

6. Economic Outlook

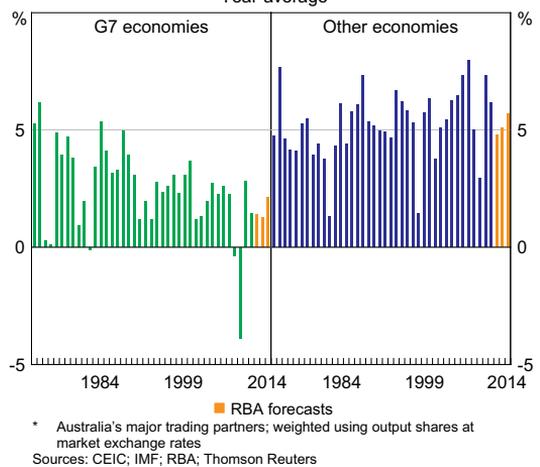
The International Economy

With developments over the past few months broadly in line with the expectations at the time of the November *Statement*, the global forecasts are largely unchanged. World GDP growth is expected to be around 3½ per cent in 2013, before picking up to around 4 per cent in 2014, similar to the forecasts of the International Monetary Fund (IMF) and those published by Consensus Economics (Graph 6.1).

The forecasts assume that the political process in the United States avoids a severe tightening of fiscal policy, with growth in the US economy returning to a long-run average pace supported by the recovery in the housing market and accommodative monetary policy settings. Activity in the euro area is forecast to stabilise in the first half of 2013 and then grow modestly. This assumes that the euro area crisis continues to be managed in a manner that avoids serious destabilisation. While the forecasts are based on the absence of any major negative shocks in the United States and euro area, and hence they assume that global financial markets remain relatively calm, the main downside risk still appears to emanate from the euro area, as discussed below.

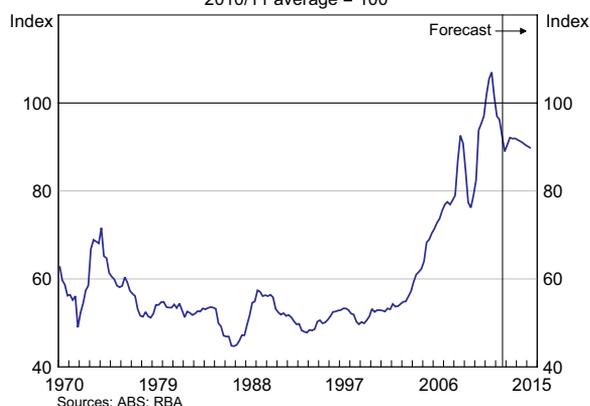
Despite the outlook for only modest growth in the large advanced economies overall, global growth is expected to be close to its long-run average in 2013 because of the relatively strong growth, and increasing size, of the fast-growing Asian economies. In particular, GDP growth in China over the next two years is expected to be a little stronger than in 2012, underpinned by growth in domestic demand.

Graph 6.1
Global GDP Growth*
Year-average



Since the November *Statement*, the price of iron ore has increased significantly, reportedly in response to some restocking by Chinese steel producers after a significant drawdown in inventories over the second half of 2012. Other commodity prices have increased a little. However, forecasts of commodity prices in the medium term are mostly unchanged and so overall the profile for the terms of trade is largely as it was in the November *Statement*. Over time, the terms of trade are expected to decline gradually as the large amount of investment in the resource sector currently underway globally is likely to lead supply of bulk commodities to increase faster than demand (Graph 6.2).

Graph 6.2
Terms of Trade
 2010/11 average = 100



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\$1.03, TWI at 77), which is around the same as the November *Statement*. The forecasts are based on the price for Brent oil remaining at US\$113 per barrel, slightly higher than the assumption in November. The cash rate is assumed to be unchanged over the rest of the forecast period at 3 per cent, following the 25 basis points cut in December. The cash rate assumed for the forecasts is more than 200 basis points lower than its post-1996 average, while borrowing rates are currently 95–140 basis points below average. Finally, the forecasts assume that annual growth in the working-age population over 2013 and 2014 is 1.7 per cent and 1.8 per cent, respectively, a touch higher than the previous forecasts and in line with the recent pick-up in the rate of immigration.

The available data show that while growth in the domestic economy over the year to the September quarter was around trend, it had slowed somewhat through the year. This was evident in a slowing in consumption growth, in line with softer growth in employment and labour income. The Australian Government's fiscal consolidation also weighed on growth. However, output growth appears to have picked up in the December quarter with a sharp rise

in coal and iron ore exports. Dwelling investment has begun to recover after declining steadily over 2011/12, and business investment is likely to have continued to increase. Overall, GDP growth over 2012 is likely to have been close to 3½ per cent, which is broadly in line with the November *Statement* forecast (Table 6.1).

GDP growth is expected to be below trend at around 2½ per cent over 2013 before picking up to just under 3 per cent over 2014. These forecasts have been revised down since the November *Statement*, largely reflecting the slightly weaker outlook for mining and non-mining investment. Overall, the soft outlook over the next year or so reflects a number of factors: mining investment is expected to peak, both fiscal consolidation and the persistently high level of the Australian dollar will weigh on growth, and there is little sign of a near-term pick-up in non-mining business investment.

The downward revisions to business investment for both the mining and non-mining sectors have been concentrated in spending on machinery and equipment. This largely reflects weaker-than-expected data in the ABS capital expenditure survey, as well as subdued investment intentions reported in business surveys and the Bank's liaison. The forecast for investment in buildings and structures in the mining sector has been lowered from mid 2013 onwards, as a range of information suggests that mining investment is likely to peak before the end of this year.

Over the past six months, the largest downward revisions to the mining investment profile have been in the coal sector. Despite recent rises, prices for both coking and thermal coal remain more than 20 per cent lower than they were a year ago and most forecasters expect prices to remain relatively subdued over the medium term, with global demand for coal dampened by the increase in natural gas production in the United States. The fall in iron ore prices over the September quarter was reportedly a factor in the delay of some iron ore projects. Notwithstanding the significant increase in the iron ore price of late,

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	3½	2½	2–3	2–3	2½–3½	2½–3½
Non-farm GDP growth	3½	2¾	2–3	2–3	2½–3½	2½–3½
CPI inflation	2.2	3	2–3	2–3	2–3	2–3
Underlying inflation	2¼	2½	2–3	2–3	2–3	2–3

	Year-average					
	2012	2012/13	2013	2013/14	2014	2014/15
GDP growth	3¾	3	2–3	2–3	2¼–3¼	2½–3½

(a) Technical assumptions include A\$ at US\$1.03, TWI at 77 and Brent crude oil price at US\$113 per barrel
Sources: ABS; RBA

mining company statements indicate that they remain focused on containing costs and it remains difficult to obtain finance for some projects. A small downward revision was also made to the outlook for investment in the liquefied natural gas sector. This reflects the effect of delays to the construction of some projects, which has been partially offset by changes to the cost of construction.

The outlook for the rest of the economy remains mixed. Growth in public demand is expected to be very subdued over the next two years, as both the Australian and state governments undertake significant fiscal consolidation (although there may be some rebound in the December quarter from the unusually sharp fall in measured public investment in the previous quarter). On the other hand, a gradual recovery in residential construction investment looks to be underway, as lower interest rates, rising rental yields and an improvement in conditions in the established housing market have created a more favourable environment for investment.

The outlook for consumption is little changed from the time of the November *Statement*. The available data suggest that after growing rapidly early in 2012, consumption grew at a more moderate pace thereafter, in line with slower growth in labour income. Looking ahead, consumption spending is expected to grow a little below trend in the near

term before picking up slightly. With consumption growth broadly in line with income growth, the household saving ratio is expected to remain fairly steady.

Employment growth has remained subdued in recent months, with the unemployment rate drifting gradually higher. Sectors exposed to the mining sector have scaled back their demand for labour and remain focused on minimising costs, while the ongoing fiscal consolidation has weighed on public sector employment. Employment is expected to grow only modestly in the near term, broadly in line with the outlook implied by a range of leading indicators. Employment growth is then expected to pick up gradually, but to remain below the pace of population growth over most of the forecast horizon. Accordingly, unemployment is expected to drift gradually higher.

Given the softer outlook for labour demand, growth in the wage price index is expected to ease further to around 3¼ per cent over the forecast period, a little above the rates recorded in 2009/10 following the global downturn. Even so, growth in unit labour costs is forecast to rise somewhat over the forecast period as productivity growth is expected to decline gradually from the relatively high rate recorded over the past year.

Inflation

The outlook for inflation is a little lower than the forecasts published in the November *Statement*. Data for the December quarter indicate that year-ended underlying inflation has been around 2¼ per cent since the middle of last year. The earlier data were revised down slightly and so, reflecting this lower starting point, the forecasts are lower in the near term. The year-ended rate of underlying inflation is then expected to pick up a little to around 2½ per cent. Looking further out, the forecasts are slightly lower than previously, with the weaker outlook for domestic activity and labour demand expected to contain unit costs amid continued productivity improvements.

Over the first half of the forecast period, the profile for headline CPI is expected to be affected by a number of recent one-off factors. Although most of the direct effects (on utility prices) of the introduction of the carbon price appear to have come through in the September quarter, the introduction of the carbon price is expected to make a further modest contribution to quarterly headline and underlying inflation in early 2013. By the end of 2013, headline inflation is expected to fall back to around the middle of the target range as the effects of the introduction of the carbon price largely drop out.

Risks

Overall, the risks to the international outlook appear to be more balanced than at the time of the previous *Statement*. The main identifiable source of downside risk continues to be the banking and fiscal problems in the euro area. European policymakers continue to work to address the underlying structural causes and alleviate some of the symptoms of the crisis, and in doing so have reduced the near-term risks. However, recovery in economic activity is some way off and prospects remain fragile. The crisis economies, in particular, remain vulnerable to adverse shocks, including the possibility of social unrest in response to austerity measures. Risks to the upside and downside now appear more evenly balanced for

both China and the United States. The large degree of monetary stimulus in place in many economies, particularly the major advanced economies, has seen significant increases in asset prices and could well lead to a larger pick-up in economic activity than is currently anticipated.

Economic activity in the United States continues to expand moderately, with some of the restraining influences on the economy slowly unwinding. The reduction in the downside risks from a sharp fiscal consolidation has made the outlook for the US economy seemingly more balanced. The downside risks have not been completely eliminated and ongoing negotiations on fiscal policy and debt could further dampen consumer, business and financial market confidence and hamper the ensuing recovery. But if this uncertainty is resolved, with fiscal consolidation not occurring too rapidly in the near term, then the improvement in sentiment could result in an increase in investment and consumer spending, which would in turn bolster growth.

There has been a general increase in confidence that growth in China has stabilised. Nevertheless, there remains some uncertainty about the nature of future policies given the extended leadership transition in many parts of the government and state-owned enterprises. As China continues to develop, there is also the potential for imbalances in the housing market or financial system, which could ultimately prove destabilising for the broader economy. In Japan, the new government has announced plans to boost domestic growth and combat deflation, including through public spending. A large fiscal stimulus could, however, increase downside risks further down the track. Territorial disputes in the region remain a risk to economic activity.

The forecasts for the Australian economy continue to embody a recovery in non-mining business investment, though it is expected to remain relatively low as a share of economic activity. While the underlying drivers of investment are supportive of growth, the absence of any clear indications of a pick-up in non-mining investment means that the

outlook remains quite uncertain. The preconditions for an ongoing recovery in dwelling investment are also in place, although the lack of improvement in the demand for new detached houses to date raises questions about the breadth and strength of the recovery.

While information received since the November *Statement* still suggests that the peak in the mining investment boom is near, considerable uncertainty remains about the exact profile for spending. Furthermore, given the recent pick-up in the price of iron ore, it is possible that the existing caution of miners could lessen and more projects be considered economically viable.

There is also considerable uncertainty surrounding the outlook for public spending, given the large fiscal consolidation currently underway and planned by the Australian and state governments. The Australian Government's recent announcement that the federal budget is unlikely to return to surplus in 2012/13, owing to weaker-than-expected revenue growth, has reduced the likelihood of larger cuts

to total public spending in the near term. Nevertheless, while the staff forecast is for subdued growth in public demand over the next two years, this will depend in part on state and federal government revenue, which is sensitive to changes in commodity prices.

The risks around the outlook for inflation reflect the usual mix of factors pertaining to aggregate demand, the labour market, productivity and the exchange rate. While the labour market is expected to remain soft over the forecast horizon, a more pronounced or protracted slowdown in activity could see a larger-than-expected rise in unemployment, which would constrain wage costs and consumer incomes, and also limit firms' ability to raise prices. The effects of the high exchange rate on inflation may also be proving to be longer lasting than expected. On the other hand, while wage growth has moderated recently, a continued softening in nominal wage growth and continued growth in productivity are likely to be required to keep cost pressures consistent with the inflation target.