

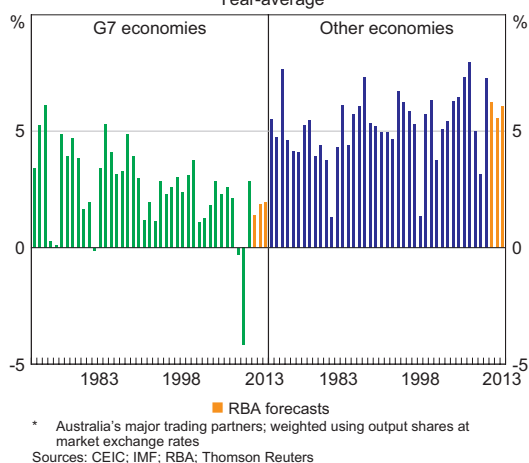
6. Economic Outlook

The International Economy

The IMF's September forecasts were for global growth to be around trend in 2011 and 2012, with annual growth of around 4 per cent in each year. These forecasts are weaker than three months earlier, with the downward revisions largely reflecting a softer outlook for the euro area and the United States, where concerns about the sustainability of sovereign debt positions have increased uncertainty and lowered confidence. The Bank's central scenario is a little weaker than the IMF's forecasts, mostly reflecting a more pessimistic view on Europe (Graph 6.1). Growth in emerging economies is, however, expected to remain firm, contributing around three-quarters of total global growth, although it has also been revised down modestly given trade and financial market linkages to the advanced economies. This central scenario is based on the assumption that sovereign debt problems in Europe do not cause a marked further deterioration in financial and economic conditions there. The recent announcement by European leaders on a package of measures initially led to some improvement in confidence, although much work still needs to be done to put public finances in a number of euro area countries on a more sustainable footing; this is highlighted by the current political turmoil in Greece. Accordingly, the risks to the forecasts remain skewed to the downside, as discussed further below.

The Chinese economy has grown by around 9 per cent over the past year, with growth moderating slightly in line with the authorities' efforts to restrain demand and limit inflation. The Bank's forecasts assume some further moderation over the next year or so, with growth of 8–9 per cent expected over the next couple of years. Given current tight financial

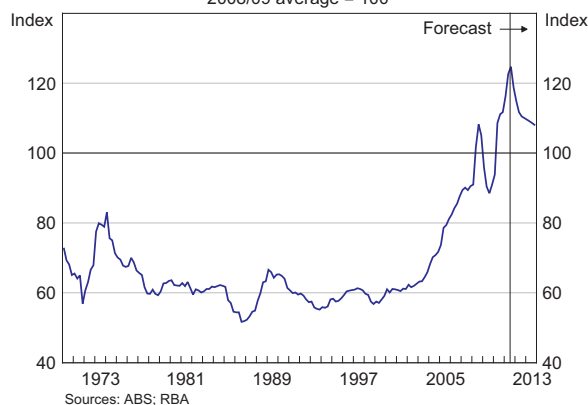
Graph 6.1
Global GDP Growth*
Year-average



conditions, including restrictive measures affecting the property market, the authorities have scope to respond if the problems in the advanced economies threaten a more significant slowing in growth. A number of other emerging markets also have scope to ease monetary and fiscal policies should it be needed.

For some time, the Bank has been expecting that the terms of trade would gradually decline as global production of resources, including coal and iron ore, increases (Graph 6.2). The recent falls in commodity prices and the slowing in global demand suggest that the peak in the terms of trade has now been reached and indeed the recent significant falls in the price of iron ore suggest that the decline could be happening a little faster than earlier expected. However, assuming continuing solid growth in China, commodity markets are likely to remain quite tight and the terms of trade are forecast to remain at very high levels compared with recent decades.

Graph 6.2
Terms of Trade
2008/09 average = 100



Domestic Activity

As usual, a number of technical assumptions are employed in the preparation of the forecasts. The exchange rate is assumed to remain at its current level over the forecast horizon (A\$ at US\$1.03, TWI at 76), which is a little lower than at the time of the *August Statement*. The price of Tapis oil – which is the most relevant for Australian fuel prices – is assumed to remain at US\$116 per barrel over the forecast period, which is also a little lower than in August. The cash rate is assumed to be unchanged over the forecast period. Finally, the forecasts

assume a slightly higher rate of population growth than was expected in August, with annual growth averaging around 1.6 per cent over the forecast period. This revision is based on the most recent data for population growth and forecasts from the Department of Immigration and Citizenship.

Growth over the forecast period has been revised lower since the *August Statement*. Momentum in the non-mining economy appears to have slowed somewhat, as evidenced by the softer-than-expected labour market outcomes over the past six months. In addition, the recovery in coal production appears to be occurring more slowly than expected. Accordingly, growth over 2011 is now expected to be around 2¾ per cent, a downward revision of around ½ percentage point since August (Table 6.1). GDP growth is then expected to pick up gradually to be around 3–3½ per cent over 2012 and a little stronger in 2013 (with the temporary increase to 4 per cent in mid 2012 reflecting the base effects of low coal exports in 2011). The downward revision relative to earlier forecasts reflects slightly weaker forecast growth in domestic demand plus a downward revision to the expectation for medium-term growth in coal exports. Growth in domestic demand, however, is still expected to be strong over the forecast period, with gross national expenditure

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

			Year-ended			
	June 2011	Dec 2011	June 2012	Dec 2012	June 2013	Dec 2013
GDP growth	1.4	2¾	4	3–3½	3–3½	3–4
CPI inflation	3.6	3¼	2	3¼	3¼	2½–3
Underlying inflation	2½	2½	2½	2¾	2¾	2½–3
CPI inflation (excl carbon price)	3.6	3¼	2	2½	2½	2½–3
Underlying inflation (excl carbon price)	2½	2½	2½	2½	2½	2½–3
Year-average ^(b)						
	2010/11	2011	2011/12	2012	2012/13	2013
GDP growth	1.9	1¾	3¼	4	3¼	3¼

(a) Technical assumptions include A\$ at US\$1.03, TWI at 76 and Tapis crude oil price at US\$116 per barrel

(b) Based on the quarterly national accounts release rather than the recent annual release

Sources: ABS; RBA

increasing at a rate of around 4 per cent. Part of this demand will be met through strong growth in imports, with the import content of resource projects expected to be gradually increasing, especially in the case of liquefied natural gas (LNG) projects.

Growth over the next few years is expected to be driven by mining-related activity, with below-trend growth in the non-mining economy. With the announcement of final investment approval for the Wheatstone LNG project, a pipeline of close to \$150 billion in LNG projects is now approved or under construction. Significant expansions to iron ore and coal production capacity are also underway, and will contribute to solid growth in resource export volumes over the next few years.

The near-term outlook for the overall non-mining economy remains subdued, with conditions likely to continue to diverge across industries. Business surveys and liaison suggest that investment intentions for the next year have softened over 2011, reflecting the high level of the exchange rate, the unwinding of the earlier fiscal stimulus and the greater uncertainty about the outlook for global growth. Further out, a gradual recovery is expected in non-mining investment, although the recovery is forecast to be more muted than following previous downturns.

The household saving ratio is expected to remain at around current levels over the forecast period. In the near term, household spending is likely to be affected by the decline in net wealth from falls in equity and housing prices, the fall in sentiment and increased concerns about the risk of unemployment. Over the next few years, however, household spending is expected to grow broadly in line with income growth.

The unemployment rate is forecast to rise a little, before declining gradually as the economy gains momentum later in the forecast period. The weaker near-term profile for employment partly reflects the downward revisions to domestic activity outlined above. In addition, with growth in the non-mining economy, which accounts for the bulk of

employment, expected to be more subdued than the anticipated rapid growth in the mining sector, the forecast for employment growth is lower than the usual relationship with aggregate output growth would suggest. Consistent with this, growth in the wage price index is expected to remain around its current pace at a little less than 4 per cent. Together with a forecast improvement in productivity growth, this is expected to result in some moderation in growth of unit labour costs.

Inflation

There has been a downward revision to the inflation forecast, reflecting the revision to the forecast for economic activity and a reassessment of the recent pace of inflation in the wake of the September quarter data and the 16th series CPI review.

Underlying inflation is estimated at a little below 2½ per cent over the year to the September quarter. The disinflationary effect from the appreciation of the exchange rate since 2009 has contributed to falls in tradable goods prices over the year, although this disinflationary impetus appears to have diminished over the past two quarters. Inflation in non-tradables goods and services has stabilised at around 3½ per cent, a little below the average pace of the past decade. With the exchange rate assumed to remain at its current level, import prices are not expected to subtract significantly from inflation in the period ahead. However, domestically generated inflation is expected to pick up more slowly than previously expected. This is conditional on an improvement in productivity growth and wage growth remaining around its current pace. Overall, underlying inflation, excluding the impact of the introduction of a price on carbon, is expected to be consistent with the inflation target over the forecast period, although it is expected to pick up a little towards the end of the forecast period, with a greater likelihood that it will be in the top half of the target range than in the bottom half.

The headline rate of inflation is expected to continue to be influenced by some volatile items and the

introduction of the carbon price. In the next few quarters, there will be an unwinding of the effects of the floods and Cyclone Yasi on the prices of fruit and vegetables, especially bananas. As prices return to more normal levels, headline inflation is expected to be below underlying inflation, at around 2 per cent over the year to June 2012. The introduction of the carbon price in July 2012 is then expected to result in headline inflation exceeding underlying inflation temporarily. As in the *August Statement*, the forecasts assume that the full 0.7 percentage point effect of the initial introduction of the carbon price occurs over the second half of 2012. Consequently, the year-ended rate of headline inflation is expected to be above 3 per cent for the first year after the introduction of the carbon price. Underlying inflation is expected to be temporarily boosted by around ¼ percentage point over the year following the introduction of the carbon price.

Risks

For the global economy, the risks to the central forecast remain skewed to the downside, with the sovereign debt and banking problems in the euro area remaining the most prominent risks. The central forecast assumes that the European authorities do enough to avert extreme financial dislocation, but are unable to avoid periodic bouts of considerable volatility and uncertainty. Under this central scenario, confidence can be expected to remain weak and growth in the euro area is likely to remain subdued. However, a wide range of downside scenarios are possible, stemming from the interaction of the stretched fiscal situations of a number of sovereigns, the poor capital position of some banks and the weak growth outlook. A materialisation of the downside risks would likely be very disruptive for Europe and could result in a deep recession. There would also be flow-on effects to the rest of the world through financial, confidence and trade linkages.

Risks to the outlook for other parts of the world appear less skewed. While a further deterioration in global economic conditions would result in reduced

demand for exports from China and other Asian economies, as noted earlier, policymakers in most of these economies have significant scope to ease monetary and fiscal policies in response to emerging signs of economic weakness, particularly to the extent that domestic inflation pressures appeared to be easing. Furthermore, if there is a sustained improvement in confidence in global financial markets, the healthy state of corporate balance sheets in the United States could see an acceleration of business investment and economic growth, a noticeable improvement in the labour market and some recovery in the housing market.

The possibility of a sharp economic deterioration in Europe represents a downside risk for the Australian economy. Given strong trade links with Asia, it is likely that Australia would be less directly affected than some other countries by a deterioration in Europe, although the economy would still be affected through falls in asset prices and weaker household and business confidence. Commodity markets could be expected to weaken and growth in domestic incomes would be lower. While there is a large pipeline of committed LNG projects that would be expected to continue, some planned expansions to coal and iron ore capacity could, in a downside scenario, be delayed. It is also likely that there would be a depreciation of the exchange rate, which would provide some offset for the economy. Overall, however, demand growth could be expected to be weaker than in the central forecast. An additional downside risk concerns the possibility of new rainfall-related disruptions to coal production, given the emerging La Niña weather pattern.

The possibility of a general improvement in global confidence represents an upside risk for the Australian economy. In addition, the forecasts envisage that the spillover effects from the mining sector to the non-mining sector are smaller than in previous resource booms, and it is possible that these effects will turn out to be stronger than currently expected as the mining boom continues to build.

The possibility of a significant global economic downturn is the main downside risk for inflation. The experience of 2009 shows that domestic cost pressures can ease quickly in the event of a major negative external shock. In such an event, inflation could be expected to be lower than in the central forecast. On the upside, while the central forecast is for inflation to remain consistent with the 2–3 per cent target range, there is some risk that the recent easing in wage pressure reported in business liaison may turn out to be temporary. More generally, the inflation forecast is conditional on some improvement in labour and multifactor productivity growth relative to the poor outcomes of the past 5 to 10 years, so that a continuation of the weak productivity performance would put pressure on domestic costs and inflation. ❖