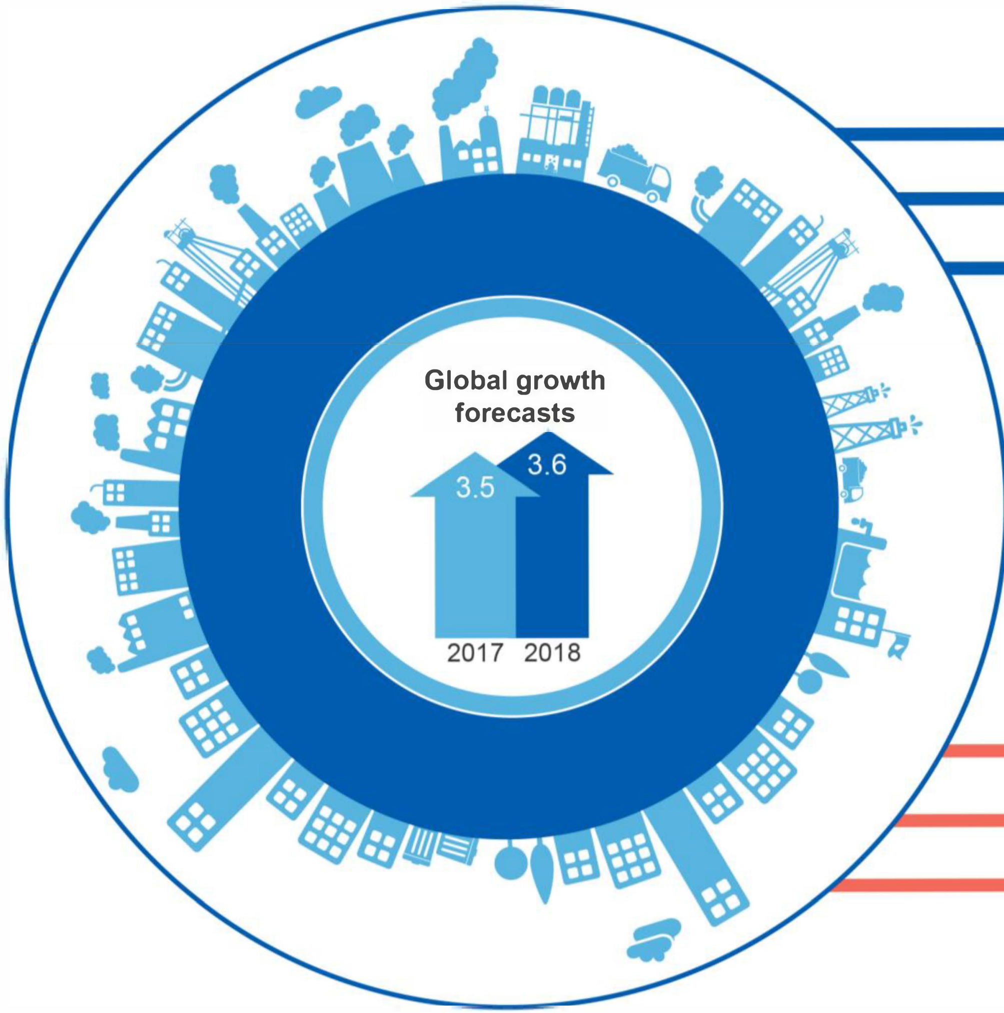
Macroeconomic outlook

Resources and Energy Quarterly June 2017



Key drivers

Manufacturing conditions remain firm

Surveys of manufacturing activity indicate positive outlook

Industrial production **up 3.3 per cent** in April 2017 (year-on-year growth)

PMIs (Purchasing Managers Indicies) are expansionary

Trade volumes are increasing

Increased **3.4 per cent** in April 2017 (year-on-year growth)

Low interest rates around the world

Key risks

Sharper than expected **slowdown in China**

Inflation spill overs in the US from faster than expected interest rate rises

Low productivity and wage growth

Global outlook

The March 2017 *Resources and Energy Quarterly* noted early signs of a broadening pick up in the global economy. Conditions in the June quarter 2017 reflected a continuation of this recovery, with the growth outlook for several countries being upgraded. Global growth is forecast to reach 3.5 per cent in 2017, and 3.6 per cent in 2018, up from 3.1 per cent in 2016.

Improvements in the global outlook have been primarily driven by ongoing relatively loose monetary conditions, low energy prices, and a steady recovery in business confidence. Surveys monitoring the global manufacturing sector such as the world Purchasing Manager's Index (PMI) appear to have topped out but remain strong. The performance of the Eurozone — Germany in particular — improved, with manufacturing conditions at a six-year high.

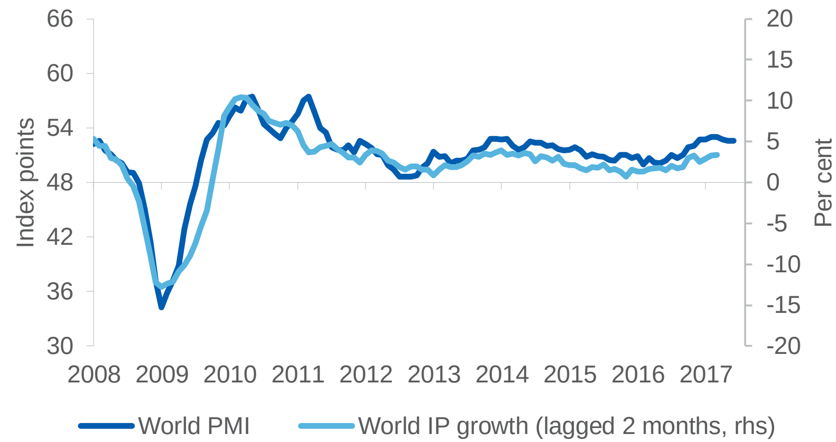
Despite positive outlooks for short term growth, there remain several risks to global growth in the medium/long term. Low productivity growth continues to plague many advanced economies, creating a drag on wage growth and weak demand.

There are other risks to the medium-term outlook. A faster-than-expected pace of US interest rate rises could result in a strong appreciation of the US dollar, which would have significant flow-on effects for many countries' debt repayments. Any significant US fiscal stimulus would potentially add to demand; given that the US economy is already close to full employment, this would add to inflationary pressures, putting pressure on the US Federal Reserve to raise rates. The 19th National Congress of Communist Party of China in November will be important for the medium term direction of the Chinese economy. A delicate balance needs to be set between economic growth and financial stability ensuring high growth figures does not come at the expense of necessary structural reforms.

China

Indicators of China's "old economy" of export and investment-led growth showed some weakness in recent months. This suggests a gradual slowing of the economy, as the transition towards consumption-led growth continues. Despite the recent weakness, growth in industrial production remains above the trend of the past two years. Manufacturing conditions also indicate expansionary conditions in the sector.

Figure 2.1: Industrial production growth vs world PMI, YoY growth



Source: Netherland CPB (2017) World Trade Monitor April; Markit (2017) JP Morgan Global Manufacturing PMI

Growth in house prices has eased from the rapid rate seen in late 2016. However, investment in real estate is firm, with a year-on-year rise of 8.8 per cent in May. Slower price growth has not impacted construction activity, with new residential construction starts rising by 8.4 per cent in May. This is likely fuelled by new developments being undertaken to reduce undersupply in major cities.

In the short term, Chinese real GDP growth is expected to ease modestly, to 6.6 per cent in 2017 and 6.2 per cent in 2018. Growing concerns over China's reliance on debt-financed investment represent the main risk to the medium term outlook. In a recent statement to the IMF Monetary and Financial Committee, the Governor of the People's Bank of China reiterated that China will undertake "prudent and neutral" monetary policy. Large injections of support will be avoided, and more efforts will be made to deleverage the economy to reduce the ratio of debt to GDP.

In Beijing, banks are taking more time to assess mortgage applications, and in some cases are ceasing to grant mortgage loans altogether. The central bank is also continuing to increase interbank interest rates, in an effort to temper asset price rises.

Although the future outlook for China remains relatively positive, an absence of additional stimulus could see growth slowing in the second half of 2017. Given that China is the world's largest consumer of raw materials, this suggests lower growth in global demand for commodities, particularly industrial metals. In May, China hosted a summit to promote their One Belt One Road Initiative — an infrastructure program aimed to link China with a broad range of countries across continents to encourage better trade links. Although Australia is not part of the initiative, the push for infrastructure development across countries could increase demand for Australia commodities.

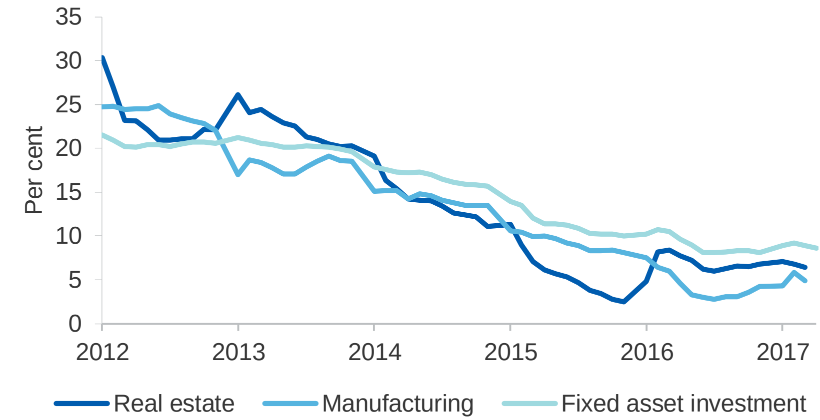
United States

US real GDP growth was weak in the March quarter (1.4 per cent annualised rate), however, growth was constrained by temporary factors including unseasonably warm weather — which limited spending on utilities. Strong consumption growth and falling unemployment continue to drive a positive near term outlook. A strong growth outlook for the US will help improve the outlook for the global economy. Business confidence has also picked up, amidst expectations of increased government spending in the future. The unemployment rate is also falling, and initial jobless claims data point to further falls in the unemployment rate in the short term.

Further expectations of an improvement in the US economy are reflected in US bond yields. Yields have risen significantly since the November 2016 election, suggesting the market is expecting inflation to pick up. Following the rise in the Federal Funds Rate in June, another rate rise is likely in late 2017, with three more expected during 2018.

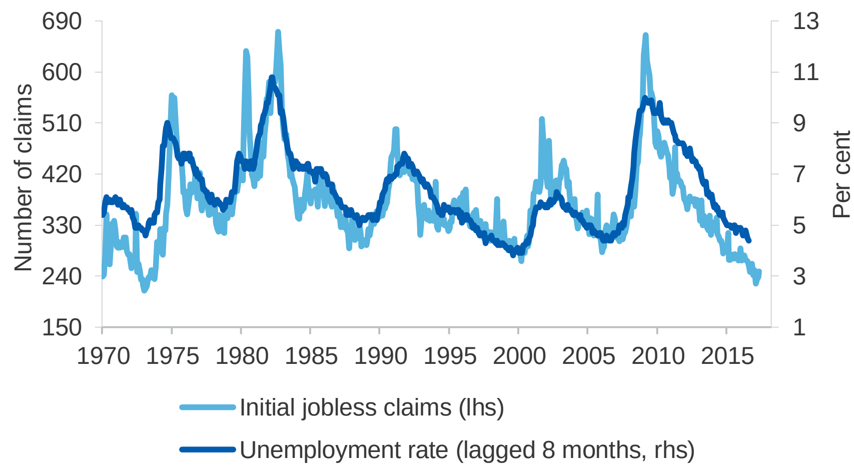
US economic growth is expected to be 2.1 per cent in 2017 and 2018. The Federal Budget, released in May, indicated there would be fiscal support in the form of tax cuts, but made little mention of the proposed infrastructure spend which dominated the presidential election campaign. Tax cuts in the proposed Budget are intended to be funded by an improvement in growth, which is assumed to jump to 3 per cent.

Figure 2.2: Breakdown of Chinese investment, YoY growth



Source: National Bureau of Statistics, China (2017)

Figure 2.3: US unemployment rate vs initial jobless claims



Source: Bureau of Labour Statistics, United States (2017) Unemployment rate; United States Department of Labour (2017) Initial jobless claims

Europe

Real GDP growth in the Eurozone in the March quarter was1.9 per cent (annual rate). Growth was driven by positive results for household consumption and investment. Conditions in the manufacturing sector are at six-year highs, while industrial production also grew 1.4 per cent in April. Energy production was the main contributor to the increase in production. Exports also showed strong growth, helped by the weaker Euro.

Political uncertainty following a number of elections earlier in the year has not affected sentiment in the Eurozone. Improving conditions in the manufacturing sector have led to an improvement in the outlook. GDP growth forecasts have been revised up to 2.0 per cent in 2017 and 1.8 per cent in 2018.

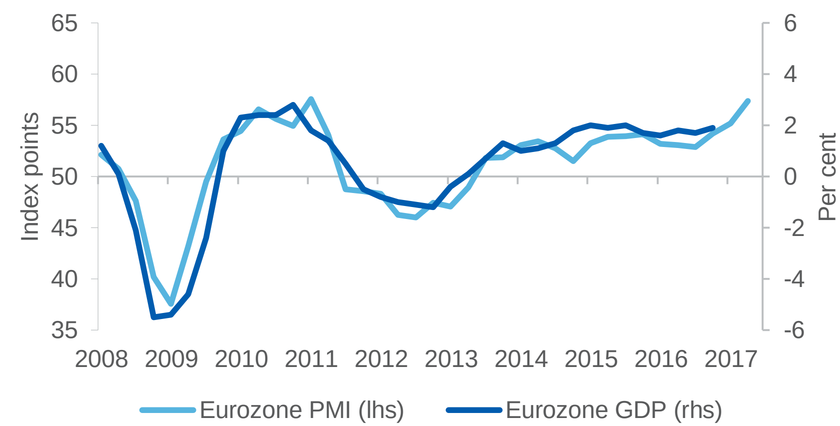
The European Central Bank (ECB) is unlikely to reverse its accommodative monetary policy in the near future. At the May ECB Board meeting, the President of the ECB reiterated that the bank would continue its quantitative easing measures until December 2017. However, after seeing strong growth figures for the March quarter, the ECB indicated there would be no further interest rate cuts.

Japan

Japan recorded strong growth (of 2.2 per cent) in the March quarter (seasonally adjusted annualised rate). This result was driven primarily by rising exports, as increased demand for technology and smartphones benefited Japanese component makers. Domestic consumption has also increased, though there has not been a corresponding increase in wages. Although manufacturing conditions faltered slightly in May, business sentiment remains solid.

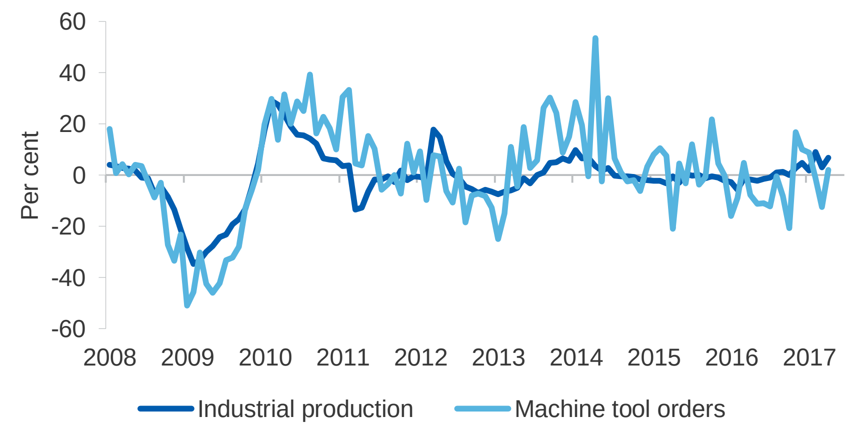
Positive expectations of future growth were also reflected in the Bank of Japan's (BoJ) statement following the May BoJ Board meeting. The economic outlook has now been classified as "turning toward a moderate expansion", due to improvements in exports and production. However, low inflation continues to plague the central bank, with price growth remaining persistently under the BoJ target of 2 per cent. The BoJ is expected to continue with quantitative easing measures, to keep prices from falling and to encourage investment.

Figure 2.4: Eurozone PMI vs Eurozone real GDP, YoY growth



Source: Eurostat (2017) Euro Area Gross Domestic Product; Markit (2017) Eurozone Composite PMI

Figure 2.5: Japanese industrial production vs Machine tool orders, YoY growth



Source: Ministry of Economy, Trade and Industry, Japan (2017) Indices of Industrial Production; Japan Machine Tool Builder's Association (2017) monthly Machine Tool Orders

The IMF forecasts growth of 1.2 per cent in 2017, fuelled by continued growth in net exports. Growth is forecast to fall back to 0.6 per cent in 2018. Low growth is expected to continue into the medium term, as income growth remains weak and population ageing puts pressure on the available labour force.

South Korea

South Korea recorded strong real GDP growth of 2.7 per cent in the March quarter (year-on-year), supported by strong exports and industrial production. However, in recent months, manufacturing activity has contracted, due to rising input costs and falls in New Orders. This weakness has led to a downward revision in the growth outlook; GDP is now expected to reach 2.7 per cent in 2017 and 2.8 per cent in 2018 (both revised down by 0.3 percentage points).

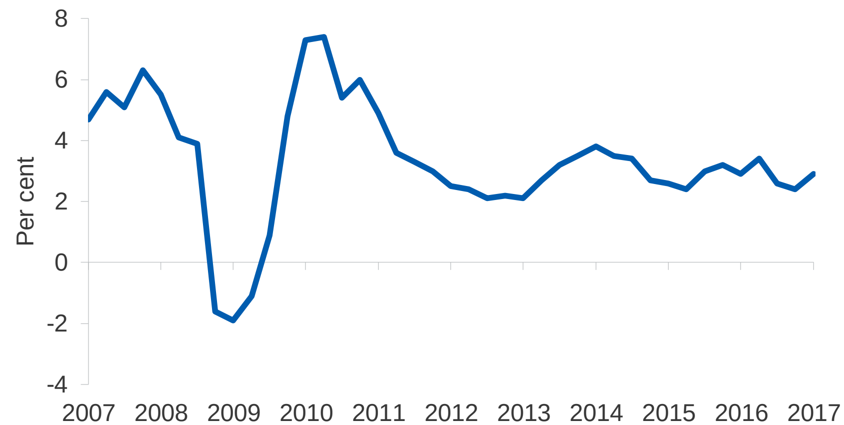
With the outcome of the recent snap election now settled, there should be a greater element of political stability in South Korea.

India

Real GDP growth was weaker in the March quarter, dropping to 6.6 per cent (annual) as the effects of demonetisation of high-value currency notes lingered. As a result, growth is forecast to be only 7.2 per cent in 2017. Despite this slowing, India will still be the fastest growing economy in the world, having surpassed China.

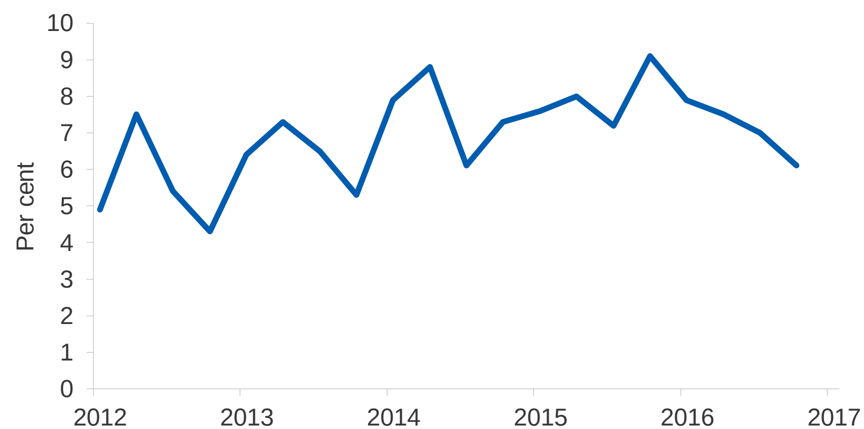
Sizeable increases in public sector wages and pensions are supporting private consumption, while structural reforms — particularly the introduction of the goods and services tax and measures to improve the ease of doing business — are projected to help private investment revive. Growth is expected to recover in 2018, reaching 7.7 per cent.

Figure 2.6: South Korea real GDP, YoY growth



Source: Bank of Korea (2017)

Figure 2.7: India real GDP, YoY growth



Notes: Not seasonally adjusted
Source: Central Statistical Organisation, India (2017)

Table 2.1 Key world macroeconomic assumptions

Per cent	2016	2017 a	2018 a	2019 a
Economic growth b				
Advanced economies	1.7	2.0	2.0	1.9
United States	1.6	2.1	2.1	1.9
Japan	1.0	1.2	0.6	0.8
European Union 28	2.0	2.0	1.8	1.8
Germany	1.8	1.6	1.5	1.4
France	1.2	1.4	1.7	1.7
United Kingdom	1.8	2.0	1.5	1.6
South Korea	2.8	2.7	2.8	3.0
New Zealand	4.0	3.1	2.9	2.6
Emerging economies	4.1	4.5	4.8	4.9
Emerging Asia	6.4	6.4	6.4	6.3
South East Asia d	4.9	5.0	5.2	5.3
China e	6.7	6.6	6.2	6.0
Chinese Taipei	1.4	1.7	1.9	2.0
India	6.8	7.2	7.7	7.8
Latin America	-1.0	1.1	2.0	2.5
Middle East	3.8	2.3	3.2	3.2
World c	3.1	3.5	3.6	3.7
Inflation rate b				
United States	1.4	2.2	2.4	2.3

*Notes: **a** Assumption; **b** Change from previous period; **c** Weighted using purchasing power parity (PPP) valuation of country gross domestic product by IMF **d** Indonesia, Malaysia, the Philippines, Thailand and Vietnam; **e** Excludes Hong Kong*

Source: IMF (2017) World Economic Outlook; IMF (2017) Article IV Consultation with the United States of America - Concluding Statement of the IMF Mission; Department of Industry, Innovation and Science