

## RECENT ECONOMIC DEVELOPMENTS

Recent economic developments have been broadly consistent with the view presented at the Mid-Year Economic and Fiscal Outlook (MYEFO) in December.

Looking first at the global economy, global growth prospects are improving in what continues to be a slow drawn-out recovery from the financial crisis. Encouragingly, sentiment has been improving in recent months. That said, both old and new downside risks remain.

Advanced economies are picking up and growth in China remains solid, while other emerging market economies are softer. While the outlook for emerging market economies has been more moderate and mixed of late, they are still expected to contribute the bulk of global growth.

In China, the economy grew 7.7 per cent in 2013, unchanged from 2012. Although this was the equal-slowest pace of growth since 1999, the outcome was slightly higher than the official growth target of 7.5 per cent.

While China is expected to maintain solid growth over the near term, important risks remain. These include risks in the less-regulated parts of China's financial system (the 'shadow banking system'), which must be managed at the same time that authorities push ahead with wider reforms to improve the allocation of capital.

A key component of these reforms will be to remove the remaining controls on interest rates, particularly the ceiling on retail deposit rates. With more market-determined interest rates, the resulting higher returns on household savings should support the Chinese economy's transition towards greater household consumption and away from investment.

The United States continues its modest but steady recovery, and is poised for stronger economic growth. Household balance sheets have continued to be repaired, and the drag from fiscal policy, which probably reduced growth in 2013 by about 1.5 percentage points, has abated. The passage of the December budget deal and, most

recently, the passage of a bill to suspend the debt ceiling until March 2015, have added to confidence that budget deadlocks will not derail the recovery.

The US Federal Reserve announced in December that it would begin the process of gradually unwinding its asset purchases program, with a further step in the process announced in January. This marks the beginning of the renormalisation of US monetary policy, and is clearly a milestone on the long road to the recovery of the US economy.

It has, however, been associated with a reassessment by financial markets of the growth prospects and vulnerabilities of those emerging markets with significant inflation, fiscal deficits, current account deficits, or fraught political environments.

In the euro area, the economy appears to have turned the corner, but the recovery remains weak and uneven. A permanent resolution to the crisis will require further politically difficult reforms, particularly the successful implementation of single banking resolution authority, and further progress towards a framework for providing fiscal transfers in the event of severe asymmetric shocks – those that hit some countries within the Eurozone, but not other.

An emergent risk is that continued low inflation combined with anaemic growth in the Eurozone, may see longer term inflation expectations drift down, raising the risk of deflation. Price declines in the periphery are improving their competitiveness relative to the Eurozone core, although this is at the expense of higher real debt burdens and real interest rates.

In Japan the short-term outlook has been boosted by fiscal and monetary stimulus, but a sustained recovery relies on structural reforms to lift growth and investment.

Turning to the domestic economy, the outlook at MYEFO was for below trend growth to continue over 2013-14 and 2014-15, as the Australian economy transitions slowly to broader based non-resources sources of growth. Recent data releases have been broadly consistent with this outlook.

The September quarter 2013 National Accounts showed an economy growing below trend, with growth of 0.6 per cent in the quarter and 2.3 per cent over the year. Growth outside the resource sector remained subdued, with below average outcomes for consumption and dwelling investment in the quarter.

Resources investment, which made a major contribution to economic growth in recent years – is now at or around its peak. The latest capital expenditure (CAPEX) survey suggests that resources investment will remain elevated in 2013-14, supported by a few large LNG projects. Resources investment is expected to fall significantly as these projects are completed around the middle of the decade.

While the latest CAPEX survey also suggests that investment intentions outside the resources sectors of the economy remain weak, there have been some positive signs. Business confidence, as measured in the NAB Monthly Business Survey, has been above average for the past five months. The survey also reports significantly improved business conditions over the past two months, after being negative for over a year. Business credit growth picked up a little in December, after a relatively flat second half of 2013, although it remains well below its 10-year average.

To date, the clearest sign of a recovery in the non-resources sectors has been in the housing market, particularly for established homes, with house prices, auction clearance rates and housing finance all pointing to a recovery. While monthly private residential building approvals fell in December, the overall trend has improved noticeably, with approvals up over 20 per cent over the past year. The strength to date has been concentrated in high-density dwellings.

Retail sales also showed signs of improvement in the lead up to Christmas. Retail trade volumes rose a solid 0.9 per cent in the December quarter, following a 0.8 per cent rise in the September quarter. Household consumption growth will need to strengthen further to support the transition to broader based growth.

The most recent outcome for consumer sentiment, for February, recorded a fall. The survey reported that negative news around the motor vehicle industry and other well-known organisations over the past few months may have contributed to the fall in sentiment, although it remains to be seen for how long this fall is sustained.

As the MYEFO foreshadowed, conditions in the labour market remain subdued, with the unemployment rate drifting higher to 6.0 per cent in January. Employment growth was flat in January (down 3,700 persons), and flat over the twelve months to January (up 1,400 persons).

Consistent with overall spare capacity in the labour market, wages growth has been weak. The Wage Price Index rose by 2.6 per cent over the year to the December quarter. This was well below its 10-year average growth rate of 3.7 per cent and represents the weakest through-the-year growth since the start of the series in 1997. Growth in both private and public sector wages were well below their 10-year average rates.

Slow wage growth will help support employment as the economy transitions, although the subdued labour market conditions are likely constrain household spending.

The headline CPI rose by 2.7 per cent through the year to the December quarter, up from 2.2 per cent to the September quarter. The December quarter outcome was a little higher than expected. The prices of tradeable goods rose through the 2013 calendar year, for the first time since 2011, which may have been a result of a faster-than-usual pass through of the exchange rate depreciation. Of note were seasonal strength in travel prices and a rise in fruit and vegetable prices following adverse weather in some areas. Tobacco prices also rose strongly as a result of the increase in the tobacco excise. However, inflationary pressures remain modest, reflecting excess capacity in the labour market and softness in wage growth.

Non-rural bulk commodity prices remained steady during the second half of 2013, but have eased since the beginning of 2014. Despite higher export volumes contributing to real GDP growth, softening non-rural bulk commodity prices and weak domestic price growth from low wage growth imply a subdued outlook for growth in nominal GDP over the forecast period, again as foreshadowed in the MYEFO.