Overview

Following weaker global economic conditions through the middle of the year, the recent economic data have generally been a little more positive. In the United States, growth is continuing at a moderate pace and there are now signs that growth may have stabilised in China, helped by a pick-up in infrastructure investment. In Europe, although economic activity across the region remains weak, reflecting in part the impact of fiscal consolidation, recent policy announcements have helped to stabilise financial conditions. Economic activity in east Asia has been weighed down by slower growth of global trade and consequently monetary and fiscal policies have been eased a little in some countries in the region.

World GDP growth is currently expected to be around 3¼ per cent in 2012 and to pick up gradually to 3½ per cent in 2013, which is around the long-run average. A modest recovery in the euro area during next year and a continuation of moderate US growth are expected to help boost growth in the east Asian economies to around its trend pace. This is likely to be supported by a gradual pick-up in growth in China in response to the earlier easing in financial conditions and a further modest easing in fiscal policy. While conditions are expected to improve gradually across the globe, activity in the euro area and the United States is expected to remain below potential for some time.

Prices for Australia's iron ore and coking coal exports fell sharply over July and August, driven by a moderation in Chinese demand for steel. Since then, iron ore and steel prices have partially recovered, although spot prices for coking coal have declined further. Thermal coal prices have also fallen significantly since the middle of the year. In contrast, global food prices are higher than earlier in the year and base metals prices have remained broadly unchanged. By the end of 2012, Australia's terms of trade are expected to have fallen by around 15 per cent from their peak in September 2011, a little more than had earlier been expected. Some recovery in bulk commodity prices in the early part of 2013 is forecast on the expectation that Chinese demand for steel picks up a little. But further out, prices are expected to continue to decline gradually given the expansion in supply generated by the very high levels of resource investment globally.

Actions by major central banks, and signs of progress in addressing Europe's fiscal and banking problems, have underpinned an improvement in global financial market conditions since the middle of the year. Conditions in euro area sovereign debt markets improved markedly following announcements by the European Central Bank about its willingness to take decisive actions to preserve the euro. Long-term interest rates faced by highly rated sovereigns, including Australia, remain at exceptionally low levels. Capital markets remain open to corporations and well-rated banks, and Australian banks have had no difficulty accessing funding, including on an unsecured basis. Australian banks continue to shift away from wholesale liabilities towards domestic deposits.

The national accounts show that, after especially strong growth in the March quarter, Australia's GDP growth was closer to trend in the June quarter. More recent indicators of activity suggest that the economy continued to grow moderately in the September quarter.

Mining investment has continued to grow rapidly in recent quarters. Work on the substantial pipeline of liquefied natural gas (LNG) projects is continuing. However, in response to the decline in prices for iron ore and coal, rising costs and a still high level of the exchange rate, mining companies have scaled back their investment plans. Exports are estimated to have grown moderately in the September quarter, with coal exports affected by lingering disruptions to supply from Queensland as well as weaker global demand.

Outside of the resources sector, indicators of private non-residential investment remain subdued, although business credit has picked up over the past year as interest rates have come down.

Household consumption rose strongly in the first half of the year, due in part to some temporary factors. The value of retail sales declined in July but has been rising since then. Sales of motor vehicles to households have been strong in recent months.

While household dwelling investment continued to decline over the first half of the year, there have been signs in recent months of a prospective improvement, partly in response to reductions in interest rates. Private residential building approvals, dwelling prices and auction clearance rates have all increased. The overall demand for housing finance has been broadly stable over the course of the year and many home owners are taking advantage of lower borrowing rates to pay off their loans more quickly.

After employment growth picked up in the first half of 2012, it slowed over recent months and the unemployment rate increased slightly. There has been a substantial fall in employment in the construction industry over the past year, partly reflecting a delayed response to the decline in total building work done; industry liaison suggests that this process of adjustment may now be coming to an end. More broadly, leading indicators of labour demand have declined further over recent months and point to only modest near-term employment growth and to the unemployment rate edging a little higher.

While the labour market has softened through the year, wage growth as measured has so far been little changed. In the June quarter, wage growth edged higher in year-ended terms, but remained close to the average of the past decade, and still well below the pace seen over 2005–2008 when the unemployment rate was lower than it is currently. Wage growth in the private sector remains higher than in the public sector, driven by mining and professional & scientific services, offset in part by softer wage growth in retail and household services. Business surveys and liaison suggest that private sector wage growth may have softened a little over more recent months.

Inflation picked up in the September quarter from the low level recorded in the June quarter. The September quarter outcome was affected by the introduction of the carbon price and means testing of the private health insurance rebate. Non-tradables inflation increased in the September quarter even abstracting from the one-off policy-induced effects. This owed in part to a rise in new dwelling price inflation and a broad-based increase in food price inflation, while inflation in the prices of a range of market services remained subdued. Over the past two quarters, there have been small increases in tradables prices (excluding volatile items such as fruit and vegetables), suggesting that the downward pressure on these prices from the earlier appreciation of the exchange rate is waning.

The various measures suggest that underlying inflation was around ¾ per cent in the September quarter and around 2½ per cent over the year. This is close to ½ percentage point higher than the rate of underlying inflation three months ago.

The outlook for the Australian economy is a little weaker than that presented in the August *Statement*. Over the year to June 2013, GDP growth is expected to be a little below 2¾ per cent before gradually picking up to just under 3 per cent over 2014. Most of this revision to the outlook is accounted for by a change in the profile for mining investment, which is now forecast to peak a little earlier and at a lower level than had earlier been expected (around 8 per cent of GDP rather than around 9 per cent). This change reflects the reappraisal of spending plans in the coal and iron ore sectors as well as a reassessment of the profile for spending on some large and complex LNG projects. Exports are still forecast to grow substantially over the forecast period given the increase in capacity resulting from the large pipeline of resource investment projects.

Lower interest rates, rising rental yields and an improvement in conditions in the established housing market are expected to support rising dwelling investment. Business investment outside of the resource sector, which has been low, is likely to gradually recover over the next two years, though business surveys and liaison point to muted growth in the near term. Consumption is anticipated to grow at an around-trend pace over the forecast horizon. Public spending is expected to subtract from growth over 2012/13 owing to fiscal consolidation at state and federal levels.

Forecasts for inflation remain largely unchanged from the August *Statement*. Underlying inflation is expected to remain within the inflation target range over the next two years. Although the rate of inflation was a little higher than had earlier been expected, the effect of this on the inflation forecast is offset by the slightly weaker outlook for domestic economic activity and employment. This softer outlook is expected to help contain domestic inflationary pressures over the forecast period. In line with the stability in the exchange rate over the past year, tradables prices are expected to remain broadly flat. Underlying inflation is expected to be close to 2½ per cent over most of the forecast period. The combination of the carbon price effect and earlier volatility in fruit and vegetable prices is expected to see headline inflation rise above 3 per cent in year-ended terms in the first half of 2013, before declining to around 2½ per cent thereafter.

The risks to the global outlook remain tilted to the downside, primarily reflecting the risks associated with the banking and fiscal problems in the euro area. While the policy announcements in Europe over the past few months have helped to improve financial market conditions, much work remains to be done to repair private and public sector balance sheets and enhance prospects for sustainable growth.

Elsewhere in the world, the risks are more balanced. For the United States, the forecasts anticipate that only around half of the sharp fiscal contraction embedded in existing legislation occurs. But there remains uncertainty surrounding the timing and nature of new legislation and, hence, the extent of the fiscal consolidation that will actually take place. In China, while the near-term risks to growth look to have declined, some uncertainty regarding the policy outlook remains.

On the domestic front, the outlook for growth is sensitive to prospects for mining investment and the timing and extent of the anticipated recovery in both dwelling and business investment outside of the resource sector. Investment plans of iron ore and coal miners remain dependent upon the prices of bulk commodities, which will in turn depend on the strength and nature of growth in China. Also, the exact timing of spending on committed investment projects in the resource sector is inevitably uncertain given their size and complexity. The current level of the exchange rate could also have a more contractionary effect on output than anticipated.

The outlook for inflation depends on whether soft demand in some parts of the economy helps to contain domestic cost pressures as the effects of the earlier rise in the exchange rate are now waning. Some slowing in wage growth is likely to be necessary to maintain inflation around its current rate. Further growth of productivity will also be needed to keep inflation consistent with the medium-term inflation target. A strong pick-up in demand could add to inflationary pressures just as the disinflationary impact of the earlier exchange rate appreciation wanes, resulting in higher-than-expected inflation.

The Board reduced the cash rate twice in late 2011 and twice again in mid 2012, bringing interest rates for borrowers to below their medium-term averages. Subsequently, the outlook for global growth weakened a little, the prices for Australia's bulk commodity exports fell significantly and yet the exchange rate remained higher than might have been expected. The sharp fall in spot prices of bulk commodities has led to a change in the spending plans of firms in the resource sector and it now appears that the peak in investment in the resource sector is likely to occur a bit earlier and at a lower level than had previously been expected. Accordingly, at its October meeting, the Board judged that, with the growth outlook for next year looking a little weaker and inflation expected to be consistent with the target, it was appropriate for the stance of monetary policy to be more accommodative.

As a result of this sequence of reductions in the cash rate, interest rates for borrowers are clearly below their medium-term averages and savers are facing increased incentives to look for assets with higher returns, though the exchange rate remains higher than might normally be expected. While the impact of monetary policy changes takes some time to work through the economy, there are signs that easier conditions have been having some of the expected effects, and further effects can be expected over time. At the November meeting, with the more recent positive news on the international economy and with inflation a little higher than expected, though still likely to be consistent with target over the year ahead, the Board judged that the stance of monetary policy remained appropriate, for the time being.

Over the period ahead, as the peak in resource investment approaches, the Board will be monitoring the strength of other components of demand, as well as trends in costs and prices. The Board will adjust the cash rate as appropriate to foster sustainable growth and low inflation.