6. Economic Outlook

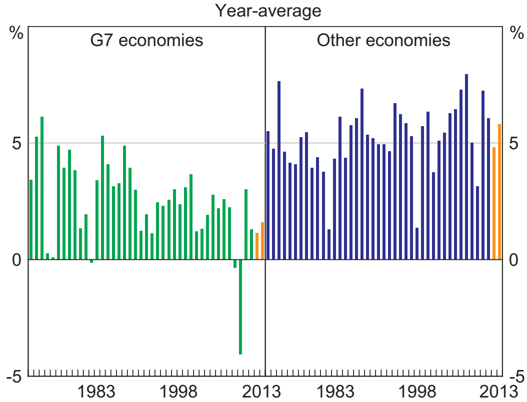
The International Economy

The global outlook has weakened since mid 2011, with the euro area economy appearing to have slipped into recession. The euro area authorities have made progress in developing a comprehensive response to the sovereign debt and banking sector problems, although further measures will be required. In contrast, the recovery in the United States is continuing after a soft patch in mid 2011, although there is still considerable spare capacity in the labour market and broader economy. Growth in emerging economies is likely to be a little softer than earlier expected, reflecting both trade and financial linkages with Europe and the broader effects on domestic demand of the global economic uncertainty.

In line with these developments, the International Monetary Fund's (IMF) January forecasts were for global growth to slow to a below-trend pace of 3.3 per cent in 2012 before strengthening to 3.9 per cent in 2013, with growth in Australia's major trading partners (weighted by export shares) around a percentage point higher than that in each year. The Bank's central scenario is broadly similar (Graph 6.1). The projected recovery in 2013 largely reflects the expectation of some easing in sovereign debt concerns in Europe and an anticipated policy response to the slower growth in Asia. Nevertheless, it is likely to take some years for the worst-affected economies in Europe to restore their competitiveness and ensure more sustainable debt profiles, and there is still a risk of a disorderly outcome, as discussed below.

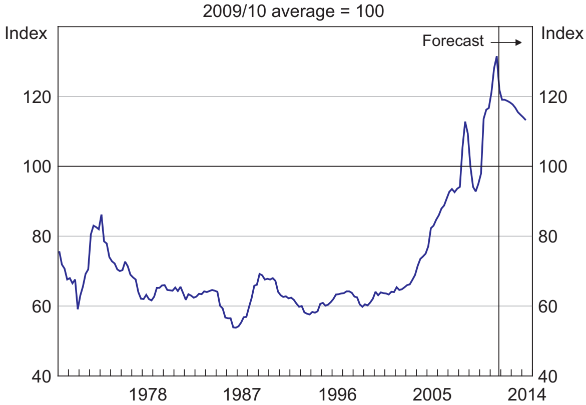
The terms of trade are estimated to have fallen slightly from their record level in the September quarter, but remain high (Graph 6.2). With global

Graph 6.1
Global GDP Growth*
Year-average



* Australia's major trading partners; weighted using output shares at market exchange rates; RBA estimates for 2011
Sources: CEIC; IMF; RBA; Thomson Reuters

Graph 6.2
Terms of Trade
2009/10 average = 100



Sources: ABS; RBA

commodity prices mostly a little higher than in early November, consistent with the improvement in global sentiment over the past month or so, the Bank's forecast path for the terms of trade has been revised up slightly. However, the terms of trade are still expected to decline gradually over the forecast period, reflecting slower growth in global demand for commodities and increased global supply capacity for bulk commodities.

Domestic Activity

In preparing the domestic forecasts, a number of technical assumptions have been employed. The exchange rate is assumed to remain at its current level over the forecast horizon (A$ at US$1.07, TWI at 78), which is a little higher than assumed in the November *Statement*. The price of Tapis oil – which is the most relevant for Australian fuel prices – is assumed to remain at US$125 per barrel over the forecast period, US$9 higher than in November. The cash rate is assumed to be unchanged over the forecast period. Finally, the forecasts assume that growth in the working-age population will pick up slightly over the forecast period to 1.6 per cent in 2013 and 2014, based on the most recent data for population growth and forecasts from the Department of Immigration and Citizenship.

GDP growth over 2011 is estimated to have been around 2¾ per cent, with conditions quite uneven across industries and regions in the economy. As was expected, work is accelerating on the large pipeline of liquefied natural gas (LNG) projects, which is boosting imports of capital goods. In Queensland, the recovery in coal production from the floods has taken longer than initially expected, with Queensland coal exports still below pre-flood levels. Consumer spending has grown at around the same pace as household income over the past year, with stronger spending on services and on overseas trips offsetting slower growth in spending on goods, particularly at department stores. At the same time, the high exchange rate, the completion of some fiscal stimulus programs and uncertainty about the global economic outlook have weighed on growth in some sectors. Consistent with this divergence in conditions, the strong growth in mining activity and associated stronger labour market outcomes in Western Australia are flowing through to stronger consumer spending, with some early signs that this is also occurring in Queensland. Growth in demand in other states has been weaker.

The domestic economy is expected to grow at an around-trend pace in 2012 and 2013 (Table 6.1). The forecast profile is broadly similar to the outlook at the time of the November *Statement*, but is weaker than forecast in mid 2011 reflecting the weaker outlook for global economic growth, with the uncertainty about the European situation expected to weigh on household and business spending decisions. The pipeline of mining investment projects and solid growth in resources exports are expected to continue to support growth, with activity more subdued in sectors of the economy benefiting less from the mining boom or being adversely affected by the high exchange rate.

Growth in mining sector investment is being underpinned by the $180 billion of LNG projects approved or under construction, including the recently approved US$34 billion Ichthys LNG project, which will transport gas by pipeline from the Browse Basin off the coast of Western Australia to Darwin. The investment in LNG production facilities will subsequently drive a surge in LNG exports; the commissioning of the Pluto project is expected to boost exports starting around March this year, with other projects expected to come online from late 2014. The outlook for iron ore and coal exports also remains strong. Based on mining, rail and port infrastructure projects currently under way or in planning, significant growth in coal export capacity is expected over the next three years. Large expansions in iron ore capacity are also in the pipeline.

Growth outside the mining sector is expected to remain below trend over the forecast period.

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

	Year-ended					
	Dec 2011	June 2012	Dec 2012	June 2013	Dec 2013	June 2014
GDP growth	2¾	3½	3–3½	3–3½	3–4	3–4
CPI inflation	3.1	1¾	3	3¼	2½	2½–3
Underlying inflation	2½	2¼	2¾	2¾	2½	2½–3
CPI inflation (excl carbon price)	3.1	1¾	2½	2½	2½	2½–3
Underlying inflation (excl carbon price)	2½	2¼	2½	2½	2½	2½–3
	Year-average					
	2011	2011/12	2012	2012/13	2013	2013/14
GDP growth	2	3¼	3½	3–3½	3–3½	3–4

(a) Technical assumptions include A$ at US$1.07, TWI at 78, Tapis crude oil price at US$125 per barrel
Sources: ABS; RBA

Non-mining investment is forecast to remain subdued over the next year, consistent with the near-term outlook in business surveys, but is expected to pick up gradually further out. In the building industry, conditions remain weak in both the office- and home-building sectors. The high level of the exchange rate is also weighing on trade-exposed sectors including manufacturing, tourism and education. Further, sizeable fiscal consolidation plans have been announced for 2012/13, with public demand as a share of GDP likely to return to its average over the 2000s.

Growth in household spending is expected to remain moderate in the near term, as softer labour market outcomes, concerns about developments abroad, and declines in net wealth weigh on spending. Consumption growth is then expected to pick up gradually in line with income growth, with the household saving ratio expected to remain around its current level over the forecast period.

Employment growth is expected to remain fairly subdued in the first half of this year. With firms expressing caution about hiring, growth in labour demand is likely to be met partly through increased hours for existing employees, and the unemployment rate is expected to increase modestly. Employment growth is expected to begin to strengthen later in the year in line with solid GDP growth and as firms' current caution subsides somewhat. The unemployment rate is expected to decline modestly over the later part of the forecast period, broadly in line with forecasts in the November *Statement*.

Given the outlook for the labour market, the wage price index is expected to continue to increase at around its current rate. With some improvement in productivity expected, growth in unit labour costs over the forecast period is expected to be below the elevated rate seen over 2005–08.

Inflation

The outlook for inflation is little changed from the forecasts published in the November *Statement*.

The latest CPI data indicate underlying inflation was around 2½ per cent over 2011, with quarterly inflation outcomes lower in the second half of the year than in the first half. The forecasts incorporate small downward revisions to expected inflation in the near term, which imply year-ended underlying inflation dipping to around 2¼ per cent in June

2012 as the large quarterly increases from the first half of 2011 drop out of the annual numbers. Looking ahead, domestically generated inflation pressures are expected to ease slightly in line with lower growth in unit labour costs and the easing in capacity pressures that has occurred. However, the disinflationary impetus from lower import prices evident over the past few years is expected to wane, and tradable prices are expected to begin making a modest positive contribution to inflation over the forecast period. Overall, underlying inflation (excluding the effect of the carbon price) is forecast to remain within the target range over the next few years, with the year-ended underlying rate declining slightly in the near term before drifting gradually higher to be in the upper half of the target range by 2014.

A number of one-off factors are expected to affect the profile for headline CPI inflation over the first half of the forecast period. The continued unwind of the spike in fruit prices will see headline inflation fall below underlying inflation in the near term. Then, from the September quarter 2012, the headline numbers will be boosted by the introduction of a price on carbon, which is expected to add 0.7 percentage points to headline inflation over the following year; the effect on underlying inflation is expected to be around ¼ percentage point.

Risks

The central outlook for the global economy assumes a continuation of the uncertainty surrounding the sovereign debt problems in Europe. However, as in previous forecasts, it also assumes that a disorderly outcome is avoided. This remains the major downside risk for the global economy. If this risk did eventuate it would lead to a severe recession in Europe, which would spill over to the rest of the world through trade, financial and confidence linkages. However, there have been some positive developments over the past six weeks or so, including the agreements made at the Euro Summits in early December and late January as well as the European Central Bank's extension of three-year funding to banks, which appear to have reduced this risk somewhat.

Risks are more balanced in the case of the US economy. Based on current legislation, a large fiscal consolidation is scheduled to occur in 2013, which would be significantly contractionary for the US economy. The Bank's central forecast assumes, consistent with recent forecasts from the IMF and the OECD, that some compromise is reached and that only part of the currently legislated consolidation occurs. The possibility of a larger consolidation remains a downside risk. On the upside, however, the recovery in the United States economy could strengthen more than in the central forecast, with a self-sustaining cycle of an improving labour market and increases in consumption and investment, particularly given that business balance sheets are generally in good shape.

Risks to the outlook for China and other economies in Asia appear to be skewed slightly to the downside. Growth has slowed in these economies, reflecting both domestic policy settings and trade, financial and confidence linkages to Europe. These economies do, however, have ample scope to ease monetary and fiscal policies in response to emerging economic weakness, which should support growth.

As noted in the November *Statement*, the possibility of a sharp slowing in Europe and contagion to the rest of our trading partners remains the key downside risk to the Australian economy. In this scenario, business and consumer confidence would likely decline, while a slowing in global demand for commodities would see prices fall more sharply than in the central forecast and some of the planned expansions to mining production may be postponed or scaled back. In this environment, there would be scope to boost domestic demand via policy stimulus and it is possible – as in late 2008 – that the exchange rate would depreciate, which would be stimulatory for some sectors. Overall, however, growth would be weaker than in the central forecast.

More broadly, there is some uncertainty surrounding the growth outlook resulting from the significant structural change that is occurring in the economy. History offers little basis on which to judge the net impact on the economy of, on the one hand, a once-in-a-century investment boom in the resources sector and, on the other, a high real exchange rate. The Bank has been expecting for some time that the economy would undergo a period of significant structural adjustment, with resources shifting into the mining sector and with other parts of the economy adjusting to the higher level of the exchange rate. Over the past year there has been considerable evidence that this structural change is occurring, with subdued conditions in the manufacturing, tourism and education sectors. One risk is that this adjustment process leads to larger job shedding in some sectors over the next few years and that employment growth is weaker than in the central forecast. However, given the very high level of investment, especially in the mining sector, it is possible that aggregate output growth could be stronger than the around-trend pace of the central forecast.

The risks to the inflation outlook appear evenly balanced. The major downside risk to inflation emanates from the risk of a heightening of the problems in Europe resulting in slower domestic growth. The risks on the upside relate more to domestic factors. In particular, the inflation outcomes over the past two years have been helped by falls in the prices of tradable goods and services as a result of the appreciation of the exchange rate that started in the first half of 2009. While non-tradables inflation has recently been lower than the peak rates seen in 2008, it has been running at a higher rate than would appear to be consistent with inflation being around the centre of the medium-term target range if tradables inflation was no longer being held down by an appreciation of the exchange rate. Accordingly, some modest easing in domestic cost pressures, including from stronger productivity growth in the domestically oriented services sectors, is likely to be required in the medium term. Inflation could be expected to be higher than in the central scenario if this easing in cost pressures does not occur.