

Overview

Over the course of this year, the recoveries in the United States and euro area economies have continued but growth has slowed in the Asian region. The slowdown in the Asian region has been associated with lower growth of global trade volumes and industrial production and has contributed to a decline in the prices of Australia's resource exports. Core inflation has generally been steady in both the advanced and emerging economies, but at rates below central banks' targets. Globally, monetary policy remains very accommodative and finance remains readily available to creditworthy borrowers.

Chinese economic growth has eased over 2015, with weakness in construction contributing to a slowdown in the industrial sector. Although residential property prices have risen a little in recent months, sales have retraced some of the rise seen earlier in the year and real estate investment remains weak. In contrast, the pace of growth in consumption and in the output of the services sector has been maintained over 2015. Growth in infrastructure investment has moderated but remains high, supported by a pick-up in project approvals. The authorities have adjusted a number of policies to support demand, including a further easing of monetary policy in recent months.

The economic recovery in Japan lost momentum around the middle of this year. Both domestic and external demand have slowed. Despite this, the labour market in Japan remains tight and nominal wages have been growing moderately. Core inflation has increased over the past couple of years, but remains below the Bank of Japan's (BoJ) 2 per cent target. In the rest of east Asia, softening external

demand has led to a slowing in GDP growth over the year to date, and there are more recent signs that domestic demand has eased in most economies in the region. In India, in contrast, domestic demand remains strong and has been provided some support by the easing in monetary policy by the Reserve Bank of India this year.

In the United States, the recovery in domestic final demand has been sustained and there has been ongoing improvement in labour market conditions, notwithstanding a slight moderation in GDP growth in the September quarter. The euro area economy has been growing above trend and the unemployment rate has declined further, but remains high. Core inflation has picked up this year but remains below the European Central Bank's (ECB) target.

Growth in Australia's major trading partners is expected to be slightly below its decade average over the next two years. This reflects an expectation that growth of the Chinese economy will continue to slow gradually and an assessment that the slowdown in growth in the rest of the Asian region will be more persistent than previously anticipated. The outlook for growth in the Asian region is a key source of uncertainty for the forecasts. The Chinese authorities have taken steps to support growth, and have scope to ease policies further. It is possible, however, that the slowing in the industrial sector will broaden to other parts of the economy that have been relatively resilient to date. Changes in the outlook for Chinese economic activity could have a noticeable effect on its trading partners in the region and on commodity prices.

The outlook for Australia's terms of trade is little changed since August. Key commodity prices are much lower than a year ago, reflecting both increased supply, including from Australia, and weaker demand. The Australian dollar is adjusting to the lower commodity prices. The forecasts for commodity prices assume that there will be only a limited reduction in supply from high-cost producers, many of which are in China. However, it is possible that high-cost producers globally will cut their production further in response to the long period of lower commodity prices. This represents an upside risk to the forecasts for Australia's terms of trade.

Globally, monetary policy is expected to be more accommodative in the near term than had been anticipated in August. The path for the US policy rate implied by market pricing is now lower than it was a few months ago and many observers expect that the ECB and BoJ will announce further monetary policy easing. Also, the Peoples' Bank of China cut benchmark interest rates and reduced banks' reserve requirement ratios in October.

The Australian economy has continued to grow at a moderate pace and the rebalancing of activity away from the resources sector is continuing. Overall, growth appears to have picked up in the September quarter, as resource exports and dwelling investment returned to growth following temporary weakness in the June quarter.

Indicators of consumption, including retail sales, motor vehicle sales and surveys of consumers' perceptions of their own finances, suggest that consumption grew at a moderate pace in the September quarter, supported by the low level of interest rates and improvements in the labour market. Consumption growth is forecast to increase, notwithstanding the expectation that income growth will be modest over the forecast period given that wage growth is likely to remain subdued. Hence, the forecasts imply a further gradual decline in the household saving ratio. Households' decisions regarding their saving and borrowing will

depend, among other things, on their response to changes in wealth, and are an important source of uncertainty for the forecasts given the significance of consumption growth to domestic demand.

The low level of interest rates is expected to continue to support housing market activity. Forward-looking indicators of housing activity, though somewhat mixed, generally point to further growth in dwelling investment, albeit at a moderating rate. Auction clearance rates and housing price growth in Sydney and Melbourne have declined over recent months. Lending standards have been tightened in response to changes in APRA's supervisory measures and, more recently, many lenders have announced increases in mortgage rates for both investors and owner-occupiers. Housing credit growth has increased a little over recent months, with growth in lending to investors easing slightly while that for owner-occupiers appears to be picking up. Supervisory measures are helping to contain risks that may arise from the housing market.

Survey measures of business conditions in the non-mining sector are clearly above their long-run average levels, most notably for services. The support to economic activity from the depreciation of the exchange rate has been particularly apparent in the sizeable contribution to growth from net service exports. The strength of business conditions in the services sector has translated into employment growth but has had little effect on investment to date, given that firms in many parts of this sector tend to be less intensive in their use of capital. Indications of investment intentions and a decline in the stock of non-residential building work yet to be done continue to suggest that a pick-up in non-mining investment is not in prospect in the near term. However, some of the conditions for a recovery in non-mining business investment are in place. Rates on business borrowing continue to edge down and business credit growth has picked up. Also, surveys of conditions in goods-related industries have improved over recent months. The strength and timing of the anticipated recovery

in non-mining business investment is uncertain and remains one of the key risks to the domestic forecasts.

Conditions in the labour market have continued to improve. Employment growth has been stronger than had been expected and there has been a noticeable pick-up in the participation rate. Measures of job vacancies and advertisements have continued to increase and point to further growth in employment in the months ahead. It appears that the increase in demand for labour has been roughly matched by the increase in the supply of labour. The unemployment rate has been steady at around 6–6¼ per cent for over a year now. The relatively high level of the unemployment rate and low growth of wages indicate that spare capacity exists.

Inflation in the September quarter was lower than had been forecast across a broad range of goods and services. Various measures suggest that underlying inflation declined to a bit above ¼ per cent in the September quarter, and to between 2 and 2¼ per cent in year-ended terms. The outcome for headline CPI inflation was lower still, in part owing to the temporary effects of the earlier decline in fuel prices, which remain around 10 per cent lower than a year earlier. Domestic inflationary pressures are well contained, consistent with low growth in labour costs and spare capacity. The prices of tradable items (excluding volatile items and tobacco) were little changed both in the September quarter and over the past year. This suggests that the upward pressure on the prices of many tradable items from the earlier exchange rate depreciation has been tempered by heightened competitive pressures domestically, which is consistent with messages from liaison. Nevertheless, gradual pass-through of the exchange rate depreciation is expected to place some upward pressure on the prices of tradable items over the next few years.

The forecast for growth in economic activity over the next two years is not materially different from what was presented in the previous *Statement*. GDP growth is expected to be between 2 and 3 per cent

over the year to June 2016, rising to 2¾–3¾ per cent over the year to June 2017, which is around its long-run average. Resource exports will remain a key driver of growth over the period ahead. Household consumption, supported by low interest rates and growing employment, is forecast to make an important contribution to growth in aggregate expenditure over the next couple of years. Low interest rates have also been supporting growth in dwelling investment, although some slowing in the pace of growth is expected. The improvement in domestic demand and the increased support to demand for domestic production afforded by the lower exchange rate are expected, in time, to lead to a rise in non-mining business investment. In contrast, and as before, further large falls in mining investment are anticipated, although the largest subtraction from GDP growth from this source is expected to occur during the current financial year. Also, growth in public demand is forecast to be a bit below average over the next couple of years.

Employment growth is forecast to remain relatively strong and the participation rate is expected to increase a little further. Accordingly, the unemployment rate is projected to remain around current levels before declining gradually as economic growth picks up. This suggests that the economy will be operating with a degree of spare capacity and domestic cost pressures are likely to remain subdued over the forecast period. How much spare capacity there is, and the extent to which it will affect wage and inflation pressures, is a source of uncertainty. One issue is the effectiveness with which the skills of available workers can be matched to vacant jobs, particularly given the sectoral shift in activity towards the services sector and away from the mining sector. Another consideration is the extent of competitive pressures across different markets, which is always difficult to assess.

The profile of inflation has been revised down in light of the low outcome in the September quarter. While quarterly CPI data are always subject to a degree of volatility and measurement error, the

broad-based nature of the low inflation outcome in the September quarter suggests that inflationary pressures are a bit more subdued than had earlier been anticipated. As a result, underlying inflation is now forecast to be close to 2 per cent in year-ended terms over the course of most of the next year, before picking up to around 2½ per cent. Underpinning this, domestic inflation pressures are likely to remain well contained and the depreciation of the exchange rate is expected to place gradual upward pressure on tradable prices.

The Reserve Bank Board reduced the cash rate by 25 basis points at its February meeting and then again at its May meeting. These and earlier reductions, and the depreciation of the exchange rate since 2013, are working to support economic growth. This is evident

in a range of indicators, including employment growth, job vacancies, surveys of business conditions and trade data. At the November meeting, the Board judged that the prospects for an improvement in economic conditions had firmed a little over recent months and that it was appropriate to leave the cash rate unchanged. At the same time, the Board recognised that the economy is likely to be operating with a degree of spare capacity for some time yet and noted that the outlook for inflation may afford scope for further easing of policy, should that be appropriate to lend support to demand.

The Board will continue to assess the outlook, and hence whether the current stance of policy will most effectively foster sustainable growth and inflation consistent with the target. ❖