As this and the large rise in fuel prices in the September quarter drop out of the year-ended rate, headline inflation is expected to fall back. Over the forecast horizon, inflation is forecast to be consistent with the target.

The depreciation of the exchange rate since April 2013 is expected to exert mild upward pressure on inflation for several years, reflecting the drawn out pass-through that has occurred historically. The depreciation has seen a rise in import prices, which firms are expected to pass through gradually to final retail prices. In turn, this should encourage consumers to shift some of their spending toward

domestically produced goods and services, and may allow domestic producers to lift prices and margins. Altogether, the lower exchange rate is expected to add around ½ percentage point to underlying inflation over each of 2014 and 2015. However, it could be that the 'second stage' of exchange rate pass-through – from import prices (across the docks) to the prices facing consumers – may have been more rapid than has been the case historically.

Working in the other direction, the subdued outlook for the labour market is expected to exert downward pressure on wages and so inflation. Growth in labour costs is expected to remain moderate, while labour productivity is expected to continue to grow. While it is difficult to ascertain the extent to which slower wage growth has been passed on to final prices, the relatively high December quarter inflation outcome suggests that, so far, there has been less pass-through of the slowing in wages to final prices than had been anticipated.

The CPI will also be affected by changes in the price for carbon. As in the previous *Statement*, the forecasts incorporate a path for the carbon price that is based on current legislation. On this basis, a floating carbon price will be introduced on 1 July 2015, which on present indications would be expected to see the carbon price fall to be similar to that of European permits. Consistent with the previous forecasts, and estimates in the 2013/14 Australian Government budget, this change would subtract a bit less than ½ percentage point from CPI inflation in 2015 and around half that much from underlying inflation.

The government has stated that it intends to repeal the carbon price on 1 July 2014. Based on modelling by Treasury, the introduction of the carbon price was expected to add 0.7 per cent to the CPI and its removal may well result in a reduction in the CPI of a similar magnitude. Under this outcome, the forecast for CPI inflation would be lower by around 0.7 percentage points over the year to June 2015 at around 2 per cent (with inflation in the subsequent period being higher than the current forecasts because the price of carbon would not be declining at that time). Underlying inflation would respond by less than this, with the forecasts a little more than ¼ percentage point lower over the year to June 2015, at around 2¼ per cent.

The government has also stated its intention to increase tobacco excise in a sequence of steps over a period of four years. The first of these increases was implemented in December, which contributed to inflation in the December quarter and will do so again in the March quarter. Further increases in the excise have not yet been legislated and therefore are not incorporated in the forecasts. If they came to pass, they would be expected to add around ¼ percentage point per year to the forecasts for headline inflation over the next few years. Underlying inflation would not be affected.

Risks

For most economies, the uncertainty surrounding the forecasts continues to appear broadly balanced; there have been some welcome developments on some of the risks to the global outlook identified in the previous *Statement* while other risks have emerged. In the United States, the risks now seem somewhat to the upside. There has been a positive resolution to the political discord regarding budget funding, which had earlier created significant uncertainty around fiscal policy (although as yet there is not an agreement on the debt ceiling). In addition, the Federal Reserve's scaling back of its asset purchases, and the provision of some guidance on the possible future path of its asset purchases, has reduced uncertainty about the course of monetary policy. The economic recovery is gathering pace and the strong financial position of firms means that business investment, and domestic demand more broadly, could recover even faster than expected. In the euro area, while the economy has shown some modest improvement of late, the risks remain to the downside, reflecting the ongoing need for resolution of banking and fiscal problems.

In Japan, there is a risk that the increase in the consumption tax will have a negative impact on economic activity. The increase in the consumption tax rate in the late 1990s was one factor contributing to the slowdown at that time, although this time around the Japanese Government has put in place a temporary fiscal stimulus to offset the initial contraction in spending.

In China, the near-term outlook will depend on the balance that can be achieved between structural reforms, including the need to place financing on a more sustainable footing, and the authorities' apparent resolve to maintain relatively strong rates of growth. Further efforts to reduce the scale of financing activity to more sustainable levels could result in increased financial market volatility and a sharper short-term slowdown in growth. In a similar vein, the reform agenda announced by the authorities in November (encompassing reforms to the financial sector, central-local fiscal relations, rural land markets, state-owned enterprises and the pricing of utilities) could raise the long-term productive capacity of the economy at the expense of some near-term growth. If these efforts were to stall, however, growth could be stronger in the near term at the risk of weaker growth in future years.

A number of emerging market economies have experienced an increase in financial market volatility recently. This has followed a general lessening of the appetite for risk compounded by country-specific problems. If, however, such pressures were to deepen or become more widespread, it could have a significant effect on emerging market growth and weigh on the outlook for the global economy more broadly.

On the domestic front, at this stage the implications for activity and prices of the higher-than-expected inflation data for the December quarter are unclear.

It could be that there was a higher than usual degree of noise in the data, which can occasionally occur owing to the difficulties of measurement or the timing of price changes. This would imply that the higher-than-expected inflation recorded in the quarter will not persist.

Alternatively, the stronger inflation outcome raises the possibility that there is less spare capacity in the economy than previously thought, which would suggest that the outlook for inflation would be somewhat higher than previously anticipated. This could be because there has been some strengthening of demand in recent months that enabled firms to increase prices. But, while some measures of trading conditions and profitability have improved, the behaviour of share prices for listed retailers and information from liaison do not yet point to a broad-based increase in demand and evidence on changes in profit margins over the recent period is mixed.

There could also be less spare capacity in the economy if supply is increasing more slowly than previously thought. However, this is hard to reconcile with the weak state of the labour market.

Another possibility is that the December quarter CPI outcome reflected, in part, faster pass-through of the exchange rate depreciation than in the past. Such faster pass-through could persist for several quarters, adding to inflation in the near term, or it could prove temporary.

A range of other risks appear much as they were a few months ago. There are few signs of an imminent turnaround in non-mining investment intentions, but in time the very stimulatory financial conditions could see non-mining investment pick up at a pace more in line with past sharp upturns than the gradual improvement embodied in the forecasts.

While it is widely accepted that mining investment will decline from its very high level over coming years, there is considerable uncertainty about the timing and magnitude of the decline. The most recent ABS survey of mining investment expectations suggests that there may yet be some more strength in mining investment in the near term. While this provides some short-term upside risk, public information from mining companies and the Bank's liaison suggests that mining investment is likely to decline sharply over the next few years. Indeed, the lack of new commitments for large-scale projects suggests that there is limited upside risk further out in the forecast profile,

although there is still some uncertainty surrounding the prospects for some large investments. Similarly, there are risks surrounding the boost to growth of economic activity from LNG exports in 2015/16 given that there is little historical precedent of such projects to guide this forecast.

The willingness of households to increase their consumption spending slightly faster than the relatively soft pace of income growth represents a key risk to the outlook. If, instead, the saving rate remains steady or even increases, this would imply slower consumption growth than assumed in the forecasts. Alternatively, the saving rate could decline more sharply than the moderate reduction implied in the forecasts, particularly in light of the recent and prospective strength in housing market conditions. If stronger consumption and housing market conditions were to be accompanied by a substantial increase in leverage, it could raise longer-run concerns from the perspective of macroeconomic and financial stability. While the growth of aggregate housing credit has remained moderate to date, it has been increasing of late, more so in some segments of the market.

The fiscal consolidation foreshadowed by state and federal governments implies the weakest period of growth in public demand for at least 50 years. With below-trend growth in the economy, it is possible that governments will not restrain spending growth to the extent assumed. Alternatively, budget deficits at the federal level are projected to be noticeably larger over the forecast period than expected at the time of the November *Statement*, which could lead to greater spending restraint.

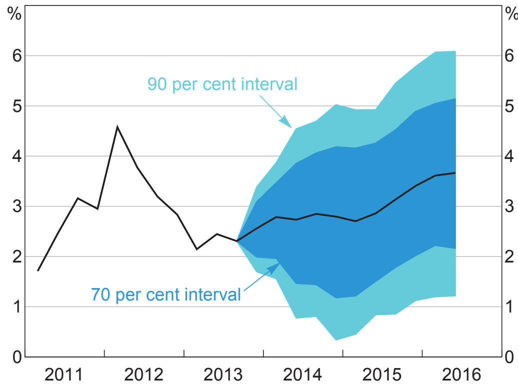
The path of the exchange rate is a significant uncertainty for the forecasts, as always. The exchange rate has depreciated by a further 5 per cent since the November *Statement*, contrasting with the usual assumption used then that the exchange rate would remain unchanged. Just as the appreciation of the exchange rate that accompanied the resources boom shifted demand towards external sources, thereby relieving pressure on domestic capacity, a depreciation helps to rebalance demand by stimulating traded parts of the domestic economy. With the terms of trade expected to decline, the exchange rate could decline further, over time. But with numerous forces affecting the exchange rate – the anticipated gradual decline in resource prices, the sharp decline in resource investment and associated capital inflow, the increase in income payments to foreign owners accruing from strong growth in resource exports and the conduct of monetary policy in major countries – the exchange rate path is highly uncertain.

Softer-than-expected growth in activity would see the labour market weaken more than anticipated, placing additional downward pressure on wages and inflation. Wage growth has slowed more than expected over the past year, and an environment of lower wage growth may prove more entrenched than expected. However, with the depreciation of the exchange rate expected to exert some upward influence on inflation over the next few years, domestic costs need to remain contained for inflation to remain consistent with the target. With employees having sustained a period of slow growth in real incomes, stronger-than-expected growth in activity and an associated recovery in the labour market – which saw employees seek to regain spending power – could result in more upward pressure on nominal wage growth, and so inflation, than forecast.

These identified, and other unknown, risks mean that the path for GDP and inflation may well differ from the forecasts presented. One way of demonstrating the uncertainty surrounding the GDP and inflation forecasts is to present confidence intervals based on historical forecast errors (Graph 6.3 and Graph 6.4).[1] ✢

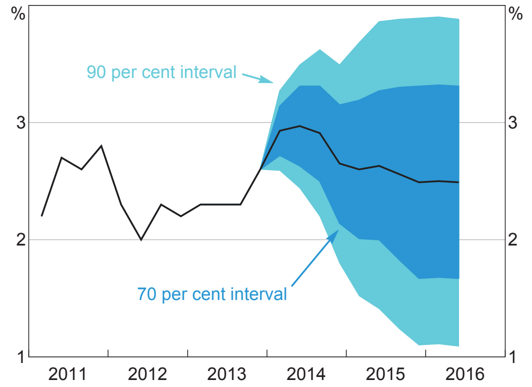
1 This is based on Bank research; see Tulip P and S Wallace (2012), 'Estimates of Uncertainty around the RBA's Forecasts', RBA Research Discussion Paper No 2012-07 and RBA (2013), 'Box E: Forecast Confidence Intervals', *Statement on Monetary Policy*, February, p 68, for further details.

Graph 6.3
GDP Growth Forecast*
Year-ended



* Confidence intervals reflect RBA forecast errors since 1993
Sources: ABS; RBA

Graph 6.4
Trimmed Mean Inflation Forecast*
Year-ended



* Confidence intervals reflect RBA forecast errors since 1993
Sources: ABS; RBA