

3. Domestic Economic Conditions

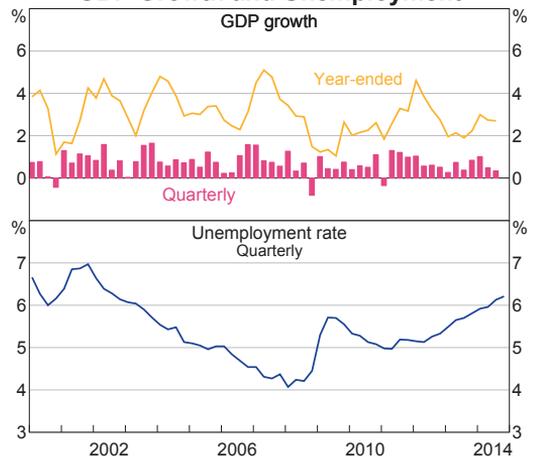
The Australian economy has grown at around 2½ per cent on average in the past two years (Graph 3.1). Declining mining investment has continued to weigh on activity, though growth of mining activity overall has remained firm, supported by an increase in resource exports. Over the past year, non-mining activity has picked up slightly (Graph 3.2). Dwelling investment has strengthened relative to a year ago, supported by low interest rates and rising housing prices, and consumption growth has picked up from its lows in 2013, although it remains below average (Table 3.1). While non-mining business investment remains subdued, conditions are in place to support growth.

Growth of economic activity appears to have been a bit below average in the second half of 2014. A range of indicators suggest that consumer spending increased at a moderate pace in the December quarter, while indicators of dwelling investment remain at high levels. Mining investment is expected to have declined further, while exports continued to expand. Survey measures suggest that business conditions and capacity utilisation have remained around average. The decline in commodity prices will have reduced resource sector profits and growth of labour income is likely to have remained weak.

A number of indicators suggest that conditions remained soft in the labour market, consistent with a continuation of below-trend growth in economic activity. Although employment growth picked up, spare capacity continued to increase over 2014. In particular, the unemployment rate increased gradually, continuing its trend of the past few years.

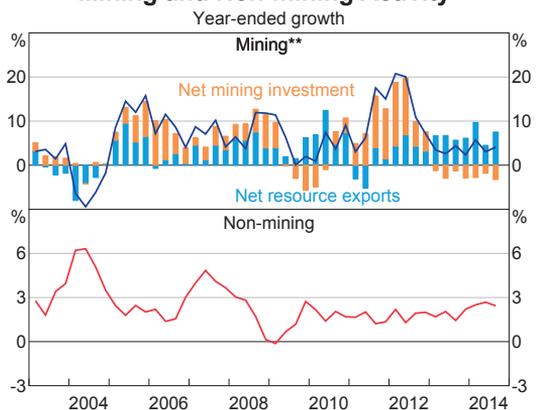
Leading indicators of labour demand have picked up a little since late 2013, but still point to only modest employment growth over coming quarters.

Graph 3.1
GDP Growth and Unemployment



Source: ABS

Graph 3.2
Mining and Non-mining Activity*



* Mining and non-mining activity estimated by RBA

** Components are contributions to year-ended mining activity growth; contribution of changes in mining inventories omitted

Sources: ABS; RBA

Table 3.1: Demand and Output Growth
Per cent

| | September quarter 2014 | June quarter 2014 | Year to September quarter 2014 |
|--------------------------------------|------------------------|-------------------|--------------------------------|
| GDP | 0.3 | 0.5 | 2.7 |
| Consumption | 0.5 | 0.8 | 2.5 |
| Dwelling investment | -0.9 | 1.0 | 6.8 |
| Mining investment ^(a) | -5.0 | 1.5 | -15.2 |
| Non-mining investment ^(a) | 2.2 | -0.8 | 2.1 |
| Public demand | -1.2 | 0.8 | 0.9 |
| Exports | 2.8 | -1.5 | 7.1 |
| Imports | -0.9 | 2.4 | -0.8 |
| Nominal GDP | -0.1 | 0.3 | 2.7 |
| Real gross domestic income | -0.4 | -0.3 | 0.8 |

(a) RBA estimates
Sources: ABS; RBA

Household Sector

Household consumption growth has picked up from its lows in early 2013, but remains below its long-run average pace (Graph 3.3). Slow growth of labour income has constrained growth of consumption, which remains moderate despite the effect of very low interest rates.

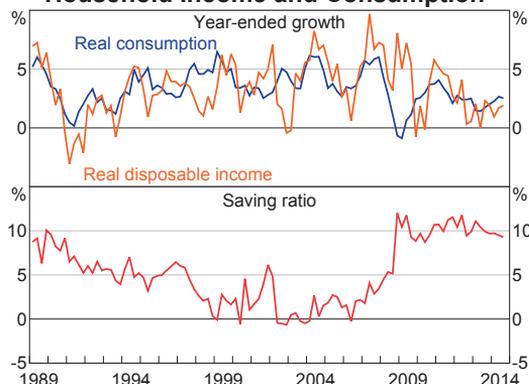
Nevertheless, consumption has been growing faster than household incomes, with the saving ratio declining gradually over the past couple of years.

This is not surprising given the sizeable increases in housing prices, which have helped to boost wealth. Indeed, consumption growth has been fastest in New South Wales and Victoria, which have experienced the strongest housing markets and, relatedly, have had less direct exposure to the contraction in mining investment that has dampened growth in Queensland and Western Australia (Graph 3.4).

Recent indicators suggest that growth of household consumption may have picked up a little in the December quarter (Graph 3.5). Retail sales volumes increased by 1.5 per cent in the quarter, supported by discretionary spending on items such as durable goods. Liaison with retailers suggests that sales growth continued around this pace in January. The recent declines in oil prices are likely to have had a positive effect on consumption growth in the December quarter (through higher real household incomes); the bulk of the effect on fuel prices, however, is expected to occur in the March quarter (see 'Box C: The Effects of the Fall in Oil Prices'). Motor vehicle sales have been little changed recently, although they are at high levels. Measures of consumer sentiment are at or below average levels, and consumers' unemployment expectations remain elevated.

Graph 3.3

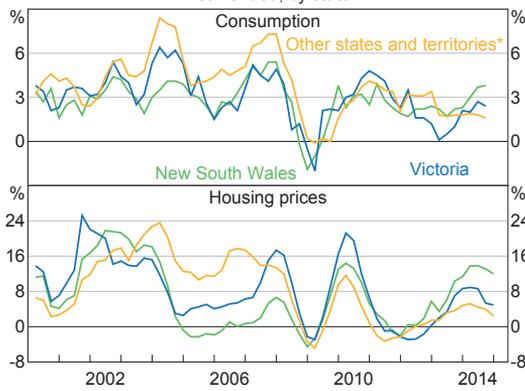
Household Income and Consumption*



* 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

Sources: ABS; RBA

Graph 3.4
Consumption and Housing Price Growth
Year-ended, by state



* The 'other' consumption series has been chain-linked by the RBA
Sources: ABS; Australian Property Monitors; RBA

Graph 3.5
Consumption Indicators

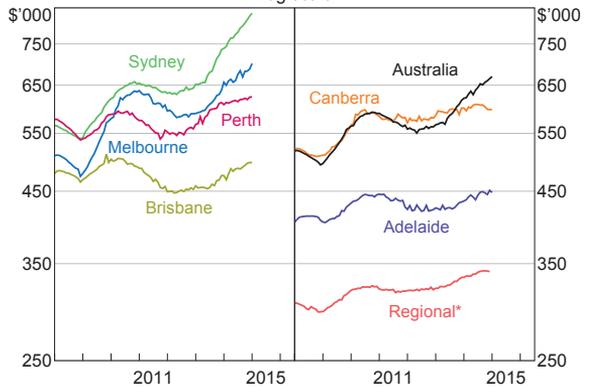


* Rescaled to have the same average as the W-MI index since 1996
Sources: ABS; ANZ-Roy Morgan; RBA; Westpac and Melbourne Institute

The pace of national housing price growth slowed noticeably in early 2014 but, looking through the volatility, appears to have changed little since then. Notwithstanding this, growth of housing prices remained strong over recent months, particularly in Melbourne and Sydney (Graph 3.6). At around 8 per cent, housing price growth remains well above the growth rate of household incomes. Survey measures of housing price expectations declined in the December quarter and remain below the levels reached in late 2013. Most non-price indicators of housing market activity remain consistent with

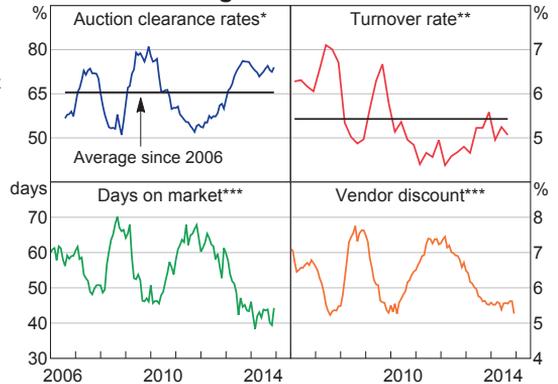
strong conditions in the established market, which should provide further support to consumption in the near term (Graph 3.7).

Graph 3.6
Housing Prices
Log scale



* Excludes apartments; measured as areas outside of capital cities in mainland states
Sources: CoreLogic RP Data; RBA

Graph 3.7
Housing Market Indicators



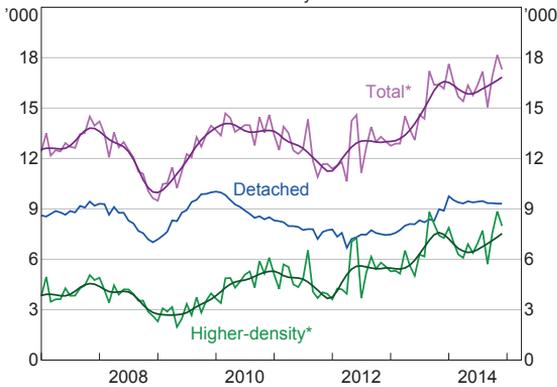
* Average of Melbourne and Sydney
** Share of dwelling stock, annualised
*** Capital city dwelling stock weighted median, private treaty sales only
Sources: Australian Property Monitors; CoreLogic RP Data; RBA; Real Estate Institute of Victoria

The nationwide rental vacancy rate has been gradually drifting up since the mid 2000s. Accordingly, rental price inflation has slowed, which, combined with strong housing price growth, has resulted in rental yields continuing to fall.

Consistent with the strong growth in housing prices, low interest rates and above-average population growth, there has been considerable growth in

dwelling investment, which increased by 7 per cent over the year to the September quarter. Timely leading indicators point to further growth in dwelling investment in the December and March quarters. Dwelling approvals, particularly those for higher density homes, have stayed at a high level recently (Graph 3.8). Loan approvals for new dwellings increased by 5 per cent over the year to November and the number of first home owner grants paid for new dwellings has continued to trend higher, increasing by 22 per cent over the past year.

Graph 3.8
Private Dwelling Approvals
Monthly

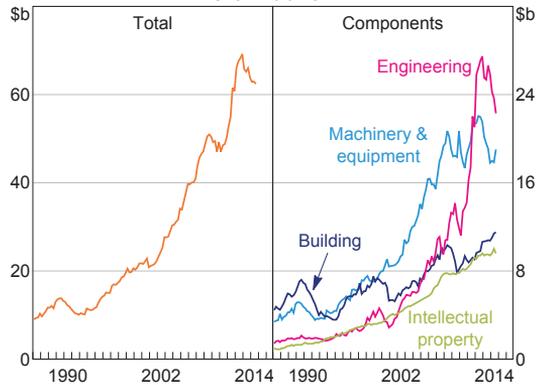


* Smoothed lines are ABS trend measures
Source: ABS

Business Sector

Private business investment overall fell slightly in the September quarter and by 5 per cent over the year (Graph 3.9). In year-ended terms, a sharp fall in mining investment was only partially offset by a small increase in non-mining business investment. The decline in mining investment since its peak in mid 2012 reflects the completion or winding down of large-scale iron ore, coal and liquefied natural gas (LNG) projects. The decline in mining investment is expected to continue over the next few years, as current projects are completed and very few new mining investment projects are likely to go ahead, particularly given the decline in commodity prices. The latest estimate derived from the ABS capital expenditure (Capex) survey suggests that nominal

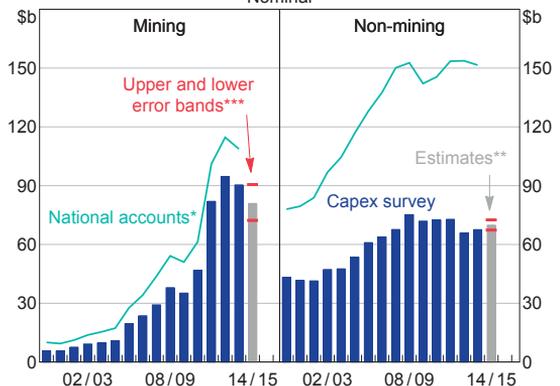
Graph 3.9
Private Business Investment*
Chain volume**



* Adjusted for second-hand asset transfers between the private and other sectors; excluding cultivated biological resources
** Reference year is 2012/13
Sources: ABS; RBA

mining investment could decline by over 10 per cent in 2014/15, although there is considerable uncertainty around this estimate and the Bank's liaison information points to an even larger fall (Graph 3.10). Mining sector profits fell by 8 per cent over the year to the September quarter, with the sharp decline in commodity prices partially offset by the lower Australian dollar exchange rate and cost-cutting measures; further declines in commodity

Graph 3.10
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

prices since then are likely to continue to reduce mining sector profits in the near term.

There has been a little growth in non-mining business investment over recent years and recent data suggest that it will remain subdued for a time. The latest Capex survey implies that nominal non-mining investment may increase by around 3 per cent in 2014/15. The Capex survey suggests that investment will pick up in the rental, hiring & real estate, construction and retail trade industries, with some offset from a further decline in manufacturing and utilities investment. Survey measures of business conditions are around long-run average levels. The surveys also suggest that capacity utilisation is around its long-run average. Meanwhile, non-mining profits have increased steadily over the year. Given this, and with strong population growth and finance readily available at low cost, many of the conditions associated with stronger investment are in place (Graph 3.11). Even so, non-residential building approvals remain at a low level. This is consistent with weak underlying conditions in the commercial property market, with the national CBD office vacancy rate at its highest level since 1997.

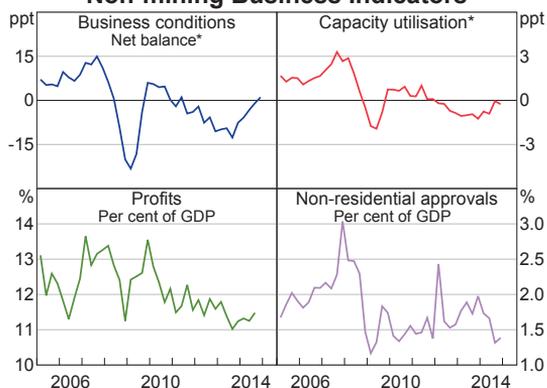
In time, the further exchange rate depreciation seen recently is expected to spur business investment via additional support to demand for domestic firms

producing tradable goods and services. This effect will be offset to some extent by the higher cost of imported inputs. The sharp decline in oil prices over the second half of 2014 is likely to provide some support to firms that use fuel as an input in production or indirectly via the boost it will provide to household consumption. The mining sector is itself a big user of fuel, which accounts for around one-fifth of the costs associated with iron ore and coal production and is also a substantial part of the cost of transport for bulk commodities.

External Sector

Export volumes grew strongly over the year to the September quarter, driven by resource exports. Iron ore export volumes rose by around 25 per cent, reflecting expansions to production and infrastructure capacity (Graph 3.12). Coking and thermal coal exports also rose over the year. Given the remaining commitments to expand capacity, exports of iron ore and, to a lesser extent, coal are expected to continue to increase over the next couple of years. Over 2015, LNG exports are expected to increase as a number of LNG projects that are currently under construction begin production.

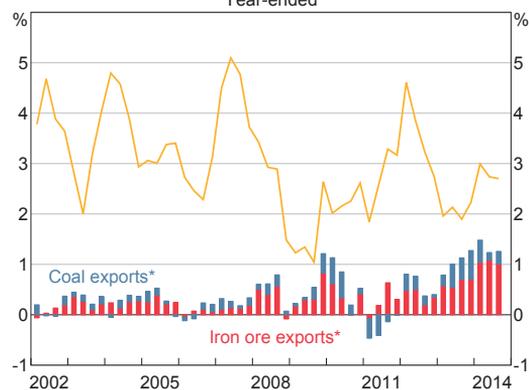
Graph 3.11
Non-mining Business Indicators



* Investment share weighted; deviation from average since 1989; three-month moving average

Sources: ABS; NAB; RBA

Graph 3.12
GDP Growth
Year-ended

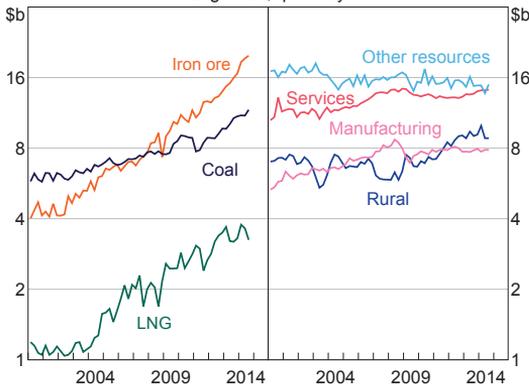


* Contribution to GDP growth; percentage points

Sources: ABS; RBA

Services exports grew by 4 per cent over the year to the September quarter. This was led by growth in both education and tourism exports. Manufactured export volumes have been little changed over the past four years and are well below their level in mid 2008 (Graph 3.13). The depreciation of the exchange rate since mid 2014 should provide a boost to services and manufactured export volumes. While manufacturing exports have not responded (to date) as much to exchange rate movements as might be expected based on historical experience, there is tentative evidence that service exports are benefiting from the lower exchange rate.

Graph 3.13
Export Volumes*
Log scale, quarterly



* Reference year is 2012/13
Sources: ABS; Department of Industry; RBA

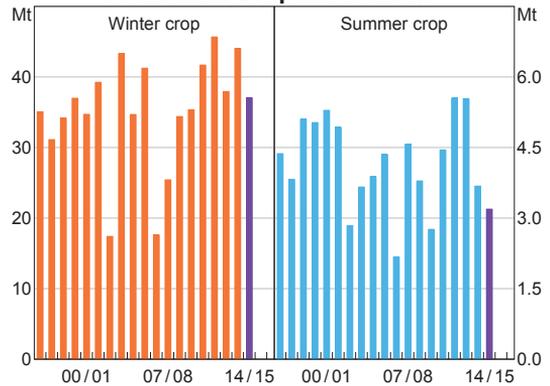
Import volumes have declined a little over the year to the September quarter, reflecting a sharp fall in mining investment and the exchange rate depreciation, which has made imports relatively more expensive. Much of the decline in imports owes to capital goods, which have fallen sharply over the year, while imports of consumption goods have grown modestly.

Farm Sector

The Australian Bureau of Agricultural and Resource Economics and Sciences latest forecast is for farm production to fall by 6 per cent in 2014/15, which would more than unwind the increase in production in 2013/14. The fall is expected to be driven by a

decrease in crop production, reflecting drier-than-average seasonal conditions over winter and spring in 2014, which reduced the winter crop production and created unfavourable planting conditions for the summer crop (Graph 3.14). Livestock production is expected to increase slightly in 2014/15.

Graph 3.14
Australian Crop Production*

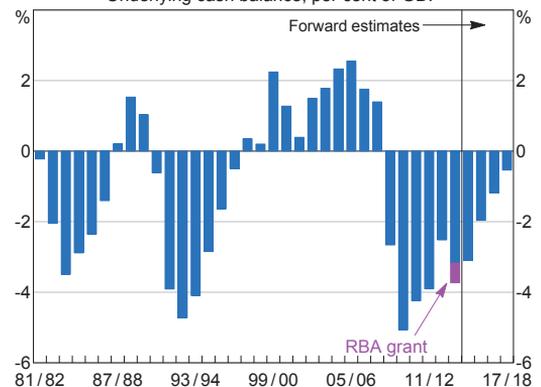


* ABARES forecast for 2014/15
Source: ABARES

Government Sector

The Australian Government's Mid-Year Economic and Fiscal Outlook, together with recent state budget updates, suggest there will be ongoing fiscal consolidation over coming years (Graph 3.15).

Graph 3.15
Consolidated Budget Balance*
Underlying cash balance, per cent of GDP



* Combined budget balances of Australian federal, state and territory governments, based on 2014/15 budgets or midyear reviews as available

Sources: Australian Treasury; State and Territory Treasuries

However, the sharp falls in commodity prices and weaker growth of incomes have lowered revenue projections compared with those made in mid 2014, while governments have generally chosen to maintain existing expenditure plans. Consequently, the consolidated budget deficit in 2014/15 is now expected to be around 3 per cent of GDP, ½ percentage point higher than was previously expected, and the consolidated budget is not expected to return to surplus before 2018.

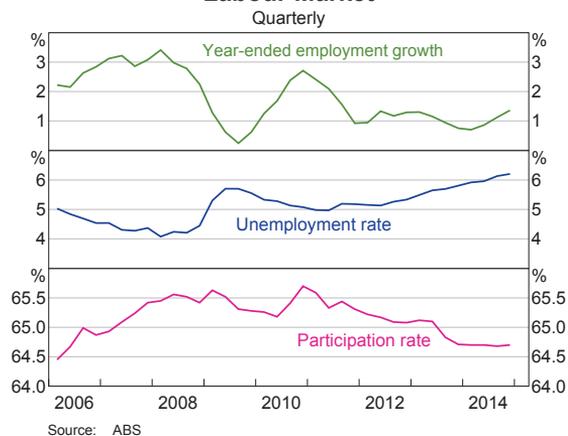
Labour Market

A number of indicators suggest that, while employment growth has picked up over the past year, spare capacity in the labour market increased further over that period, consistent with below-trend growth in the economy. Looking through the variation from month to month, there has been a continuation of the gradual upward trend of the unemployment rate, which has risen on average by 0.1 percentage points each quarter over the past two and half years (Graph 3.16). The total number of hours worked per month is little changed from its level in late 2011 (Graph 3.17). Nevertheless, growth in employment appears to have strengthened a little, with the number of people employed 1.4 per cent higher over the year to the December quarter. In addition, the participation rate appears to have stabilised somewhat through 2014, after declining over the preceding few years.

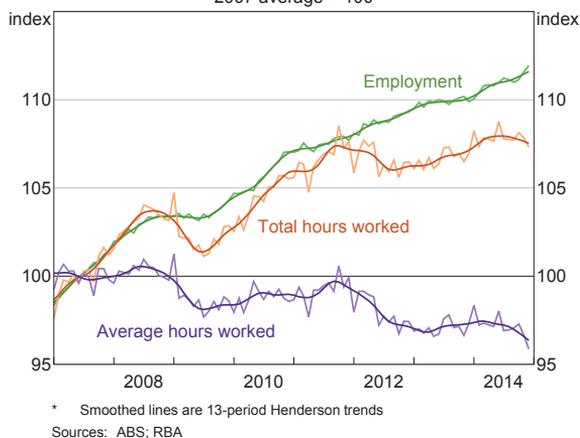
Spare capacity in the labour market is evident in a broad range of measures. The unemployment rate was 6.1 per cent in December, around its highest level since the early 2000s, and above the rate that statistical estimates suggest would be consistent with stable domestic inflationary pressures.¹ At the same time, both the participation rate and average hours worked remain lower than a few years ago. Underemployment rates have also risen, suggesting that a greater proportion of those who are

¹ More detail is contained in Ballantyne A, D De Voss and D Jacobs (2014), 'Unemployment and Spare Capacity in the Labour Market,' RBA Bulletin, September, pp 7–20.

Graph 3.16
Labour Market



Graph 3.17
Employment and Hours Worked*
2007 average = 100

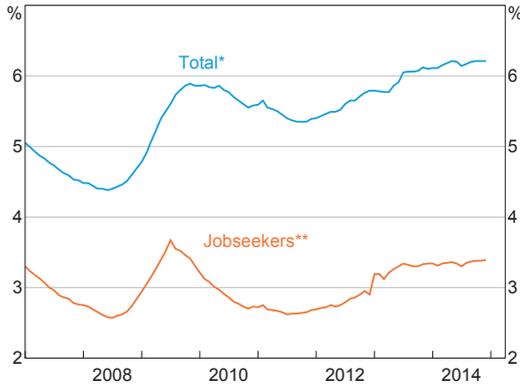


employed would like to work more hours. The rise in unemployment has largely been accounted for by the medium-term unemployed (those who have been unemployed for between 4 and 52 weeks), though the number of those unemployed for a long term (i.e. more than a year) has also increased.

Other labour market indicators also suggest that conditions remain subdued. As a share of the labour force, the number of people collecting unemployment benefits remains elevated after having increased over the preceding three years, although the jobseeker rate – which captures unemployment benefit recipients subject to a job

search requirement – has been stable since mid 2013 (Graph 3.18). In addition, the Bank's liaison suggests that firms generally face little difficulty in finding suitable labour.

Graph 3.18
Unemployment Benefit Recipients
Per cent of labour force

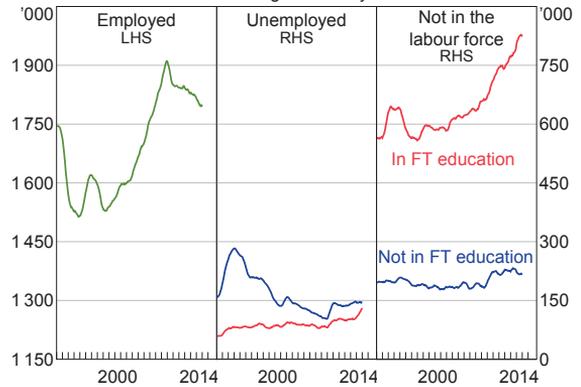


* Seasonally adjusted by RBA; break-adjusted for policy changes
 ** Seasonally adjusted by RBA; jobseekers are unemployment benefit recipients subject to a job search requirement
 Sources: ABS; Department of Social Services; RBA

Consistent with this evidence of spare capacity, the cyclically sensitive components of unemployment were elevated over the past year. Youth unemployment, which tends to be particularly sensitive to the business cycle, has increased notably; 270 000 people aged between 15 and 24 years are now unemployed, 20 000 more than a year ago. Much of the increase in youth unemployment over the past few years, and in 2014 in particular, has been accounted for by those in full-time education who are searching for work (Graph 3.19). More generally, a higher incidence of full-time education has accompanied the reduction in the size of the youth labour force. However, there is also evidence that it is becoming harder to find a job on completion of tertiary education. As a result, a rising portion of young jobseekers are yet to find their first job and the average duration of unemployment among 20 to 24 year olds has increased.

Across industries, recent employment outcomes have reflected the changing composition of economic activity away from the resources

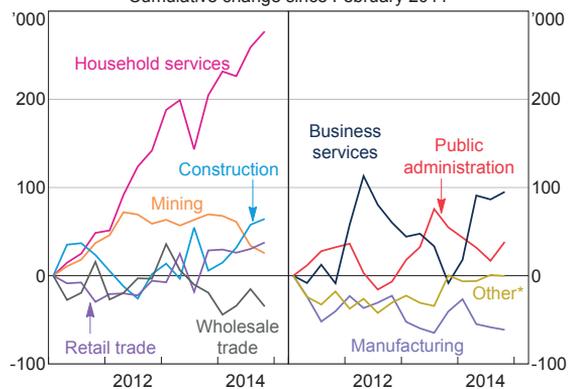
Graph 3.19
Youth Labour Force Outcomes*
Persons aged 15–24 years



* 12-month moving average of non-seasonally adjusted data; FT denotes full-time
 Sources: ABS; RBA

sector. Over the course of 2014, a large portion of employment growth was in household-focused industries, such as education, accommodation & food services, and retail trade (Graph 3.20). Also, declines in construction employment in the resources sector appear to have been more than offset by increases in other forms of construction employment, including in residential construction. Accordingly, overall construction employment rose over the course of 2014, with much of this concentrated in New South Wales. Business services

Graph 3.20
Employment Growth by Industry
Cumulative change since February 2011

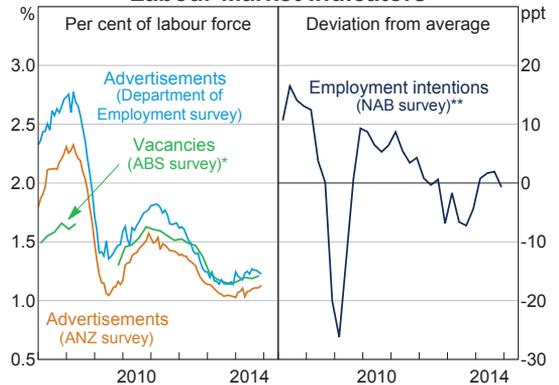


* Includes agriculture, forestry & fishing; transport, postal & warehousing; and electricity, gas, water & waste services
 Source: ABS

employment has remained little changed in recent quarters after recovering noticeably over the first half of 2014. In contrast, employment has declined in mining, manufacturing and public administration. Recent trends in aggregate labour market outcomes have been observed in most states.

A number of forward-looking indicators of labour demand, such as job advertisements, vacancies and business survey measures of hiring intentions picked up a little throughout 2014 (Graph 3.21). However, they remain at fairly low levels and currently suggest only modest employment growth in the coming quarters. ❖

Graph 3.21
Labour Market Indicators



* This survey was suspended between May 2008 and November 2009

** Net balance of employment intentions for the following quarter; deviation from average since 1989

Sources: ABS; ANZ; Department of Employment; NAB; RBA