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Research Briefing | Australia

Key calls for 2018

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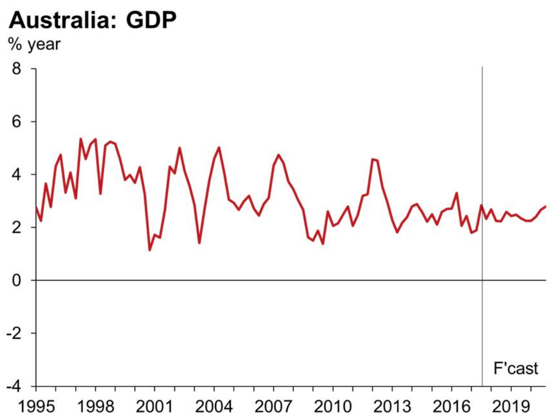
- **2017 was a mixed bag for Australia's economy. As we start 2018, we are forecasting more of the same – we expect a steady, rather than spectacular, year for the economy. Our key forecast calls are i) GDP growth will accelerate modestly, to around 2.5% y/y, ii) the unemployment rate will hold steady and real wage growth will remain very weak, iii) the RBA will keep the cash rate at 1.5% and iv) the AUD will weaken modestly from its current levels, to around 75 US cents.**

We only see a modest acceleration in GDP growth this year...

Despite a few bright spots Australia's economy underperformed in 2017. We estimate that GDP grew by just 2.2%, held back by weakness in household income and consumer spending growth, the ongoing decline in mining investment (which weighed down business investment) and a somewhat rocky start to the year for exports[1]. We expect 2018 to be better, but not by much – we are forecasting growth of 2.5% for this calendar year.

Chart 1



Source: BIS Oxford Economics

Domestic headwinds will limit the acceleration in GDP growth this year

The ramping up of LNG production and exports and the favourable global environment will drive exports, with net exports forecast to contribute 0.7%pts to growth. But growth in domestic demand will be subdued. After a spectacular 2017 growth in new government infrastructure investment is set to fall back, to around 1.7% y/y, and with further falls in mining capex set to come from the end of the LNG investment phase, new business investment is forecast to grow by just 2.3%. And we expect the residential construction cycle to turn down, with housing taking a pause to absorb new capacity and adjust to the fall in investor activity.

[1] The volume of resource exports unexpectedly dipped down in Q1, with both iron ore and coal falling, with coal sales then disrupted by the impact of Cyclone Debbie in March/April.

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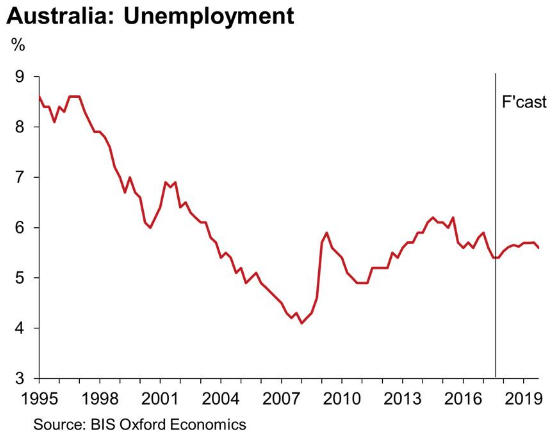
Households will also continue to struggle; spare capacity in the labour market will limit wages growth, non-wage income is being held down by low interest rates and falling property rental yields, and higher levels of indebtedness are weighing on spending power.

...which will dampen momentum in the labour market...

Jobs growth surprised on the upside in 2017, with the economy adding an impressive 380,000 jobs between November 2016 and November 2017. With the labour force able to sustainably grow by around 180,000 people pa this pace can't be maintained for an extended period. Furthermore, the labour market has run significantly ahead of output, with employment increasing 3.2% while the economy grew by just 2.2% in 2017. And with domestic demand held back by significant headwinds this year, we expect jobs growth to slow sharply, to around 140,000pa (+1.2%y/y) by the end of 2018. As a result we do not expect the unemployment rate to fall further, indeed it could drift up to around 5.6% by the start of 2019.

Chart 2

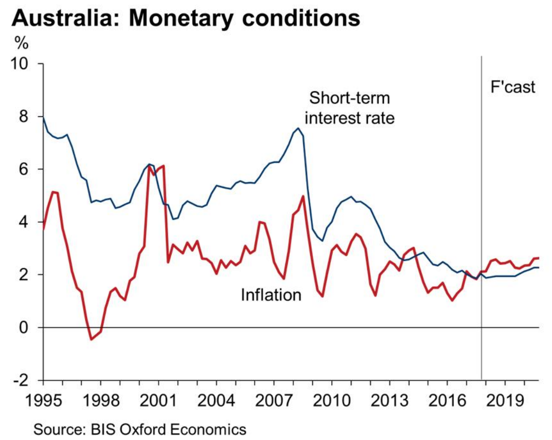


Pace of jobs growth is forecast to slow sharply, which will put the brakes on further falls in the unemployment rate

...and keep the RBA on hold

Although rate normalisation has begun in the US, UK and Canada, we expect the RBA to stay on hold until the end of 2019. The Board are facing near-term weakness in domestic demand and continued sluggish wage growth, which will result in GDP growth undershooting productive potential and core inflation remaining around 2%. Against this backdrop, loose monetary policy is needed to support the economy[2], and we expect the cash rate to remain at 1.5%.

Chart 3



Sluggish demand and core inflation stuck around 2% will keep the RBA on hold until 2019.

[2] The RBA and APRA have both highlighted that low interest rates have stoked the housing market, resulting in household debt levels rising to unprecedented levels. The authorities are taking steps to tackle this by tightening up lending rules for banks, and when it begins we expect monetary policy normalization to be slow and steady, to allow households to adjust to higher interest rates.

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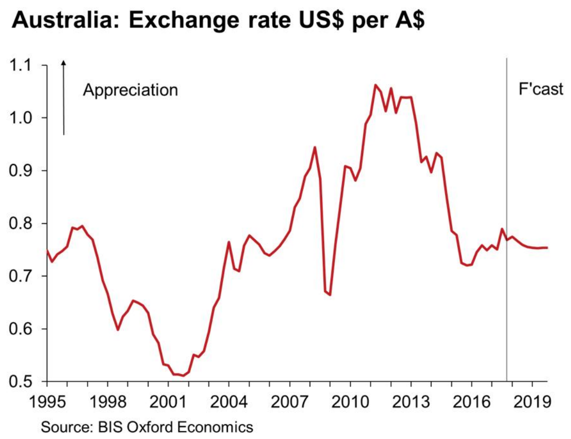
Modest softening seen in the AUD

The Australian dollar displayed its usual volatility in 2017, starting the year at below US73 cents, then rising and peaking above US81 cents in September, before drifting back to US75 cents in early December. The AUD finished 2017 at US78 cents, driven up in the last few weeks of the year by rises in key commodity prices. Moving through 2018, we expect this position to gently unwind. Iron ore and coal prices are expected to fall, with supply increases from major producers (including Australia) coming together with slower demand growth for both commodities. Coupled with this, our current macroeconomic outlook is significantly below consensus (2.5% v. 2.8%, Consensus Economics December 2017 survey), and we expect market sentiment to move against Australia as the economy underperforms current expectations and it becomes clear that the RBA won't be raising rates in the near term (in contrast to the US, where we expect to see three rate rises this year). As a result, we expect to see the AUD drift down towards 75 US cents per dollar as we move through 2018.

Chart 4



Softer commodity prices and shifting market sentiment are expected to push the AUD down as we move through 2018.

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