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Gradual and slow improvement forecast for economy... RBA expected to stay on hold for longer

RESULTS OF ANNUAL SURVEY OF ABE EXECUTIVE COMMITTEE

The results of this survey will be discussed at our conference to be held Thursday November 21 from 7:30 am 'til noon at the Four Seasons Sydney, 199 George Street, The Rocks. For detail see abe.org.au > events. For detail of Executive Committee membership, see page 6.

ABE presents a media conference to discuss the survey, findings and forecasts on Thursday November 21 at 12 noon in The Gallery at the Four Seasons Sydney, 199 George Street, The Rocks. All media welcome.

For further information contact: Tony Westmore 0419 256 339 OR Besa Deda 0404 844 817

Stephen Halmarick, Chairman, Australian Business Economists, commented:

I am pleased to release the annual survey of financial and macroeconomic forecasts made by members of the Executive Committee of Australian Business Economists (ABE). Please note that some members were unable to contribute to the survey due to their positions in the public sector.

Highlights of the Annual Survey of the ABE Executive Committee

- The Committee expects **Australian economic growth to improve modestly in 2014**, as the effects from lower interest rates continue to flow through to the economy. From an estimated growth rate of 2.5% in 2013, the median forecast is for GDP growth to rise to 2.9% in 2014, before strengthening modestly again in 2015 to 3.0%. **Despite the forecast improvement over the next two years, the pace of GDP growth is forecast to remain below trend.**
- **GDP growth is expected to be driven by robust growth in dwelling investment and net exports next year. The range of forecasts for GDP next year from the Committee is wide**, ranging from just 2.1% growth to as much as 4.0%. This broad range reflects the uncertain impact on the economy from the relatively high level of the Australian dollar (AUD) and the flow-through effect on spending from improved confidence. A significant lift in the non-mining segment of the economy is required to deliver a growth rate at the higher end of the forecast range.
- **Dwelling investment is forecast to increase by 5.7% in 2014 and 4.8% in 2015.** Low interest rates, robust population growth and underlying pent-up demand are expected to continue to underpin the upswing in dwelling investment.
- The mining investment phase is fading and the next stage - the export phase - is kicking in. This is reflected in the strong rates of growth the Committee is forecasting for exports.

Import growth is not expected to keep pace with exports, due to a softer profile for the AUD and a decline in capital imports growth. So, **a firm contribution to economic growth from net exports of 1.5 percentage points is expected next year and of 1.3 percentage points in 2015.**

- **Household consumption is forecast to pick up in 2014, from an estimated growth rate of 2.1% in 2013 to 2.7% in 2014.** Consumers are still shackled by prudence, although in recent months there have been some encouraging signs of a loosening of these shackles. These signs include improved levels in both consumer confidence and risk appetites. Low interest rates should also help boost household consumption. Further, households' balance sheets have strengthened and household wealth has improved.
- **The trade account will have a strong influence on the current account. The current account deficit (CAD) as a proportion of GDP is expected to improve modestly next year and in 2015.** The median forecast is for the CAD to be just 2.1% of GDP at the end of the forecast period, an improvement from an expected 2.4% in 2013.
- **The Australian economy has benefitted considerably from a high terms-of-trade over much of the past decade, particularly during the global financial crisis. But the terms of trade peaked in the September quarter of 2011. Moreover, the Committee forecasts a sharp fall in the terms of trade of 4.4% in 2014, followed by another predicted fall of a similar size in 2015.** These falls mean the economy will experience a net transfer of income to the rest of the world.
- **The Committee expects employment growth to remain relatively modest next year.** Jobs growth in 2014 is expected to stay at 1.1%, the same rate expected in 2013. It is forecast to improve slightly to 1.2% in 2015. There is broad agreement that sub-trend economic activity is a key driver behind the soft outlook for jobs.
- **The unemployment rate is expected to edge slightly higher, finishing the year in 2014 at 5.9% compared with 5.8% expected at the end of 2013. In 2015, the unemployment rate is expected to edge back to 5.8% by the end of the year.** There were a wide range of estimates for next year from the Committee: 5.7% to 6.6%. In 2015 the range of forecasts from the Committee is 5.5%-6.5%. A lower participation rate is expected to help cap the rise in the unemployment rate amid modest jobs growth.
- **With the unemployment rate showing little improvement next year, the growth of the labour cost index is expected to remain restrained and within the RBA's unofficial line in the sand of 4.5%. The Committee estimates the labour cost index to grow by 3.1% next year and by 3.2% in 2015.** If wages grow at these estimates, it would not provide any significant pressure on inflation.
- **Headline inflation is forecast to hug close to the middle of the RBA's 2%-3% per annum target band next year and the year after.** Meanwhile, underlying inflation is not. The Committee expects the RBA to be on hold for an extended period. The median forecast is for the cash rate to remain at 2.50% by the end of next year. The range of forecasts is more revealing than the median expectation. Among the Committee members, the range of forecasts for the cash rate for the end of next year is 2% to 3%.
- **The Federal Government's headline budget deficit is expected to rise over the forecast period, according to the median forecast of the Committee.** The improvement in the Government's bottom line should result in the deficit of \$37.7 billion in 2013-14 and a narrowing to a deficit of \$27.5 billion for 2014-15.
- **The 3-year/10-year bond yield curve is forecast to flatten to 80bp by the end of next year, from its expected closing level of around 100bp at the end of December 2013.** The flattening is due to the 3-year bond yield rising at a faster rate (from 3.1% to 3.8%) than the 10-year bond yield (from 4.1% to 4.6%) over the reference period. The lift in the

yield at the shorter-end of the curve is consistent with the Committee's expectation that the RBA is near or at the end of its easing cycle.

- **The Australian dollar is forecast to end 2013 at US\$0.9500 and then depreciate moderately to end next year at \$US0.8800.** The range of forecasts is, however, a very wide \$US0.8200-\$US0.9400. The softer profile is consistent with the moderation expected by the Committee in Australia's terms of trade.
- **The ASX200 share market index is forecast to be 1.2% higher by the middle of next year, from the 5,275 level the Committee expects the ASX 200 index to be at the end this year.** The high end of the forecasts includes the ASX 200 reaching the 6,000 level in 2014; the ASX 200 has not broken above this critical psychological level since 10th January 2008.
- The Committee was also asked to provide their **long-term forecasts for the economy.** The median forecast for GDP in 2018 was 3.0%, a little under the long-term trend rate for the economy. The unemployment rate is expected to be at 5.0% at the end of 2018 and the cash rate at 4.25%. Meanwhile, headline and underlying inflation were expected to grow by 2.50%, on average, in 2018. Finally, at the end of 2018 the Australian dollar was expected to be at \$US0.8500 and the ASX 200 index at 6,500.

This year the Committee was also asked a number of special questions around both the local and global economic outlook.

- **Most Committee members believed that the global economy was in recovery but in the slow lane and not without risk factors to watch.** The recovery is also expected to follow a path that is unlikely to be smooth. Most Committee members noted that tail risks had eased but not disappeared. **The banking system in Europe was the most commonly highlighted potential source of risk.** Another risk factor frequently noted was the impact from an unwinding of quantitative easing in the US. However, there were also concerns stemming from the potential for key central banks around the world to keep rates low for too long. China was not off the risk radar. Risks for China were seen to stem from the potential for "heavy handedness" with regards to credit.
- **The Committee widely expects the US Federal Reserve to cut back on its \$US85n-per-month bond-buying program.** The question came down to when. The widely favoured date among the Committee was **March 2014** with the entire quantitative easing program to be phased out within one year. Only one Committee member expected the Fed to wait until 2015 to begin tapering. A few Committee members did not rule out a December 2013 move, but factors such as end-of-year liquidity issues and a change in the Fed Chair position were seen as complicating a move before March 2014. There was a divergence in the Committee on the size of the initial taper. It varied from \$US5bn-\$US25bn. The median sat at \$US10bn.
- **Most Committee members expect China to grow between 7%-7.2% next year.** Chinese policymakers remain committed to reforms, which are expected by the Committee to produce slower output growth while growth rebalances from investment towards consumption. The range of forecasts from the Committee was 7%-8.5%.
- **The bulk of the Committee expects the government to return the budget to surplus in 2017/18. Risks to Australia's AAA sovereign rating in the near term were viewed as small** because of Australia's comparatively low level of public debt and the Government's stated intention to move back to surplus. The Committee is hopeful that the Commission of Audit provides the background for starting some necessary reforms to address the longer-term budgetary position. Other steps in the right direction identified by Committee members included raising the rate of GST, widening the base of the GST, identifying savings through targeted welfare payments to those that need it and reviewing the appropriateness of large industry assistance packages to the private sector.

- **The Committee viewed infrastructure spending as an important source of growth for the Australian economy in the medium to long-term.** It highlighted the possibility of some catch up in public infrastructure spending because there has been a degree of underinvestment in infrastructure by the States over an extended period. Moreover, in recent years there has arguably been some crowding out of public investment by strong private investment. The Committee saw **some scope for infrastructure spending to be used as a part of counter-cyclical fiscal policy.** However, the Committee cautioned that such an approach could compromise the quality of possible projects. Further, the long-lead time involved means using infrastructure in this way (in practice) could be difficult.
- **The Committee did not predict Australia would experience the debt-purging downturn that the US and Europe experienced in housing after the GFC.** Some Committee members noted that Australian house prices have rebounded strongly, partly in response to the RBA's rate cuts. But relative to income, house prices have been broadly flat for a number of years. It was further noted that Australian households have not deleveraged like those elsewhere but comparisons can be deceiving. Australian household also have a large amount of pre-payments locked away as a mortgage buffer.
- **On the question of adopting quantitative controls to cool growth in housing prices, the Committee believes there is reluctance from policymakers to go down this road.** This reluctance is seen to stem from concerns that intervention can cause other distortions in the housing market. It is also on the grounds that caps on LVRs have a disproportionate effect on first-home buyers; to affect existing home buyers trading up the cap would have to be set very low, and that would squeeze out first-home buyers. Also, there are concerns that while these measures limit the increase in arrears rates when house prices fall sharply, there is little evidence from offshore to suggest that they actually prevent boom-bust cycles in housing. The Committee feels more focus should be applied to improving the supply side of the housing equation.
- The Committee views the **AUD as playing a critical role in rebalancing growth now that mining investment is falling.** The Committee expects the AUD to depreciate over the next year. The survey responses also noted that the debate ignores the fact that just over 70% of exporters simultaneously import, so any notion of a Gregory effect in Australia were ill founded.
- **Lack of confidence, uncertainty in the economy and until recently the political landscape was identified as important factors behind the weakness in private investment outside of mining.** The relatively high AUD was also viewed to have played a role. Lack of financing opportunities was not generally seen to be an issue in constraining non-mining investment.
- **It was a widely held belief among Committee members that the unemployment rate has not yet peaked. Most Committee members expected the peak to occur next year. The range of forecasts for the peak is 5.9% to 6.7%. The median is 6.0%.** There was greater dispersion in the survey replies around the timing of the peak in the jobless rate, but the median sits around the middle of next year. A meaningful improvement in the unemployment rate was largely not expected until 2015. Many members noted that there was a recent moderation in the rate of deterioration across a number of labour-market leading indicators. However, the Committee viewed this recent improvement in the leading indicators with caution due to the sluggish state of domestic demand and the less labour-intensive nature of the next phase of the resource cycle. Committee members also highlighted the trend in the participation rate, which has been moving lower, and is helping temper the rise in the unemployment rate.

- **Most members in the Committee did not expect the RBA to cut the cash rate any further. Most Committee members also did not anticipate a quick turnaround in the monetary-policy cycle.** The general consensus was that official interest rates would remain low for longer because of factors that included sub-trend growth and a benign inflation environment. The earliest timing for a rate hike from the Committee was Q3 2014, while the latest time for the start of a tightening cycle was late 2016. **The median expectation for the first rate hike was the first half of 2015.**

Table 1: ABE Survey of the Exexecutive Committee, Summary

All forecast variables are annual average % change unless otherwise stated

| | 2012 | 2013 (e) | 2014 (f) | | 2015 (f) | | | | |
|------------------------------------|---------------|-----------------|-------------------|-------------------|-----------------|-------------------|---------------|---------|------|
| | <i>Actual</i> | <i>Median</i> | Median | Low | High | Median | Low | High | |
| National Accounts | | | | | | | | | |
| Private Consumption | 3.2 | 2.1 | 2.7 | 2.1 | 4.0 | 3.1 | 2.5 | 3.7 | |
| Dwelling Investment | -3.7 | 4.0 | 5.7 | 1.1 | 10.8 | 4.8 | 2.2 | 7.3 | |
| Business Investment* | 15.4 | 0.1 | -3.7 | -13.7 | -0.1 | -2.5 | -10.3 | 0.0 | |
| Inventory (ppt contribution) | 0.0 | -0.4 | 0.1 | -0.2 | 0.3 | 0.0 | 0.0 | 0.2 | |
| Exports | 5.8 | 6.6 | 6.6 | 5.9 | 10.1 | 7.1 | 4.5 | 11.2 | |
| Imports | 6.3 | -1.6 | 3.0 | -2.5 | 7.7 | 3.3 | -4.6 | 6.5 | |
| Net Export (ppt contribution) | -0.1 | 1.7 | 1.5 | 0.3 | 2.4 | 1.3 | 0.7 | 2.5 | |
| GDP | 3.7 | 2.5 | 2.9 | 2.1 | 3.7 | 3.0 | 2.9 | 3.6 | |
| Labour and Inflation | | | | | | | | | |
| Employment | 1.1 | 1.1 | 1.1 | 0.3 | 1.6 | 1.2 | 0.9 | 1.8 | |
| Unemployment Rate (end period) | 5.4 | 5.8 | 5.9 | 5.7 | 6.6 | 5.8 | 5.5 | 6.5 | |
| Labour Price Index | 3.6 | 3.0 | 3.1 | 2.5 | 3.5 | 3.2 | 3.0 | 3.7 | |
| Headline CPI | 1.8 | 2.4 | 2.5 | 2.2 | 3.3 | 2.5 | 2.1 | 2.9 | |
| Underlying CPI | 2.3 | 2.3 | 2.5 | 2.2 | 2.7 | 2.4 | 2.1 | 2.8 | |
| Other | | | | | | | | | |
| Terms of Trade | -10.4 | -2.3 | -4.4 | -8.0 | -0.8 | -4.4 | -8.1 | -0.5 | |
| Current Account Deficit (% of GDP) | -3.7 | -2.4 | -2.2 | -3.3 | 2.0 | -2.1 | -4.4 | 0.3 | |
| Headline Cash Budget (\$Abn)** | -47.0 | -21.0 | -37.7 | -36.5 | -50.0 | -27.5 | -19.4 | -40.0 | |
| | | | Dec-13 (f) | Jun-14 (f) | | Dec-14 (f) | | | |
| | | | Median | Median | Low | High | Median | Low | High |
| Financial (all end period) | | | | | | | | | |
| Cash Rate | 3.0 | 2.50 | 2.50 | 2.00 | 2.50 | 2.50 | 2.00 | 3.00 | |
| 3-Year Government Bond Yield | 2.67 | 3.10 | 3.30 | 2.95 | 3.70 | 3.80 | 3.40 | 4.00 | |
| 10-Year Government Bond Yield | 3.27 | 4.08 | 4.38 | 4.20 | 4.70 | 4.55 | 4.25 | 5.20 | |
| AUD/USD | 1.0378 | 0.9500 | 0.9050 | 0.8500 | 0.9500 | 0.8800 | 0.8200 | 0.9400 | |
| ASX 200 | 4,649.0 | 5,275.0 | 5,337.5 | 4,800.0 | 5,600.0 | 5,571.0 | 5,500.0 | 6,000.0 | |
| | | | 2018 (f) | | | | | | |
| | | | Median | | | | | | |
| Longer-Term Outlook | | | | | | | | | |
| GDP | | | 3.0 | | | | | | |
| Unemployment Rate (end period) | | | 5.0 | | | | | | |
| Headline CPI | | | 2.5 | | | | | | |
| Underlying CPI | | | 2.5 | | | | | | |
| Cash Rate (end period) | | | 4.25 | | | | | | |
| AUD/USD (end period) | | | 0.8500 | | | | | | |
| ASX 200 (end period) | | | 6,500.0 | | | | | | |

* Excluding second-hand purchases

** Financial year (2013 is 2012/13 and so on)

ABE Executive Committee 2013

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Secretary

Mr Warren Hogan Chief Economist, ANZ

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|----------------------------|---|
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| Mr Geoff Weir | Managing Director, Financial Sector Services Pty Ltd |

Australian Business Economists ABN 60 959 647 104

PO Box 7267 Bondi Beach 2026 Australia

tel: 0419 256 339 fax: 02 9365 6067

email: info@abe.org.au web: abe.org.au

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