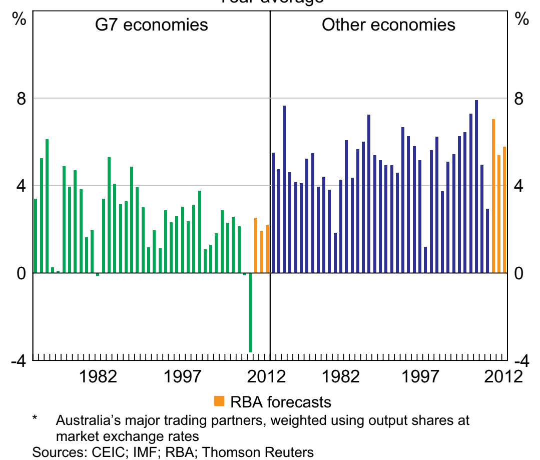
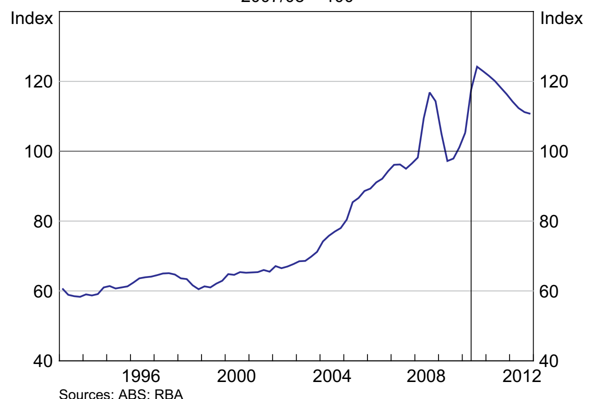
Economic Outlook

The International Economy

The world economy has continued to expand over the period since the May *Statement*. With many Asian economies having experienced strong V-shaped recoveries, growth in Asia has been especially robust over the past year. However, growth is now slowing towards more sustainable rates, with a gradual withdrawal of the earlier exceptional monetary and fiscal stimulus underway in a number of countries, including China. In the advanced economies, where the degree of economic slack remains greater, growth is estimated to have been relatively firm in the June quarter, but is also forecast to moderate in the latter part of this year and in 2011. This reflects expected headwinds from ongoing banking sector repair and fiscal consolidation to reduce budget deficits and stabilise public debt ratios.



Consistent with this outlook, the domestic forecasts are based on the expectation that global output will grow by a little over 4½ per cent in year-average terms in 2010. Such an outcome would be above the average rate of global growth recorded during the decade prior to the recent global downturn (Graph 82). World output is then projected to expand by a little under 4 per cent in 2011, and by around 4 per cent in 2012.



While the May forecasts envisaged a gradual easing in prices for iron ore and coking coal over the forecast period, developments in commodity markets over the past three months have prompted a revision, with contract prices now forecast to decline a little more quickly, but to around the same end-point as in the previous forecasts. This implies a slightly lower level of the terms of trade over most of the forecast period. Nonetheless, the terms of trade are expected to remain at a historically high level and to continue to support domestic incomes over the forecast period (Graph 83).

Domestic Activity

As discussed in earlier chapters, the Australian economy continued to expand over the first half of 2010, supported by elevated commodity prices, high levels of public investment and ongoing strong growth in the population. Employment growth has been strong, underpinning household income. Measures of business and consumer confidence have remained generally positive, though some caution is evident in behaviour. Over the period ahead, a rebalancing of growth is expected, with public investment set to decline as fiscal stimulus projects are completed, while private demand is expected to become a more important driver of growth. The outlook for investment in the resources sector remains favourable and the high level of the terms of trade is boosting incomes and demand.

The central forecasts are summarised in Table 14 and are based on the technical assumption that the cash rate moves broadly in line with market expectations. As noted in previous *Statements,* this technical assumption does not represent a commitment by the Board to any particular path for policy.

The central forecast for the domestic economy is similar to that at the time of the May *Statement*. In year-ended terms, GDP growth is forecast to be around 3¼ per cent over 2010 and to strengthen to 3¾ per cent over 2011 and 4 per cent over 2012, with growth in the mining sector stronger than in other sectors reflecting the reallocation of resources within the economy. In year-average terms, GDP is estimated to have grown by 2¼ per cent in 2009/10, and is forecast to grow by 3½ per cent in 2010/11 and 3¾ per cent in 2011/12. The forecast of robust GDP growth in 2011 and 2012 is partly driven by forecasts of above-average growth in the capital stock, especially in the resources sector, and the labour force. The latter assumes both continued above-average growth in the working-age population and a modest increase in the participation rate. Nevertheless, from 2011 through to the end of the forecast period, some tightening of capacity is expected following the period of below-average growth in 2008 and 2009. The labour market is expected to tighten gradually over the forecast period.

The outlook for overall demand is driven less by consumption than has been the case over much of the past couple of decades. While consumer confidence is buoyant and the labour market is strong, growth in household consumption is expected to be a little weaker than that in income. As a result, the saving rate is expected to rise modestly, with households being more cautious about their finances than in the past. Business investment is forecast to grow strongly over the forecast period, driving growth in domestic demand. The outlook for the business sector is positive, with signs that investment is picking up following temporary weakness in the wake of the tax incentives for equipment spending. Investment is also being underpinned by strong internal

Table 14: Output Growth and Inflation Forecasts[(a)]
Per cent, over year to quarter shown

	Dec 2009	June 2010	Dec 2010	June 2011	Dec 2011	June 2012	Dec 2012
GDP growth	2.8	3	3¼	3¾	3¾	3¾	4
Non-farm GDP growth	2.8	3	3¼	3½	3¾	3¾	4
CPI inflation	2.1	3.1	3¼	3¼	2¾	3	3
Underlying inflation	3¼	2¾	2¾	2¾	2¾	3	3

(a) Technical assumptions include A$ at US$0.92, TWI at 70, WTI crude oil price at US$84 per barrel and Tapis crude oil price at US$87 per barrel.
Sources: ABS; RBA

funding for businesses; survey measures of business profits remain at above-average levels, with the recent increases in bulk commodity contract prices providing a boost to mining profits. Engineering investment is expected to grow strongly over the period, reflecting the $43 billion Gorgon LNG project and a number of other significant resources projects in iron ore, coal and LNG. Resource exports are expected to grow strongly as a result of the earlier and ongoing significant expansions in capacity.

Inflation

Underlying inflation eased to around 2¾ per cent over the year to the June quarter, down from a peak of just over 4½ per cent in the September quarter 2008, and in line with expectations at the time of the May *Statement*. This easing reflects the significant moderation in capacity utilisation, demand pressures and some non-labour input costs through 2008 and 2009, and the slowing in wage growth. These factors, together with some contribution from the substantial appreciation of the exchange rate since early 2009, are expected to result in underlying inflation remaining at around 2¾ per cent over the next year or so.

Underlying inflation is then expected to gradually move higher, to be around 3 per cent in 2012. This reflects the effects of higher levels of capacity utilisation in the economy and a forecast pick-up in wage growth from recent relatively low levels as the labour market tightens. Inflation in non-tradable items is expected to remain firm, with significant contributions from rent, utilities and other housing costs. However, tradables inflation is likely to be moderate in the near term, due to recent softness in the retail sector and some ongoing effect from the exchange rate appreciation in 2009 on imported consumer prices. Overall, the outlook for inflation is little changed from that in May.

Headline CPI inflation was 3.1 per cent over the year to the June quarter and modestly higher than underlying inflation, as had been anticipated. Year-ended CPI inflation is expected to remain a little above 3 per cent over the next year, largely due to the recent tobacco excise increase and strong utilities price inflation.

Risks

As always, there are risks in both directions around the forecasts, although overall, these risks are viewed as evenly balanced.

On the upside, global growth has been stronger than expected in recent quarters and it is possible that the forecast moderation in the pace of world growth over the next year or so will not eventuate. It is also possible that domestic private demand could be stronger than forecast, particularly if firms in the mining sector attempt to push ahead with investment more rapidly than assumed in the central forecast. This would result in capacity pressures in the construction sector and the broader economy. In addition, the current cautiousness in spending by households may not persist and the forecast modest increase in the saving rate may not occur, particularly if the unemployment rate continues to trend lower and consumer confidence remains at elevated levels. If these risks were to eventuate, inflationary pressures could build more quickly than expected under the central forecast.

The main downside risk on the domestic front is that the forecast pick-up in private demand occurs more slowly than expected and does not fully offset the contraction in public investment that will be occurring over the next few quarters. The maximum effect of all the fiscal measures (including the cash payments) on the growth rate of output is estimated to have occurred around mid 2009 with the maximum effect on the level of output in early 2010, so fiscal policy will be subtracting from growth in the period ahead. Given the uncertainty about the timing of a number of planned large investment projects in the resources sector, it is possible that

overall growth over the next few quarters could be a little weaker than in the central forecast.

On the international front, there is some risk that the recent policy measures by the Chinese authorities result in a larger than intended slowing in growth. A material slowdown in steel-making and the construction sector could lead to a significant fall in commodity prices and potentially a delay in investment by resources companies in Australia. In addition, there is a possibility of a renewal of concerns about the financial position of European banks and governments, although the likelihood of this appears to have fallen somewhat over the past month or so. The direct trade effects on Australia of problems in Europe would probably be relatively limited, but there could be more significant effects if they resulted in a renewed retreat from risk taking and a slowing in the broader global economy. Under either of these scenarios, inflation would, in time, be lower than in the central forecast. ✠