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Pre-Budget Economic Outlook: a Quick Guide

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This brief provides some background data on domestic and international economies. It includes summaries of recent economic data, their underlying drivers, and discussion of the key issues and concerns arising from interpretation of these data. The information in this brief is designed to accompany the brief on the Pre-Budget Fiscal Outlook which examines the domestic fiscal policy background and decisions.

Executive summary

- Most domestic indicators suggest the Australian economy is growing less quickly:
  - latest National Accounts data show GDP growth of 2.3 per cent in the year to December 2018
  - Consumer Price Inflation was 1.5 per cent in the year to December 2018 (below the RBA 'inflation target' of 2-3 per cent, on average, over the medium term)
  - wages growth remains sluggish at 2.3 per cent through the year despite falling unemployment
  - although total new capital expenditure was up 1.9 per cent through the year, dwelling investment is expected to decline (dwelling approvals fell 28.6 per cent through the year to January 2019)
  - residential property prices are falling, particularly in Sydney and Melbourne
  - consumers are 'cautiously pessimistic'
  - business conditions and confidence have fallen
  - the monetary policy outlook is more 'evenly balanced' between a cash rate rise and a cash rate cut
- Other domestic indicators offer a more positive outlook:
  - unemployment remains low and is expected to decline further
  - the terms of trade continue to grow (by 6.0 per cent through the year)
  - commodity prices (particularly iron ore, LNG and alumina) are strong

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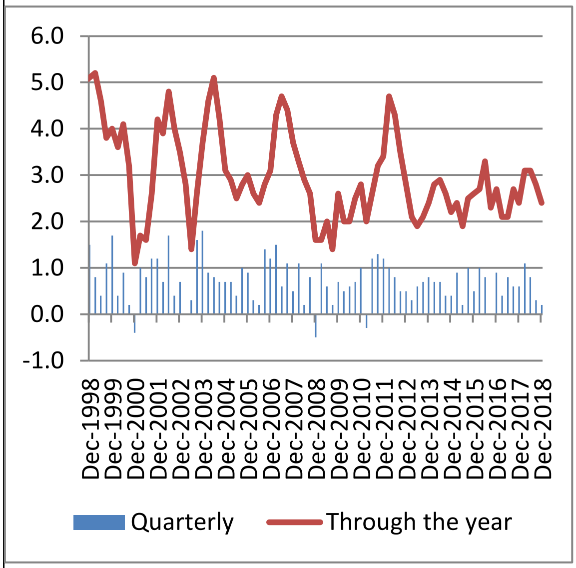
- Concerns about global growth have increased in recent months prompting downward revisions:
  - recent financial market turbulence
  - high trade tensions between the US and China (and between the US and the Eurozone for auto industries) affecting trade and investment intentions
  - weaker domestic demand, incremental policy easing and a decreasing current account surplus in China
  - rising uncertainty, including around Brexit, social unrest in France, concerns about Italy, political risks, protectionism
  - falling consumer confidence
  - shifting monetary policy rate expectations including inflation-induced policy tightening (particularly in the US)
- Some positive signs in global indicators:
  - trade war fears are dissipating
  - a delay in Federal Reserve tightening
  - strengthening emerging market economies
  - falling oil prices

Domestic outlook

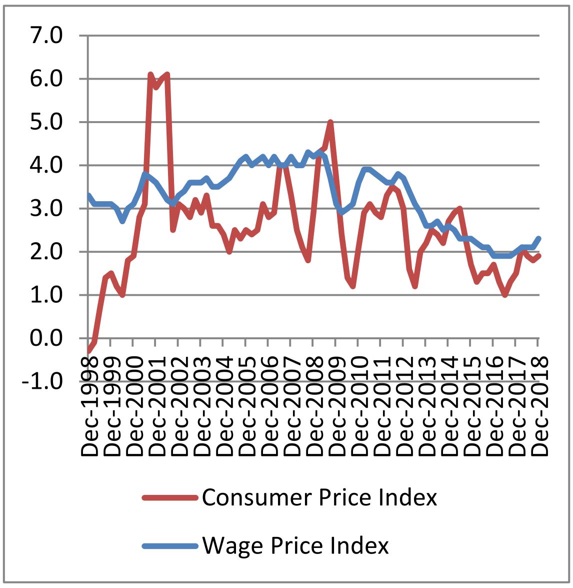
This section provides data and commentary on key variables which summarise the current and expected short term future state of the Australian macro-economy. A review of key macroeconomic indicators is followed by discussion of current areas of concern.

Table 1: Key macroeconomic indicators for Australia

Gross Domestic Product (GDP) growth (volume measures, seasonally adjusted)[1]	
 Source: ABS	GDP grew by 0.2 per cent in the December quarter 2018 (2.3 per cent through the year), following a 0.3 per cent rise in the September quarter. Compensation of employees grew 0.9 per cent in the quarter (4.3 per cent through the year). Quarterly household consumption grew by 0.4 per cent in the quarter (2.0 per cent through the year). The household savings ratio rose to 2.5 per cent. Government final consumption expenditure grew 1.8 per cent in the quarter (5.6 per cent through the year) contributing 0.3 percentage points to GDP growth. This was largely attributed to spending on disability, health and aged care services. Private investment fell by 1.3 per cent in the quarter, driven by dwellings and ownership transfer costs. Net exports detracted 0.2 percentage points from GDP growth driven by a fall in exports. Inventories held by business increased by $685 million in the quarter. The RBA's central scenario expects output growth of 3 per cent in 2019.[2] Oxford Economics forecasts GDP growth of 2.2 per cent in 2019 and 2.7 per cent in 2020.[3]

1. Australian Bureau of Statistics (ABS), *Australian National Accounts: National income, expenditure and product, Dec 2018*, cat. no. 5206.0, ABS, Canberra, 6 March 2019.
2. Reserve Bank of Australia (RBA), 'Statement by Philip Lowe, Governor: Monetary Policy Decision', RBA website, media release, 5 March 2019.
3. Oxford Economics, 'Country Economic Forecast: Australia', 12 March 2019.

Consumer Price Index (CPI) and Wage Price Index (WPI) (percentage change from corresponding quarter of previous year, all industries, seasonally adjusted)[4]



Source: ABS

The CPI increased by 0.5 per cent in the December quarter 2018 (following a 0.4 per cent rise in the September quarter), leading to a 1.8 per cent rise through the year.

The RBA expects underlying inflation to 'pick up over the next couple of years, with the pick-up likely to be gradual and to take a little longer than earlier expected. The central scenario is for underlying inflation to be 2 per cent this year and 2¼ per cent in 2020.'[5] Oxford Economics expect the CPI to reach 2.5 per cent in 2020 and 2.7 per cent in 2021.[6]

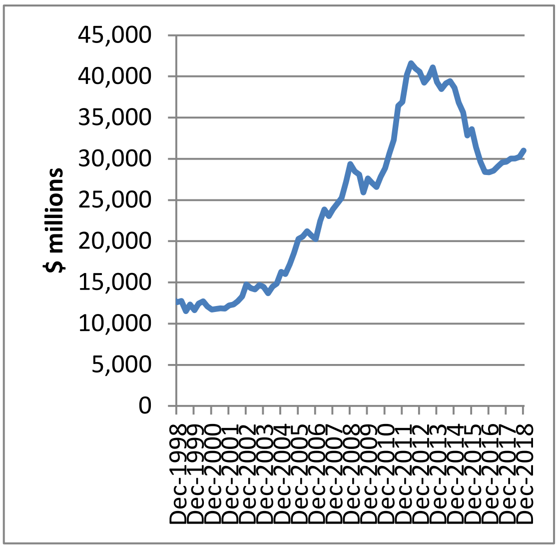
In the December 2018 quarter, the all-sectors Wage Price Index rose by 0.5 per cent (the private and public sector WPIs both rose by 0.6 per cent). Throughout the year, all sectors rose 2.3 per cent.

(In original terms, rises through the year ranged from 1.6 per cent for WA to 2.7 per cent for Victoria.)

The RBA notes that '[t]he improvement in the labour market should see some further lift in wages growth over time, although this is still expected to be a gradual process.'[7] Oxford Economics are forecasting wage growth of 3.1 per cent in 2020 and 3.6 per cent in 2021.[8]

4. ABS, *Consumer Price Index, Australia, Dec 2018*, cat. no. 6401.0, ABS, Canberra, 30 January 2019; ABS, *Wage Price Index, Australia, Dec 2018*, cat. no. 6345.0, ABS, Canberra, 20 February 2019.
5. RBA, 'Statement by Philip Lowe, Governor: Monetary Policy Decision', RBA website, media release, 5 March 2019.
6. Oxford Economics, 'Australia: Consumer Price Index', *Global Data Workstation*, accessed 12 March 2019.
7. RBA, 'Statement by Philip Lowe, Governor: Monetary Policy Decision', RBA website, media release, 5 March 2019.
8. Oxford Economics, 'Australia: Wage Price Index', *Global Data Workstation*, accessed 12 March 2019.

Private capital expenditure (chain volume measure, seasonally adjusted)[9]



Source: ABS

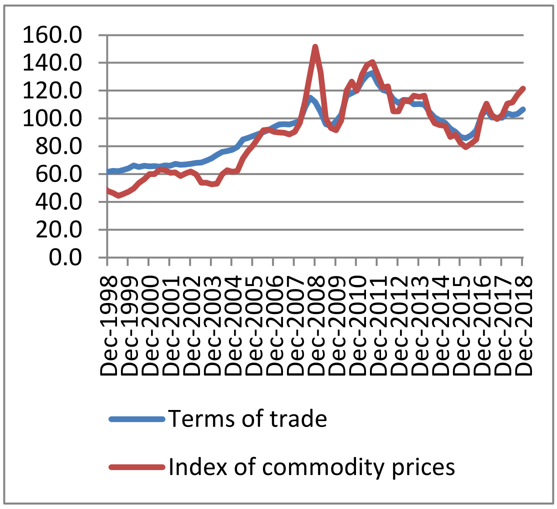
Total new capital expenditure rose by 2.0 per cent in the December quarter 2018, up 1.9 per cent through the year.

Buildings and structures capital investment grew 3.2 per cent in the quarter (down 2.9 per cent through the year); equipment, plant and machinery rose 0.7 per cent (up 8.1 per cent through the year).

Oxford Economics expect business investment to rise by 2.2 per cent in 2019, but residential construction will be a drag over the next couple of years.[10]

Dwelling investment is expected to decline with falling pre-sales and tightening financial conditions (dwelling approvals fell 28.6 per cent through the year to January 2019);[11] business investment is expected to support growth; public investment is supported by a large pipeline of infrastructure projects.[12]

Terms of trade (seasonally adjusted) **and commodity prices**[13]



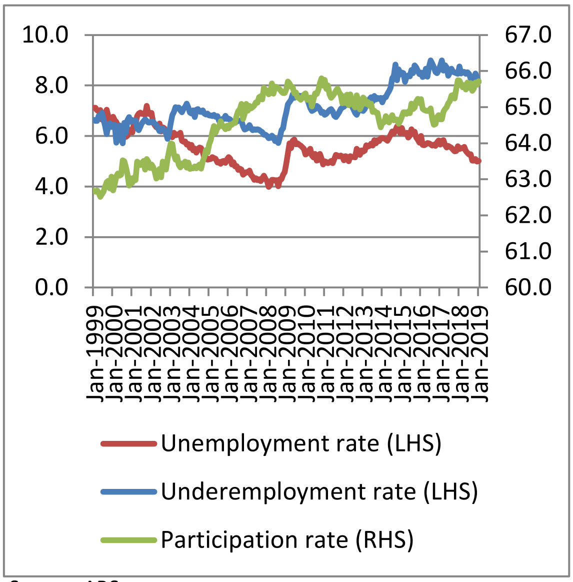
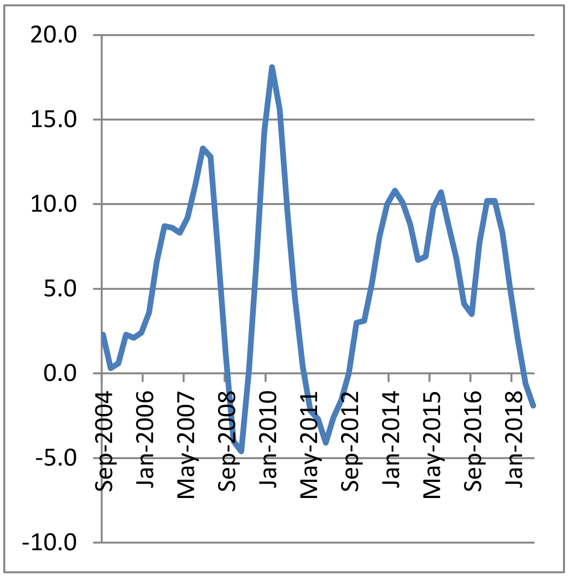
Source: ABS and RBA

The terms of trade grew by 3.1 per cent in the December 2018 quarter (by 6.0 per cent through the year).

The RBA notes that '[t]he terms of trade have increased over the past couple of years, but are expected to decline over time'[14] as Chinese demand for bulk commodities declines and other low-cost supply enters the market.[15]

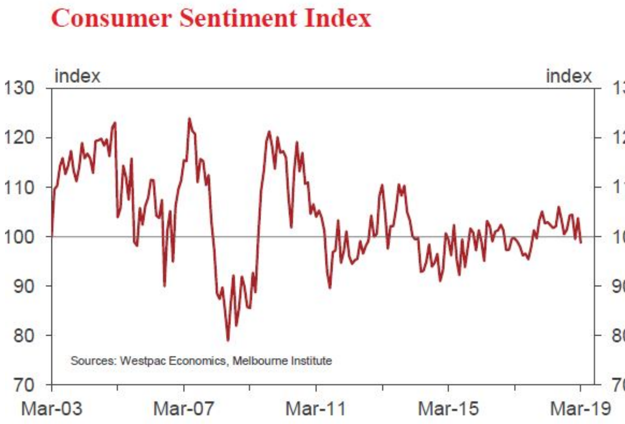
In Australian dollar terms, the Index of Commodity Prices increased by 4.6 per cent in February. The Index has increased by 15.4 per cent through the year (led by higher LNG, iron ore and alumina prices).[16]

9. Chain volume measures are designed to reflect volume changes over time, removing the impact of price changes. ABS, *Private new capital expenditure and expected expenditure, Australia, Dec 2018*, cat. no. 5625.0, ABS, Canberra, 28 February 2019.
10. Oxford Economics, *Country Economic Forecast: Australia*, 12 March 2019.
11. ABS, 'Building approvals, Australia, Jan 2019', cat. no. 8731.0, Canberra, 4 March 2019.
12. RBA, *Statement on Monetary Policy*, February 2019, p. 67.
13. RBA, 'Index of Commodity Prices February 2019', RBA website, 1 March 2019 and ABS, *Australian National Accounts: National income, expenditure and product, Dec 2018*, cat. no. 5206.0, ABS, Canberra, 6 March 2019.
14. RBA, 'Statement by Philip Lowe, Governor: Monetary Policy Decision', RBA website, media release, 5 February 2019.
15. RBA, *Statement on Monetary Policy*, February 2019, p. 68.
16. RBA, 'Index of Commodity Prices February 2019', RBA website, 1 March 2019.

Unemployment, underemployment and participation (per cent, seasonally adjusted)[17]	
 Source: ABS	In January 2019, the unemployment rate remained at 5.0 per cent; the participation rate increased by 0.1 percentage points to 65.7 per cent; the underemployment rate decreased 0.2 percentage points to 8.1 per cent. Relative to January 2018, the unemployment rate fell 0.5 percentage points, the participation rate is unchanged and the underemployment rate fell 0.6 percentage points. The RBA expects a 'further decline in the unemployment rate to 4¾ per cent … over the next couple of years'.[18] Oxford Economics are forecasting unemployment of 5.0 per cent for 2020 and 4.9 per cent for 2021.[19]
Housing prices (year-ended growth, seasonally adjusted)[20]	
 Source: ABS	The Residential Property Price Index (RPPI) for the weighted average of the eight capital cities fell 1.5 per cent in the September quarter 2018 (1.9 per cent through the year). Melbourne property prices fell 2.6 per cent over the quarter; Sydney prices fell 1.9 per cent. 'Falls in Sydney and Melbourne are no longer confined to the more expensive properties, with declines now being observed in the middle and lower segments of the market. Factors including tightening credit availability and falling property prices are weighing on activity from both investors and owner occupiers.'[21] RBA research suggests that low interest rates explain much of the rapid growth in housing prices and construction over the past few years.[22]

17. ABS, *Labour force, Australia, Jan 2019*, cat. no. 6202.0, ABS, Canberra, 21 February 2019.
18. RBA, 'Statement by Philip Lowe, Governor: Monetary Policy Decision', RBA website, media release, 5 March 2019.
19. Oxford Economics, 'Australia: Unemployment rate', *Global Data Workstation*, accessed 12 March 2019.
20. ABS, *Residential Property Price Indexes: Eight Capital Cities, Sep 2018*, cat. no. 6416.0, ABS, Canberra, 11 December 2018.
21. ABS, 'Melbourne and Sydney drive property price fall', media release, 11 December 2018.
22. T Saunders and P Tulip, 'A model of the Australian housing market', RBA Research Discussion Paper, 2019-01, March 2019.

The Westpac-Melbourne Institute Index of Consumer Sentiment[23]



Source: Westpac-Melbourne Institute

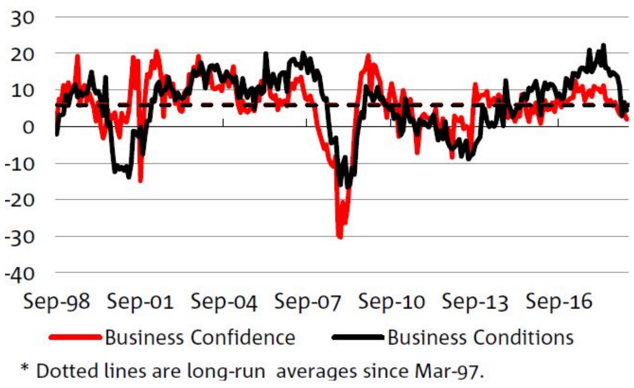
The Consumer Sentiment Index fell 4.8 per cent to 98.8 in March: consumers are 'cautiously pessimistic' (but still above the average level in 2017).

The deterioration was largely attributed to the weak December quarter national accounts update and housing market downturn.

Job loss concerns rose sharply in March.

The Index of House Price Expectations fell a further 2.7 per cent to 85.4 (a new low since 2009). Weakness remains pronounced in NSW and Victoria.

NAB Monthly Business Survey[24]



Source: NAB

'Conditions and confidence fall – now both below average.'

The fall in business conditions continues a relatively sharp decline over the previous six months; although still positive, business confidence fell (and has been below average since August 2018).

Retail remains the weakest industry by a significant margin.

Conditions in trend terms remain most favourable in the eastern mainland states. Capacity utilisation (a measure of productive efficiency) is now below average; overall survey measures of prices and inflation remain weak.

Small and Medium Enterprise (SME) business conditions continued to decline in Q4 2018. Confidence also declined and is now below average. Leading indicators weakened further in Q4.[25]

23. Westpac Melbourne Institute, *Bulletin: Consumer sentiment falls on weak growth figures,* 13 March 2019.
24. NAB, *NAB Monthly Business Survey: February 2019*, 12 March 2019.
25. NAB, *NAB SME Business Survey: Quarter 4 2018*, 14 February 2019.

Monetary policy outlook 'more evenly balanced'

In its latest *Statement on Monetary Policy* (SMP), the RBA revised down its growth forecasts 'in light of recent data, particularly for consumption. GDP growth is expected to be around 3 per cent over this year and 2¾ per cent over 2020.'[26] Forecasts for underlying inflation were also revised 'slightly lower' reflecting lower growth and 'expected near-term weakness in administered and utilities price inflation'.[27]

In a National Press Club address in February, the Governor noted that, '[f]or some years, growth in nominal aggregate household income has been unusually slow, averaging just 2¾ per cent since 2016.'[28] As a result, aggregate consumption has grown faster than income. The RBA expects a pick-up in household disposable income to help offset the effects of lower housing prices.

The RBA Governor says the chance of an interest rate cut is now 'more evenly balanced' with the prospect of an increase:

> If Australians are finding jobs and their wages are rising more quickly, it is reasonable to expect that inflation will rise and that it will be appropriate to lift the cash rate at some point. … In the event of a sustained increased in the unemployment rate and a lack of further progress towards the inflation objective, lower interest rates might be appropriate at some point.[29]

More recently, he has argued:

> There are plausible scenarios under which the next move in interest rates is up. There are also plausible scenarios under which it is down. At the moment, the probabilities appear reasonably evenly balanced.[30]

Some commentators have argued that 'rising funding pressures and deteriorating economic conditions will force the RBA to slash cash rates'.[31] ANZ has abandoned its previous prediction of two official interest rate increases next year.[32]

In a move to increase transparency, the RBA has begun to publish additional details on forecasts of key macroeconomic variables as at the November 2018 *Statement on Monetary Policy*.[33] Comparing these numbers with those in the December 2018 *Mid-Year Economic and Fiscal Outlook* (MYEFO) shows that the RBA was more optimistic than the Government about future GDP, consumption, exports and employment, but considerably less optimistic about forecast growth rates for dwelling and business investment, imports and the terms of trade.[34]

Governor Lowe has identified the following as areas to focus on in 2019:

- a slowing in global growth with the Governor expressing 'surprise at some of the reaction to the lowering of forecasts for global growth, which has been quite negative'
- the accumulation of downside risks including trade tensions between the US and China, Brexit, the rise of populism, and 'reduced support from the United States for the liberal order that has supported the international system and contributed to a broad-based rise in living standards'

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26. RBA, *Statement on Monetary Policy*, February 2019, p. 1.
27. Ibid.
28. P Lowe, 'The year ahead', address to the National Press Club, Sydney, 6 February 2019.
29. Ibid.
30. P Lowe, 'The housing market and the economy', speech, AFR Business Summit, Sydney, 6 March 2019.
31. D Hughes, 'Ubank's rate rise adds to RBA pressure', *Australian Financial Review*, 16 January 2019, p. 17.
32. D Plank, 'ANZ ditches forecast for RBA rate increases', *The Australian*, 14 March 2019, p. 21.
33. RBA, 'Forecast Table – November 2018', RBA website.
34. Commonwealth of Australia, *Mid-Year Economic and Fiscal Outlook 2018-19*, December 2018, p. 19.

- the outlook for domestic household spending, which is closely linked to the 'correction' in the housing market and the prospects for growth in household income (in turn linked to employment and higher wages growth).[35]

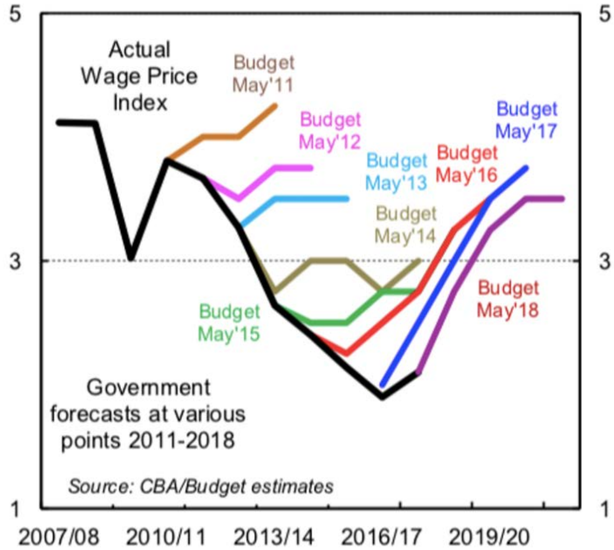
In a speech on Climate Change and the Economy by Deputy Governor Guy Debelle, he noted that 'the current drought has already reduced farm output by around 6 per cent and total GDP by about 0.15 per cent'.[36] He noted that the policy environment has a key effect, as well as the climatic environment, on the changed environment that the economy will need to adapt to. 'Both the impact of the [climate] shocks and the adjustment to those shocks affect the macroeconomic trajectory.'[37]

Low wage growth

Continuing low wage growth has been a concern of policymakers and the RBA for some time. The chart below (prepared by the Commonwealth Bank) illustrates how wage growth has fallen, rather than increased as forecast, in nearly every budget this decade.

The latest increase in the Wage Price Index, up 2.3 per cent over the year in the December 2018 quarter, has been attributed to (i) a 3.5 per cent increase in the minimum wage for award-reliant workers and (ii) an apparent acceleration of wage settlements in the (more highly unionised) public sector.[38]

Figure 1: Budget forecasts versus reality, wage growth 2007 to 2020



One recent study, *The Wages Crisis in Australia*, identifies several potential causes for the slowdown in wage growth:

- the decoupling of wage growth and labour productivity (due to technological change, globalisation)
- the increasing importance of the financial sector
- the weakening of workers' collective bargaining rights and drop in collective bargaining coverage and

35. P Lowe, 'The year ahead', address to the National Press Club, Sydney, 6 February 2019.
36. G Debelle, 'Climate Change and the Economy', speech, Public Forum hosted by the Centre for Policy Development, Sydney, 12 March 2019.
37. Ibid.
38. A Stewart, J Stanford and T Hardy, 'The five not-so-easy steps that would push wage growth higher', *The Conversation*, 29 November 2018.

- increasing female participation combined with gender pay inequity
- public sector austerity policies (including downsizing, caps on public sector wage growth)
- contracting out of social and community care services and
- increasing use of outsourcing and casual workers.[39]

The RBA Governor has cites both structural and cyclical causes for lower wage growth:

- a downward revision of the 'full employment' level of unemployment
- increasing underemployment (some part-time workers would like more hours)
- higher levels of workforce participation
- changes in the bargaining power of workers and
- a focus on cost control in an environment of uneven diffusion of technological progress.[40]

Falling house prices

According to the widely quoted CoreLogic Hedonic Home Value Index, home prices fell 4.8 per cent in 2018.[41] Housing values in in Sydney and Melbourne are predicted to fall 18-20 per cent from peak to trough in 2019.[42]

The RBA notes that the 'current correction in the housing market is a significant area of uncertainty' with implications for the broader economy depending on how households respond.[43] 'Our economy is going through an adjustment following the turn in the housing markets in our largest cities.'[44] The RBA Governor noted that:

> … unlike most other housing price corrections, this one has not been associated with rising unemployment or higher interest rates. Instead, mainly structural factors – relating to the underlying balance of supply and demand – in our largest cities have been at work. The question is: what effect will this change have on household spending?
>
> ... what we are seeing looks to be a manageable adjustment in the housing market. It is not expected to derail economic growth.[45]

The Governor points to a number of factors as justification for this argument:

- recent house price declines follow very large increases
- most households do not change their consumption in response to short-term changes in their wealth, but take a longer-term perspective
- household income growth is expected to pick up (albeit gradually) and 'income growth usually matters more for consumption than changes in wealth'.

However, he concludes:

> Even so, given the uncertainties, we are paying very close attention to how things evolve.[46]

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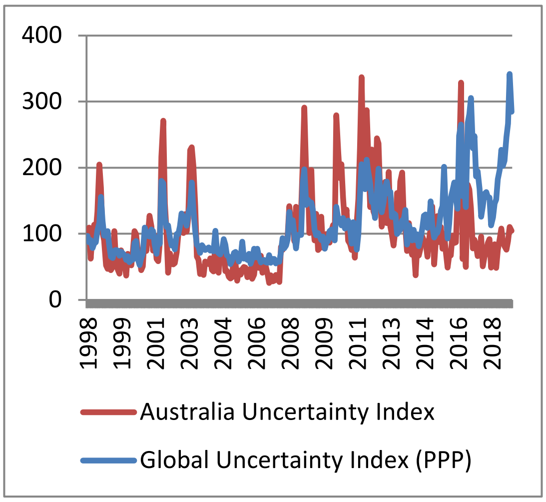
39. A Stewart, J Stanford and T Hardy (eds), *The Wages Crisis in Australia: What it is and what to do about it*, University of Adelaide Press, 2018.
40. P Lowe, 'Productivity, wages and prosperity', speech, address to the Australian Industry Group, Melbourne, 13 June 2018.
41. R Holden, 'Vital signs: so far, it's more of a house price blip than a bust in the making', *The Conversation*, 11 January 2019.
42. B Wilmot, 'Even rate cut can't stop housing meltdown', *The Australian*, 13 February 2019, p. 21.
43. RBA, *Statement on Monetary Policy*, February 2019, p. 3.
44. P Lowe, 'The year ahead', address to the National Press Club, Sydney, 6 February 2019.
45. Ibid.

Economic policy uncertainty

A team of US academics have devised a monthly index for Economic Policy Uncertainty. The index for Australia is shown in Figure 2, along with a measure of global uncertainty (a GDP-weighted average of national indices for 20 countries).[47] Although uncertainty has increased slightly in Australia over recent months, it is well below global values.

Another measure of economic risk gives Australia a score of 2.5 (low), ranking it 5 out of 164 countries.[48] Risk is unchanged from six months ago with downside risks related to: a correction in the domestic housing market affecting residential construction and consumer spending; China's shift to slower, more balanced growth; and a potential reversal of the recovery in commodity prices.

Figure 2: Economic policy uncertainty



Source: Economic Policy Uncertainty.

46. Ibid.
47. Economic Policy Uncertainty, accessed 12 February 2019. For Australia, this index is based on the number of articles in eight Australian newspapers containing the terms 'uncertain' or 'uncertainty', 'economic' or 'economy', and one or more policy-relevant terms: regulation, 'Reserve Bank of Australia', RBA, deficit, tax, taxation, taxes, parliament, senate, 'cash rate', legislation, tariff, war.
48. Oxford Economics, 'Country Economic Forecast – Australia', 12 March 2019.

International outlook

Table 2 summarises real GDP growth and inflation (CPI) data and forecasts for 2017 to 2021 for selected international economies, focusing on Australia's top two-way trading partners in 2016-17: China (23.8 per cent of total), Japan (9.3 per cent), United States (9.0 per cent), Republic of Korea (5.3 per cent) and the UK (3.7 per cent).[49] Key drivers and risks for each economy are also identified.

Table 2: Real GDP growth and inflation in selected international economies

	2017	2018	2019	2020	2021
World					
GDP growth	3.0	3.0	2.5	2.7	2.8
Inflation (CPI)	3.0	3.2	3.1	3.2	3.1
Drivers: consumer confidence higher than two to three years ago (US and Japan), strong labour markets (particularly in the US), lower oil prices, rising borrowing costs may curb investment					
Risks: escalation of US-China trade war, no-deal Brexit, weak and volatile financial markets, investment indicators weakening					
Australia					
GDP growth	2.4	2.8	2.2	2.7	3.0
Inflation (CPI)	1.9	1.9	1.6	2.0	2.3
Drivers: growth driven by exports (LNG and services) and business investment, low interest rates					
Risks: fall in commodity prices, correction in domestic housing market, high household debt, dependence on China, increasing trade policy tensions, slowing in capital spending (government investment reaching a peak with end of NBN rollout), weak consumer spending resulting from slow income growth					
China					
GDP growth	6.8	6.6	6.2	5.9	5.4
Inflation (CPI)	1.5	2.1	2.0	2.3	2.6
Drivers: expect government stimulus measures, modest improvement in household consumption, US-China trade war truce, easing financial and monetary policy					
Risks: uncertainty about trade conflict (fragile truce), slowing export growth, slowing investment, weaker domestic demand, continuing focus on growth may compromise reform program					
Japan					
GDP growth	1.9	0.8	0.7	0.3	1.0
Inflation (CPI)	0.5	1.0	0.9	1.2	0.7
Drivers: tight labour market boosting consumption, government stimulus measures to soften impact of tax rise, investment plans for large enterprises above long term averages, investment boost from 2020 Tokyo Olympics, 'no fiscal consolidation without economic revitalization', low interest rates					
Risks: 2018 growth affected by weather, weak export growth with slowing global trade, consumption tax hike in Q4 2019, equity volatility, declining working-age population, low productivity growth					

49. Department of Foreign Affairs and Trade (DFAT), '[Australia's trade in goods and services by top 15 partners 2016-17](#)', DFAT website.

	2017	2018	2019	2020	2021
United States					
GDP growth	2.2	2.9	2.3	1.8	1.8
Inflation (CPI)	2.1	2.4	1.6	2.0	2.0
Drivers: strong labour market fundamentals, rising earnings, strong consumer spending and confidence, resilient business activity, firming government outlays					
Risks: trade conflict with China, government shutdown, ongoing political uncertainty, increasing federal deficit, negotiations on debt limit ceiling, struggling housing activity, tightening financial conditions					
Republic of Korea					
GDP growth	3.1	2.7	2.3	2.4	2.6
Inflation (CPI)	1.9	1.5	1.2	2.1	2.1
Drivers: pick up in employment, front-loading of 2019 fiscal spending is expected to boost employment and investment in eight key innovative sectors, relatively fast pace of real labour earnings growth, subdued inflation, accommodative monetary policy					
Risks: slowing Chinese and global demand (for semiconductors and petrochemicals) affecting exports, weaker domestic demand, large rise in minimum wage, falling consumer confidence, high household debt					
United Kingdom					
GDP growth	1.8	1.4	1.4	2.0	2.1
Inflation (CPI)	2.7	2.5	1.9	1.7	1.6
Drivers: low inflation, looser fiscal policy, recovery in household spending					
Risks: 'disorderly' Brexit plus sterling depreciation (and poor productivity performance), protectionist trade policies slowing export growth, further cut in credit rating if public finance improvement stalls					
India					
GDP growth	6.6	7.3	7.1	7.0	6.9
Inflation (CPI)	3.3	3.9	4.2	5.4	5.4
Drivers: lower oil prices, more accommodative monetary conditions likely (new governor of RBI), smaller drag from net exports, reduced impact of demonetisation in November 2016 (estimated cost 1.5 per cent of GDP) and GST imposition (came into effect July 2017), Moody upgraded credit rating in 2017, unit labour costs among lowest in BRIC economies					
Risks: reduced lending ability of non-banking financial sector may affect overall credit availability and delay business investment plans, slowdown in private consumption, reform momentum (on land, labour, power and education) likely to slow as 2019 elections approach					
Eurozone					
GDP growth	2.5	1.8	1.3	1.5	1.4
Inflation (CPI)	1.5	1.8	1.3	1.5	1.6
Drivers: exports more resilient than expected in Q4 2018, ECB dovish, strong growth in output, confidence and private consumption in Spain, continuing growth in employment, easing inflation					
Risks: sharp slowdown in Germany, fall in manufacturing activity, weak services activity, weakness in forward-looking indicators, political risks, tensions in financial markets, weaker world trade (especially China), threat of US tariffs on European cars, political uncertainty and falling sentiment in Italy					

Source: Oxford Economics, *Global Data Workstation*, accessed 13 March 2019.

Global growth outlook

Concerns about global growth have increased in recent months, largely attributable to:

- recent financial market moves
- trade tensions between the US and China
- uncertainty surrounding Brexit
- the degree to which Chinese policymakers can fine-tune growth to prevent further economic weakness
- soft growth in the Eurozone, especially Germany and Italy and
- inflation-induced policy tightening and the phasing out of unconventional monetary policies which could trigger unintended liquidity shocks.

The January update of the IMF *World Economic Outlook* revised down estimates of global growth to 3.5 per cent in 2019 and 3.6 per cent in 2020 (0.2 and 0.1 percentage points below October projections).[50] This was attributed to 'softer momentum' in the second half of 2018 (particularly in Germany, Italy and France), weakening financial market sentiment and a deep contraction in Turkey. Potential triggers for deteriorating risk include escalating trade tensions, a no-deal Brexit and a 'greater-than-envisaged' slowdown in China.

> Across all economies, measures to boost potential output growth, enhance inclusiveness, and strengthen fiscal and financial buffers in an environment of high debt burdens and tighter financial conditions are imperatives.[51]

The Organisation for Economic Cooperation and Development *OECD Interim Economic Outlook* notes that global growth is weakening as 'some risks materialise'.[52] These risks include vulnerabilities in China, Europe and financial markets. Real world GDP growth estimates have been revised down (since November 2018) to 3.3 per cent in 2019 and 3.4 per cent in 2020. A decline of 2 per cent in domestic demand growth in China for two years is estimated to reduce world GDP growth by more than 0.5 per cent. Euro area growth could be hit by a weak UK economy as the uncertainty around Brexit continues.

However, RBA Governor Philip Lowe has stated that '… while some of the downside risks have increased, the central scenario for the world economy still looks to be supportive of growth in Australia'.[53]

These risks include trade tensions between the US and China, Brexit, the rise of populism, reduced support from the US for long-standing international agreements, and adjustments in China as the authorities aim to reduce shadow financing. If economic activity in China responds 'less vigorously' to recent fiscal and monetary policy measures, Chinese growth could be weaker than forecast.

An advanced economy monthly growth indicator—which summarises information from high-frequency data—fell in January, recording its sharpest monthly drop in seven months.[54] The leading indicator is a GDP-weighted average of 5-7 activity indicators for 20 advanced economies. The results suggest there is 'little sign yet of a rebound in growth momentum'. In levels terms, the index remained above the 2016 low point, suggesting a gradual loss of momentum in early 2019.

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50. IMF, *World Economic Outlook Update, January 2019*, January 2019.
51. Ibid.
52. Organisation for Economic Cooperation and Development (OECD), *OECD Interim Economic Outlook*, 6 March 2019.
53. P Lowe, 'The year ahead', address to the National Press Club, Sydney, 6 February 2019.
54. Oxford Economics, 'Research briefing – Global: No sign yet of the growth soft patch abating', 13 February 2019.

Financial market turbulence

In its latest *Quarterly Review*, the Bank for International Settlements (BIS) attributed recent financial market turbulence to 'a reminder of the narrow path that central banks are treading in their quest for policy normalisation, in a generally challenging policy environment.'[55]

> [U]ncertainty that surrounds the unprecedented monetary policy normalisation process no doubt makes markets more sensitive to such developments.[56]

In December 2018, BIS concluded that:

> … the market tensions we saw during this quarter were not an isolated event. As already noted on previous occasions, they represent just another stage in a journey that began several years ago. Faced with unprecedented initial conditions - extraordinarily low interest rates, bloated central bank balance sheets and high global indebtedness, both private and public - monetary policy normalisation was bound to be challenging especially in light of trade tensions and political uncertainty. The recent bump is likely to be just one in a series.[57]

High trade tensions

Trading partner growth is expected to remain around trend in 2019 and 2020 but trade tensions 'remain high' and escalation continues to be a significant risk.[58] As at 4 March 2019, trade talks between the US and China on tariff increases were still underway. Possible increases in US automotive tariffs or stricter quotas remain a concern, in particular for Germany and Japan. There is evidence that trade tensions are having adverse economic effects on trade and investment intentions, and are increasing uncertainty about the growth outlook for many economies.[59]

> The undulating prospects of trade talks with China and concomitant reactions in the markets provide a stark reminder that protectionist policies represent a major threat to the growth outlook.[60]

Bank of England calculations suggest that world GDP could fall by 2.5 per cent (over three years) following a 10 percentage point increase in tariffs between the US and all of its trading partners (assuming business confidence and financial conditions are also affected).[61]

By one estimate, a dramatic increase in trade policy tensions between the US and Asia could slow Australian growth to below 2 per cent in 2019 and 2020.[62]

Political and policy uncertainty

Political uncertainty could dampen the global growth outlook, particularly investment and consumption in the UK with Brexit uncertainty; social unrest in France with resulting policy changes; and increasing concerns about economic and fiscal policies in Italy.[63] Figure 2 (on page 11) makes clear the recent increase in global uncertainty.

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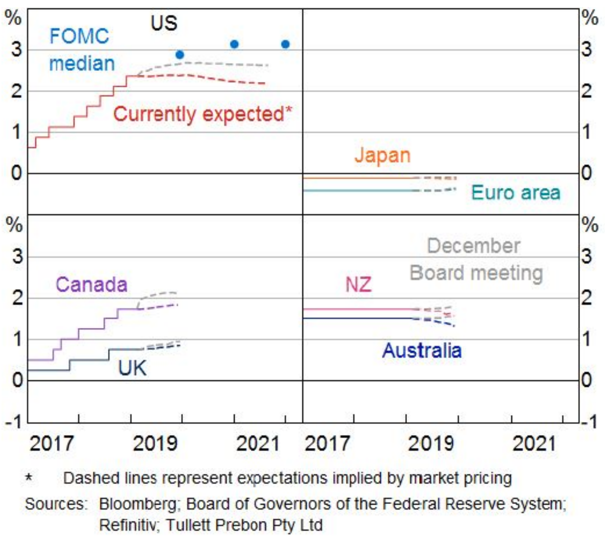
55. Bank for International Settlements, *BIS Quarterly Review: International banking and financial market developments*, December 2018, p. 1.
56. C Borio, 'BIS Quarterly Review, December 2018', media briefing, 16 December 2018.
57. Ibid.
58. RBA, *Statement on Monetary Policy*, February 2019.
59. Ibid.
60. Oxford Economics, 'Research commentary – US: macro musings', 8 February 2019.
61. M Carney, 'The Global Outlook', speech, London, 12 February 2019, pp. 17-18.
62. Oxford Economics, 'Country Economic Forecast – Australia', 12 March 2019.
63. RBA, *Statement on Monetary Policy*, February 2019.

Shifting monetary policy rate expectations

Policy rate expectations have shifted globally, particularly in the United States (see chart below). This has been attributed to reduced expectations for growth and inflation, increased concerns about downside risks and higher corporate risk premiums.[64]

Figure 3: Policy rate expectations



Source: C Kent, 'Financial conditions and the Australian dollar – recent developments', address to XE Breakfast Briefing, Melbourne, 15 February 2019. (The FOMC is the Federal Open Market Committee is the monetary policymaking body of the Federal Reserve System.)

In a speech on 12 February, Mark Carney, Governor of the Bank of England, noted that 'global momentum is now weakening in all major regions and downside risks have intensified'.[65] He attributed the deceleration to tighter financial conditions, rising trade tensions and growing policy uncertainty. In Monetary Policy Committee projections, 'the balance of headwinds to growth and more accommodative policies are expected to return global growth to around potential rates by the end of the year'.[66]

Moderating growth in the United States

The US Federal Reserve is expected to pause its tightening policy early in the year with rates not expected to rise until later in the year or even until 2020.[67] A partial US government shutdown and slowing global growth has added to the headwinds, but NAB estimates that while growth may move modestly below trend for a period, recession fears—at least in the short term—are overblown.[68]

Some concerns have been raised about the independence and legitimacy of the US Federal Reserve as it comes 'under fire' from President Trump.[69] Mr Trump publicly criticised the Federal Reserve for raising its benchmark interest rate.

> If the Fed's independence, or more likely its legitimacy, is compromised, other branches of government could leverage their newfound influence to ensure favourable short-term economic outcomes, resulting in higher risks of inflation and ineffective monetary policy in the future.[70]

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64. C Kent, 'Financial conditions and the Australian dollar – recent developments', address to XE Breakfast Briefing, Melbourne, 15 February 2019.
65. M Carney, 'The Global Outlook', speech, London, 12 February 2019, p. 2.
66. M Carney, 'The Global Outlook', speech, London, 12 February 2019, p. 8.
67. Oxford Economics, 'Global macro themes and asset views chartbook', January 2019; NAB, 'US Economic update', January 2019.
68. NAB, 'US Economic Update January 2019', January 2019.
69. Oxford Analytica, 'Weaker Fed legitimacy may harm US economic management', 25 October 2018.

The RBA expects growth in the US to moderate partly as the effects of recent fiscal stimulus begin to wane and as monetary policy becomes less accommodative. The US Government shutdown during December and January is expected to affect growth in the first part of 2019.[71]

The US accounted for 9.0 per cent of two-way trade with Australia in 2016-17. The impact on Australia of a US slowdown will also depend indirectly on the response by both the US and China to trade hostilities.

China slowdown

The slowdown in China is broad-based, across investment, consumption and exports. The trade conflict with the US remains 'a wild card' with underlying tensions between the US and China hanging over business activity and sentiment.[72] Weaker domestic demand, incremental policy easing and a decreasing current account surplus are expected to affect growth in the short term.

Household debt levels are elevated by emerging market economy standards, but China's overall private debt ratio stopped rising last year in response to official action to curb shadow banking. A controlled deceleration in growth is more likely.[73]

China recently announced additional stimulus measures to support its economy:

> While exact details of the stimulus package are yet to be unveiled, the Chinese finance ministry suggested the measures would include cutting value added tax for some companies, particularly in the manufacturing sector, as well as rebates for other businesses to ward off a more damaging slowdown. Some estimates we have seen this morning suggest the fiscal stimulus could be worth in the order of 1% of GDP.[74]

A recent academic study on the impact of China's slowdown on Australia's growth concluded that the effect on Australia of a permanent fall in China's growth rate from 10 per cent to annum to 7 per cent per annum would be to reduce Australia's growth rate by about 0.2 percentage points in the short run and approximately 0.5 percentage points in the long run.[75]

Brexit uncertainty

There is still considerable uncertainty around Brexit. On 25 November 2018, UK and EU leaders approved the text of a treaty-level Withdrawal Agreement and political declaration on the future EU-UK relationship. The Withdrawal Agreement includes a transition period running from 29 March 2019 to 31 December 2020, with the possibility of a one or two-year extension. However, this Withdrawal Agreement has, to date, been rejected (twice) by Parliament.[76]

Uncertainty over Brexit has fueled global economic uncertainty, leading to consumers cutting back on spending, businesses streamlining, closing or relocating, and financial markets demanding greater risk premia to lend. Brexit will not allow the UK to benefit from the terms of any free trade agreement between the EU and Australia. And negotiations for a separate UK-Australia agreement

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70. Ibid.
71. RBA, *Statement on Monetary Policy*, February 2019.
72. Oxford Economics, 'Country Economic Forecast: China', 30 January 2019.
73. Ibid.
74. NAB, 'Markets today: Brexit vote defeat, confidence vote and a Sterling hit', Global Markets Research, 16 January 2019.
75. N Groenewold, 'China's 'New Normal': how will China's growth slowdown affect Australia's growth?', Australian Economic Papers, vol. 57(4), December 2018, pp. 435-445.
76. On 13 March 2019, MPs voted against a 'no deal' scenario (one where the UK leaves the EU and becomes a third country on 29 March 2019 without a Withdrawal Agreement). On 14 March, MPs voted to ask the EU for a delay to Brexit (by at least three months), which requires the approval of all 27 EU member states. Prime Minister May has announced that she will be putting her Brexit deal up for another vote by 20 March.

can only start after Brexit is formalised.[77] After the initial impact on financial markets following the Brexit vote in 2016, the economic impact of a 'no-deal' Brexit is most likely to affect Australia through the UK's contribution to global economic growth.

Global risks

According to one survey, business gloom about the global economy has continued to increase, with more businesses judging that the probability of a sharp slowdown has increased over the past few months than at any time since the start of the survey three years ago.[78] Around 70 per cent of respondents think that the probability of a sharp slowdown has increased, with trade concerns dominating in the short term. A key emerging downside risk is perceived to be the Chinese economy. Over the next five years, protectionism is viewed as a significant risk, along with a hard landing in China, the global rise of populism and a break-up of the EU. Short-term upside risks include a dissipation of trade war fears, strengthening emerging market economies, delayed Federal Reserve tightening and falling oil prices.[79]

The impact on Australia of a US-led trade war—which has a significant negative impact on China and the rest of the Asia-Pacific region—has been estimated to slow GDP growth to around 1.0 per cent in 2020.[80] There is likely to be a more limited impact on the Australian economy from faster Federal Reserve tightening and a no-deal Brexit.[81]

As at January 2019, the Economist Intelligence Unit (EIU) negative global risk scenarios included:

- a US-China trade conflict turning into a full-blown global trade war (moderate risk, very high impact)
- supply shortages leading to a globally damaging oil-price spike (moderate risk, high impact)
- faster than expected US monetary tightening triggering a global slowdown (low risk, very high impact)
- a disorderly and prolonged economic downturn in China (low risk, very high impact)
- a major military confrontation on the Korean peninsula (low risk, very high impact)
- proxy conflicts in the Middle East disrupting global energy markets (moderate risk, moderate impact)
- cyber-attacks and data integrity concerns (moderate risk, moderate impact)
- territorial disputes in the South China Sea leading to an outbreak of hostilities (low risk, high impact)
- political gridlock leading to a disorderly no-deal Brexit (very low risk, low impact).[82]

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77. G Suder, '[Why wait for the Brexit fog to clear? Australian, British and multinational businesses are moving on](#)', *The Conversation*, 13 March 2019.
78. Oxford Economics, 'Research briefing – global: Oxford Economics Global Risk Survey: Q1 2019', 8 February 2019.
79. Ibid.
80. Ibid.
81. Ibid.
82. Economist Intelligence Unit, 'World Risk: Alert – global risk scenarios', 23 January 2019.