Overview

Growth of Australia's major trading partners over the past year has been a little above its historical average. In the June quarter, the pace of growth looks to have eased a little with a decline in Japan's output following the increase in the consumption tax in April. At the same time, however, growth of Chinese economic activity has picked up, driven by a rebound in exports and a pick-up in investment. This improvement in economic conditions reflects, in part, the modest stimulus provided by the Chinese authorities, which is designed to achieve their target of 7.5 per cent GDP growth in 2014. The US economy grew strongly in the June quarter (after adverse weather contributed to weakness earlier in the year) and the gradual recovery of economic activity in the euro area appears to be continuing. Inflation remains low in most countries, but has picked up in Japan and has shown some signs of lifting in the United States and in parts of Asia. Globally, financial conditions remain very accommodative.

Australia's trading partner growth is forecast to be a little above its long-run average in 2014 and 2015. The slight strengthening in growth compared with recent years reflects the expectation of stronger growth in the advanced economies as well as the growing share of Australian exports destined for China, an economy that is growing much faster than Australia's other trading partners. In China, GDP growth is expected to be close to the authorities' target in 2014 and then slow gradually thereafter. In Japan, abstracting from the volatility through the year induced by the consumption tax increase, growth is expected to be a bit above the average of the past decade in 2014, but then ease a little next year. Growth in the rest of east Asia is expected to strengthen a little in 2015, aided by continued recovery in the advanced economies.

The prices of bulk commodities have declined in the past three months. The largest falls in prices have been for iron ore, for which supply has expanded following investment in global capacity, particularly in Australia. Declines in coal prices this year have also been accompanied by an increase in global supply from lower-cost mines. The global supply of bulk commodities is expected to increase further with the completion of mining investment projects already in train, although this will be offset to some extent by the closure of some higher-cost mines, including in Australia. The global supply of bulk commodities is expected to grow roughly in line with demand over the next couple of years, with little change in prices. As a result, after declining further over the past year, the terms of trade are expected to remain at a high level historically.

Conditions in financial markets have continued to be characterised by very low volatility, notwithstanding a number of recent events that in the past have given rise to volatility. Consistent with the low volatility in markets, most sovereign bond yields have moved in a narrow range and German yields have fallen to historic lows. Spreads on lower-rated sovereigns and corporations have remained low while market access remains very good. Global share prices have continued to increase in recent months, with the US market reaching fresh highs.

The European Central Bank (ECB) announced a package of stimulatory measures aimed at addressing the risk of a prolonged period of low inflation, which included lowering the policy rate to close to zero and the rate paid on bank deposits at the ECB to below zero, as well as plans to provide low-cost long-term financing for banks to encourage them to expand their lending. The Federal Reserve has continued to reduce the rate of its asset purchases and is expected to conclude its asset purchase program in October.

Australian financial conditions remain very accommodative. Over recent months, there has been a decline in average lending rates paid, which are at historically low levels. The decline in part owes to the ongoing replacement of more expensive fixed and discount variable rate loans from previous years, as well as a reduction in interest rates on offer for some borrowers. Meanwhile, the exchange rate remains high by historical standards, with the Australian dollar little changed on both a trade-weighted basis and against the US dollar since the previous *Statement*. The exchange rate is well above its level in late January, notwithstanding the decline in commodity prices and a narrowing in the interest rate differentials between Australia and most other advanced economies since then.

Australian GDP growth picked up to an above-average pace over the second half of 2013 and early 2014, with much of this increase accounted for by a surge in resource exports. Even so, there have been signs of improved economic conditions over the past year outside the resources sector. The pattern of output growth reflects the transition from the investment to the export phase of the mining boom, and the gradual pick-up in the growth of non-mining economic activity.

With the very significant expansion in mine capacity over recent years, resource exports have grown strongly. Growth was particularly rapid in the March quarter, buoyed also by favourable weather (in contrast to conditions that typically hamper production at that time of year). Rural exports also increased sharply in the March quarter, aided by earlier favourable weather in parts of the country as well as an increase in exports of meat partly in response to dry conditions in much of Queensland and northern New South Wales. More recently, exports appear to have declined in the June quarter from the high level reached in the March quarter.

Mining investment has declined noticeably from the peak almost two years ago, although it remains at a high level and has further to fall over the coming years as projects reach completion and few new projects commence.

The pick-up in non-mining economic activity is occurring, albeit gradually. Non-mining business investment is estimated to have increased in the March quarter and survey measures of business conditions and investment intentions are around average. At the same time, however, non-mining business investment remains low relative to its average share of economic activity over recent decades and the Bank's liaison continues to report that firms are reluctant to undertake significant investment projects until they see a sustained period of strong demand.

One area where there has been a marked improvement is dwelling investment, which grew strongly in the March quarter and is clearly in an upswing. The increase in dwelling investment is being underpinned by the ongoing strength in the established housing market. Housing price inflation over 2014 to date has not been as rapid as it was over the second half of 2013, but prices continue to rise. Loan approvals are higher than they were a year ago, but have been little changed since late last year. At this level, they are consistent with growth in housing credit stabilising at a rate that is a bit faster than income growth, although the growth of investor credit has continued to outpace that of owner-occupiers.

The high rate of housing price inflation has underpinned strong growth in standard measures of household wealth. Along with the very low level of interest rates, this has seen consumption growing a little faster than household income, leading to a gradual decline in the saving rate over the past 18 months or so. Nevertheless, after picking up through 2013, consumption growth looks to have slowed in the first half of this year, with weaker retail sales growth and consumer sentiment falling to below-average levels. It remains to be seen whether this slower growth of consumption is temporary. Indeed, a timely measure of consumer sentiment has rebounded recently to be back above average.

Some labour market indicators have improved a little since the turn of the year, but overall conditions remain subdued. Employment growth has picked up following the improvement in economic activity since early 2013. The participation rate is little changed over the year to date, after a period of significant decline. Also, forward-looking indicators of labour demand have generally improved since late last year, pointing to modest employment growth over coming months. However, there remains a degree of spare capacity in the labour market. The measured unemployment rate has been quite volatile from month to month over the year to date. It is currently around its highest level in over a decade. Meanwhile, the participation rate is around its lowest level since the mid 2000s. Reflecting the spare capacity in the labour market, the growth of wages has been subdued. Over the year to the March quarter, growth in the wage price index was 1 percentage point lower than its decade average and unit labour costs were little changed.

The low growth of wages and domestic costs in general has helped to contain inflation for a range of goods and services. This is most evident in the prices of non-traded items, for which domestic costs represent a large share of their overall cost. Non-tradables inflation has slowed to be close to 3 per cent over the year to the June quarter, the lowest rate in over a decade; this has occurred notwithstanding still elevated inflation in the prices of 'administered' items and rising inflation in housing construction costs. In contrast, inflation in the prices of tradable items has picked up, owing in large part to the gradual pass-through of the depreciation of the exchange rate since earlier last year. This increase in tradables inflation has to date more than offset the decline in non-tradables inflation and overall CPI inflation has therefore increased to 3 per cent over the year to the June quarter. Part of this increase also reflected the effect of the increase in the tobacco excise on the CPI.

Underlying inflation has also increased in year-ended terms. Over the year to the June quarter, the various measures indicate that underlying inflation was 2¾ per cent, about ½ percentage point higher than a year earlier. In the June quarter, underlying inflation was ¾ per cent, higher than the ½ per cent recorded in March, but similar to the rate in the preceding two quarters.

The outlook for domestic growth is not materially different from that presented in the May *Statement*. It continues to reflect the opposing forces of the decline in mining investment and ongoing fiscal consolidation on the one hand, and the strong growth in resource exports and the support from very low interest rates on the other. GDP growth is expected to be a little below average over 2014/15 and then pick up gradually to an above-average pace, with non-mining business investment and liquefied natural gas (LNG) exports forecast to add to growth. A pick-up in dwelling investment is already under way, supported by very low interest rates, and this is expected to continue given the state of various leading indicators and underlying determinants of housing demand. While consumption appears to have grown at a moderate rate over the year to date, it is expected to increase gradually to a pace a bit above average by later next year given further growth in household wealth, low interest rates and some improvement in labour market conditions. This improvement in domestic demand, along with accommodative monetary conditions and the relatively healthy state of business balance sheets, should see growth in non-mining investment pick up over time. While mining investment is expected to fall sharply from its current level, the expansion of the capital stock that this investment is delivering will see resource exports grow strongly for some time.

The expectation of a gradual strengthening of economic growth should, in time, lead to stronger demand for labour, but with growth expected to be below trend over the year ahead, the unemployment rate is likely to remain elevated before it gradually declines in 2016. With slack in the labour market likely to be evident for some time, wage growth is anticipated to remain low.

Inflation is projected to be consistent with the target over the forecast period. Overall, domestic inflationary pressures are likely to remain subdued, reflecting the ongoing spare capacity in labour and product markets. Working in the other direction, the depreciation of the exchange rate since early 2013 has pushed up import prices, which are still being passed through to prices facing consumers. The recent abolition of the carbon price has changed the forecast for inflation and lowered the profile of the CPI; inflation is now projected to be lower in 2014/15 than previously assumed, but a bit higher in 2015/16 than previously forecast.

For most of Australia's major trading partners, the uncertainty surrounding the forecasts appears to be broadly balanced. In China, a key uncertainty relates to the possibility that continued weakness in the property market will weigh on growth and may adversely affect financial stability. Working in the other direction, the authorities might adopt more stimulatory policies aimed at bolstering growth, at least in the near term, although this could counteract efforts to contain leverage and increase risks for the economy further out. In Japan, considerable uncertainty remains regarding the strength of growth once the temporary effects of the tax increase and related fiscal stimulus subside. It is possible that the US economy experiences a stronger recovery than expected, although this could lead to a more rapid normalisation of US monetary policy with consequences for global financial markets that are difficult to predict.

The key uncertainties for the domestic economy continue to be centred on the timing and extent of the decline in mining investment and how this is balanced by the expansion of resource exports and the recovery in non-mining activity. Mining investment could decline more sharply than anticipated. On the other hand, it is possible that consumption and non-mining business investment could, in time, be stronger than expected. In particular, an extended period of low interest rates could lead to further strength in the housing market and stronger-than-expected growth in dwelling investment and consumption. Moreover, the fundamental forces are in place to support a pick-up in non-mining business investment, which could come sooner or be stronger than currently anticipated. Even if the transition of the economy proceeds as expected, the significant change in the composition of economic activity could result in either excess demand for, or supply of, particular labour skills or types of capital, and could also have implications for the exchange rate. With the terms of trade having declined, the exchange rate could depreciate over time, which would affect both output and inflation. The exchange rate could also be affected by the increase in income payments to domestic and foreign owners accruing from strong growth in resource exports, as well as the conduct of monetary policy in major countries and associated capital flows.

The cash rate has been unchanged at its current low level for a year. Over that time, rates paid by borrowers have declined somewhat and, for some borrowers, interest rates have edged lower still over recent months. These stimulatory financial conditions continue to have the expected effects on the economy. This is most evident in the strength in the housing market, which has contributed to a significant pick-up in dwelling investment but is also lending support to consumption growth. There has been some improvement in overall economic growth over the past year, even abstracting from the rapid growth of resource exports. While the non-mining economy is expected to improve a little further over the coming year, the decline in mining investment is expected to weigh more heavily than it has to date and the ramp-up in LNG exports is likely to build more significantly only towards the latter part of the forecast period. There has also been an improvement in some labour market indicators this year, although a fair degree of spare capacity remains and, given the outlook for economic activity, the unemployment rate is expected to remain elevated for some time yet. The restraint that this implies for domestic costs should offset upward pressure on prices owing to the gradual pass-through of the depreciation of the exchange rate since early 2013. With these forces roughly in balance over most of the forecast period, inflation is expected to remain consistent with the inflation target, even with lower levels of the exchange rate.

Given that assessment, the Board's judgement is that monetary policy is appropriately configured to foster sustainable growth in demand and inflation outcomes consistent with the target. On present indications, the most prudent course is likely to be a period of stability in interest rates.