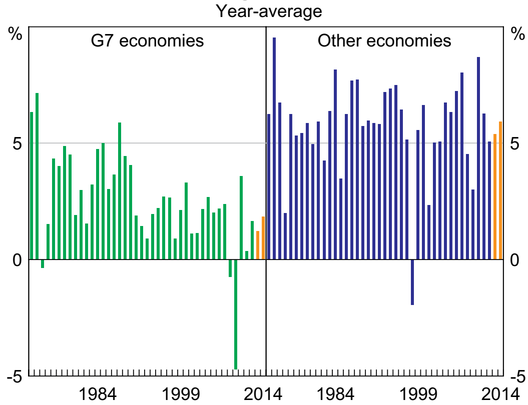
6. Economic Outlook

The International Economy

The overall outlook for growth of Australia's major trading partners (MTP) is little changed from the February *Statement*, despite changes for some individual countries. MTP growth is expected to remain close to its decade average of around 4 per cent in 2013 and then pick up through 2014, to 4½ per cent (Graph 6.1). These forecasts are broadly similar to those published by other forecasters.

Graph 6.1
Australia's Trading Partner GDP Growth*
Year-average

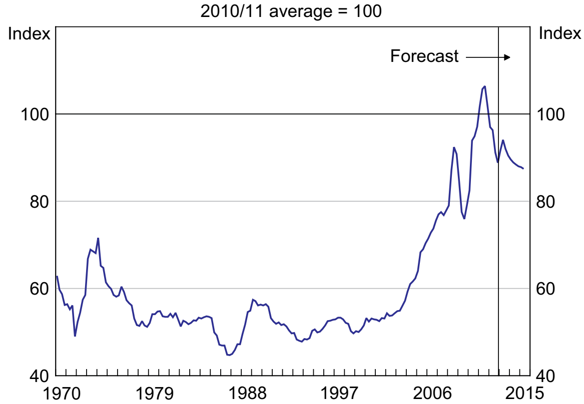


* Weighted using Australian export shares
Sources: ABS; CEIC; RBA; Thomson Reuters

By country, an upward revision to the outlook for Japan following recent policy changes has been largely offset by slightly lower-than-expected growth in the March quarter in China. Despite the slower growth in the quarter, over the forecast period growth in China is expected to average around the rates seen over the second half of 2012. The improvement in Indian growth looks set to be sustained, although growth is not expected to be as strong as it was in the December quarter 2012. The outlook for growth in east Asia is largely unchanged. Growth is forecast to pick up gradually in the United States, supported by gradual improvements in the labour market, an easing in the pace of fiscal tightening and rising household wealth. Conditions in the euro area are expected to remain weak in 2013.

The terms of trade are estimated to have picked up in the March quarter and are likely to rise again in the June quarter, but are then forecast to resume their decline as the global supply of bulk commodities increases (Graph 6.2). Although the profile is similar to that expected in the February *Statement*, the increase in the first half of 2013 is slightly stronger than was previously forecast, as iron ore prices at the start of the year remained at a relatively high level for longer than had been anticipated. Further out, the forecast for the terms of trade has been lowered a little.

Graph 6.2
Terms of Trade
2010/11 average = 100



Sources: ABS; RBA

Domestic Activity

In preparing the domestic forecasts, a number of technical assumptions have been employed, as usual. The exchange rate is assumed to remain at its current level over the forecast period (A$ at US$1.02 and the TWI at 77, which is little changed from the February *Statement*). The forecasts are based on the price for Brent oil remaining at US$103 per barrel, lower than the assumption in February. The cash rate is assumed to be unchanged over the rest of the forecast period at 2.75 per cent. (This profile is slightly higher than market expectations, which currently imply a further reduction in the cash rate over 2013.) Given this low level of the cash rate, variable borrowing rates are around their lows in 2009. Finally, the forecasts assume that annual growth in the working-age population will pick up gradually to 1.8 per cent over the forecast horizon, slightly higher than was the case in the previous *Statement*, reflecting the recent increase in the rate of net immigration and forecasts by the Department of Immigration and Citizenship.

The Australian economy expanded at an around trend pace over 2012, although growth was slower in the second half of the year than in the first. Consumer spending looks to have increased relatively strongly in the March quarter, following slow growth in the second half of last year. This is consistent with the rise in asset prices and more positive consumer sentiment despite the labour market remaining somewhat subdued. Dwelling investment has started to recover in recent quarters and this is likely to have continued in the March quarter. At the same time, however, mining investment, though still at a high level, is likely to have grown more slowly as the peak in investment approaches. Also, surveys suggest that business conditions and capacity utilisation generally remained a little below long-run averages in the early part of this year, and non-mining investment is expected to have grown only modestly. Import volumes fell in the quarter, driven by lower imports of capital goods. Exports growth slowed a little in the March quarter following strong growth in the December quarter. Public final demand, as measured in the national accounts, fell sharply in the second half of 2012, and is likely to experience only very moderate growth over the forecast horizon given the fiscal consolidation underway.

GDP growth is expected to be a bit below trend at around 2½ per cent over 2013, before picking up to an around trend pace (Table 6.1). Overall, the subdued outlook over the next year or so continues to reflect the approaching peak in mining investment, ongoing fiscal consolidation and the high level of the Australian dollar. These forecasts are essentially unchanged since the February *Statement* and are broadly in line with those published by Consensus Economics.

Table 6.1: Output Growth and Inflation Forecasts[(a)]
Per cent

	Year-ended					
	Dec 2012	June 2013	Dec 2013	June 2014	Dec 2014	June 2015
GDP growth	3.1	2½	2½	2–3	2½–3½	2½–4
Non-farm GDP growth	3.4	2¾	2½	2–3	2½–3½	2½–4
CPI inflation	2.2	2¼	2	2–3	2–3	2–3
Underlying inflation	2½	2¼	2¼	2–3	2–3	2–3
	Year-average					
	2012	2012/13	2013	2013/14	2014	2014/15
GDP growth	3.6	3	2¾	2–3	2¼–3¼	2½–3½

(a) Technical assumptions include A$ at US$1.02, TWI at 77 and Brent crude oil price at US$103 per barrel
Sources: ABS; RBA

The forecast for consumption spending has been revised a little higher since the February *Statement*, as the prospects for household demand appear slightly more positive. Retail sales have increased strongly over recent months and measures of consumer sentiment have been above average. Conditions and confidence in the established housing market have continued to improve, pointing to further growth in household wealth, while recent strong growth in both housing and personal loan approvals may provide some additional impetus to spending. In contrast, moderate employment growth in the near term and slower growth in wages than in recent years is expected to continue to restrain growth in labour income. Over the next couple of years, consumption spending is expected to grow at around its long-run average pace, broadly in line with real income growth. The forecast of continuing recovery in residential construction investment reflects lower interest rates, rising rental yields and the improvement in conditions in the established housing market having created a more favourable environment for investment.

The contribution to growth from net external trade has also been revised higher from three months ago. Notwithstanding little change to forecast growth in aggregate domestic spending, growth in imports is expected to continue to be somewhat softer than earlier expected. At the same time, the outlook for exports remains strong. Given the significant investment that has occurred to date, and that is still in the pipeline, the Bureau of Resources and Energy Economics expects bulk commodity exports to increase at an annual rate of around 10 per cent over the next six years. The increase in liquefied natural gas (LNG) exports is particularly large, and LNG is expected to account for almost one-fifth of resource exports by 2017/18, up from 6 per cent currently. The increase in exports is expected to be supported by continued demand from China and other developing economies. With infrastructure needs in China remaining large – including to accommodate the growing high-density urban population – steel consumption is likely to continue to grow, albeit a good deal more slowly than in the past decade. However, given the substantial increase in the size of the Chinese economy, the lower growth rate of the economy (compared with the past) can still generate a large increase in the demand for steel.

In the case of business investment outside the resources sector, the most recent ABS Capital Expenditure Survey suggested that there would be modest growth in 2013/14. For machinery and equipment investment, forecasts have been reduced given the continued weakness in a number of indicators of near-term investment. Notably, business surveys remain below average while business funding and capital imports have been subdued. Forecasts for investment in non-residential building have been revised up a little in the near term, reflecting a reassessment of the flow-through to investment from the large healthcare projects approved in early 2012. Despite this, the forecast for growth of non-residential building investment has been lowered further out in the period, as approvals remain at low levels and there are few signs that conditions in the office property market are improving. Nevertheless, the continued growth in consumer spending and above-average population growth are likely to support investment growth over the medium term.

The outlook for engineering investment is little changed from the February *Statement*, with continuing high levels of mining investment. The profile of projects that underlie this outlook has not changed significantly, as projects recently shelved had already been judged unlikely to proceed in the February forecasts. Survey data indicate that capital expenditure in 2013/14 will remain at a high level. With little change to the engineering investment forecast, mining investment is still expected to be close to its peak and is likely to remain elevated for some time, reflecting the large stock of projects already committed. Beyond the end of the forecast period, there is little conclusive information about probable or possible projects, but it is likely that mining investment will decline.

Growth in public demand is expected to be subdued over the next two years or so, as fiscal consolidation at both the state and federal levels is assumed to continue. The outlook for public demand is a little softer than at the time of the February *Statement* (although some rebound in the first half of 2013 is possible given the unusually sharp fall recorded in the second half of last year).

Conditions in the labour market remain somewhat subdued in line with the previous outlook. As usual, conditions differ across sectors. There have been some tentative signs of a firming in labour demand in the construction industry since mid last year as the outlook for residential building activity has improved, while demand in the resources sector, and some other sectors, has weakened. Overall, leading indicators of employment have been somewhat mixed and, while a number of the measures have stabilised after declines last year, they remain at relatively low levels. With firms more focused on seeking productivity gains, employment growth is expected to be moderate in the near term. The unemployment rate is expected to continue drifting higher until mid next year; thereafter, a return to trend output growth is expected to support an improvement in conditions.

The lower growth of wages over recent quarters has become a little more widespread across industries. Wage growth in the public sector has been modest for some time now. With the unemployment rate having risen over the past year and further increases anticipated, wage growth is expected to remain moderate at 3¼ per cent over the forecast period.

Inflation

The outlook for inflation is a little softer in the near term than the forecasts published in the February *Statement*. To a large extent, this reflects that underlying inflation in the March quarter was a bit lower than expected, at a little under ½ per cent in the quarter, and a little under 2½ per cent over the year. The year-ended rate of underlying inflation is expected to ease a little in the near term, before returning to around the middle of the target range for the remainder of the forecast period.

Tradable items in the CPI have continued to experience deflation in recent quarters, with a particularly large price fall in the March quarter, notably for consumer durable goods (see 'Box B: The Recent Deflation in Consumer Durables Prices'). This deflation has occurred despite the exchange rate having been stable for some time now and appears to reflect declines in the domestic component of these prices. The pace of deflation in these goods is expected to slow over the forecast period, albeit by slightly less than was previously assumed given the apparent pressure on reducing domestic costs and margins in recent quarters. Non-tradables inflation has been a bit above the average of the inflation-targeting era, though it appears that this largely reflects the temporary impact from major policy measures, including the introduction of the carbon price. The forecasts anticipate that domestically generated inflation pressures will remain contained as the labour market remains somewhat subdued in the near term.

The profile for headline inflation will be affected by a number of one-off factors in the first half of the forecast period. Year-ended headline inflation is expected to remain slightly above underlying inflation in the June quarter, largely because of the effects of the introduction of the carbon price on utilities prices last year. Once these effects pass, headline inflation is expected to fall temporarily below underlying inflation, reflecting recent falls in fruit and vegetables prices.

Risks

Overall, the risks to the international outlook appear to be broadly as they were at the time of the February *Statement*, that is, roughly balanced across most economies, but still tilted to the downside in Europe. In particular, in the euro area current conditions remain fragile and so the anticipated recovery later in the year could fail to materialise. While spillovers from recent banking problems have been minimal, the downside risk remains that banking and fiscal problems could escalate and spread further within the region.

In the United States, there is still much to be resolved around fiscal policy and government spending, and thus a degree of uncertainty remains. If the downside risks from fiscal policy were realised, this could break the building momentum of the US economy's recovery. However, if these risks do not materialise, it is possible that growth could accelerate given the progress of balance sheet repair in the private sector and the expansionary stance of monetary policy.

The policy actions announced in Japan since the election in December have led to upward revisions to forecasters' outlook for the economy. But very little is known at this stage about how effective the policies are going to be in stimulating real output growth and achieving the new inflation target.

Developments in the Chinese economy have added to the challenges of macroeconomic management that exist in a rapidly developing and evolving economy. The fast pace of credit growth in the March quarter has led to heightened medium-term concerns about the nature and distribution of borrowing. Adding to the challenges is the recent increase in house price appreciation, although affordability concerns may lead to a larger social housing program to alleviate supply issues, which could boost demand for resources.

The forecasts for the Australian economy continue to embody a gradual shift in growth from mining investment towards exports, non-mining business investment and household spending. While there are signs that this rebalancing is beginning, there remains considerable uncertainty about how it will proceed. In particular, there remains a large degree of uncertainty surrounding the exact profile for mining investment, especially given the general caution in the industry and continued focus on reducing costs. For non-mining business investment, the recent ABS data on firms' capital expenditure plans for 2013/14 were positive. Nevertheless, other, near-term indicators of investment remain subdued, despite conditions generally being favourable for investment overall.

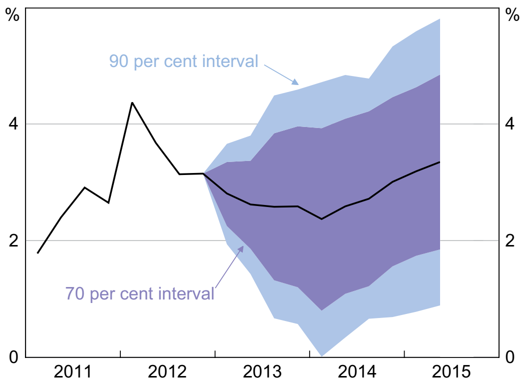
In the household sector, a key risk is that established dwelling prices rise more quickly than assumed, spurred by low interest rates. The associated boost to wealth and sentiment could in time generate stronger-than-expected consumption growth. If this were accompanied by a return to increasing household leverage, it would raise concerns from a financial stability perspective. But given the outlook for relatively subdued growth in employment and so for moderate wage inflation, it is possible that growth in labour income and spending could be weaker than currently envisaged. While the preconditions for an ongoing recovery in dwelling investment remain in place, there remains uncertainty about the breadth and strength of such a recovery.

Considerable uncertainty remains around the outlook for public spending given weaker-than-expected revenue and the fiscal consolidation at a state and federal level. The possibility of policy changes over the course of the year adds to the uncertainty.

Inflation could turn out to be lower than forecast if the labour market was to weaken more than anticipated, and wages were to prove more responsive to this than they have been to date. The sustained high level of the exchange rate may have a longer-lasting effect on pricing behaviour than the historical experience suggests, especially as firms remain focused on cost reductions and seeking efficiency gains. Indeed, the slowing in inflation to date has been in tradable goods and services, while non-tradables inflation, which tends to be less variable, has remained at a higher rate. Some moderation of non-tradables inflation will be required for aggregate inflation to remain in line with the forecasts if the disinflationary pressures on the price of tradable items wane, especially if the exchange rate depreciated significantly. Moreover, somewhat subdued conditions in the labour market over the past year appear to have been borne in part by a fall in the participation rate. If this fall in participation were to prove more permanent than expected, then the anticipated recovery in activity could meet with less spare capacity in the labour market than expected, resulting in a build-up of wage and inflationary pressures later in the forecast period.

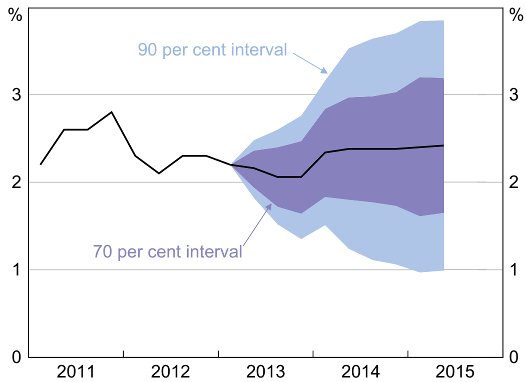
These identified, and other unknown, risks mean that the path for GDP and inflation may well differ from the forecasts presented. Confidence intervals based on historical forecast errors provide one way of gauging the uncertainty surrounding the GDP and inflation forecasts (Graph 6.3 and Graph 6.4).[1]

Graph 6.3
GDP Growth Forecast*
Year-ended



* Confidence intervals reflect RBA forecast errors since 1993
Sources: ABS; RBA

Graph 6.4
Trimmed Mean Inflation Forecast*
Year-ended



* Confidence intervals reflect RBA forecast errors since 1993
Sources: ABS; RBA

1 This is based on recent Bank research; see Tulip P and S Wallace (2012), 'Estimates of Uncertainty around the RBA's Forecasts', RBA Research Discussion Paper No 2012-07 and RBA (2013), 'Box E: Forecast Confidence Intervals', *Statement on Monetary Policy*, February, p 68, for further details.