6. Economic Outlook

The Bank's Forecasts over the Past Year

Growth through 2011 was weaker than had been expected by the Bank a year ago. As recorded by the latest national accounts, real GDP grew by 2.3 per cent over the year to the December quarter 2011, compared with the 4¼ per cent forecast in the May 2011 *Statement*, with the forecast being revised down through the year as new information became available. The lower outcome than initially forecast largely reflected weak export growth, with some smaller forecast errors in both directions for other components of activity.

As described in the 'Domestic Economic Conditions' chapter, exports in 2011 were held back by a number of factors, including the flooding of Queensland coal mines and the impact of the high level of the exchange rate on manufacturing and services exports. At the time of the May 2011 *Statement,* it was expected that coal producers would be able to remove the excess water from mines and resume full production by the September quarter. While the Australian dollar over 2011 was not too different to the level assumed in the forecasts, the effect of the persistence of the exchange rate at levels not seen for many years is having an impact on manufacturing and services exports, which were weaker than expected. The lower-than-anticipated growth in the global economy also weighed on exports. Imports were slightly stronger than forecast, partly reflecting the stronger-than-expected mining investment, which is particularly import intensive for some projects. Overall, the contribution of net exports to GDP growth over 2011 – a subtraction of 2½ percentage points – was much weaker than had been expected, with around half of the forecast error attributable to the slow recovery of coal exports.

In contrast, overall domestic demand expanded by only a little less than was forecast. While public spending was softer than expected, private demand grew roughly as anticipated, with consumption outcomes close to the forecast, dwelling investment slightly weaker and business investment slightly stronger. Within business investment, non-resource investment was weaker than forecast but resource investment was even stronger than the rapid pace of growth that had been expected. Gross national expenditure expanded by 4.8 per cent, which was in line with the forecast last May.

A year ago, it had been expected that employment growth would pick up in the second half of 2011, and that the rate of unemployment would gradually decline. But with output growth lower than expected, and with businesses and households evidently becoming more cautious about the outlook during the second half of the year, conditions in the labour market remained soft. Employment barely grew over the year to March 2012, with large increases in jobs in mining and some service industries roughly offset by declines in manufacturing, accommodation & food services, and retail. Although the rate of unemployment was little changed and at a relatively low level, a decline in labour force participation and average hours worked suggests a degree of weakness in labour demand.

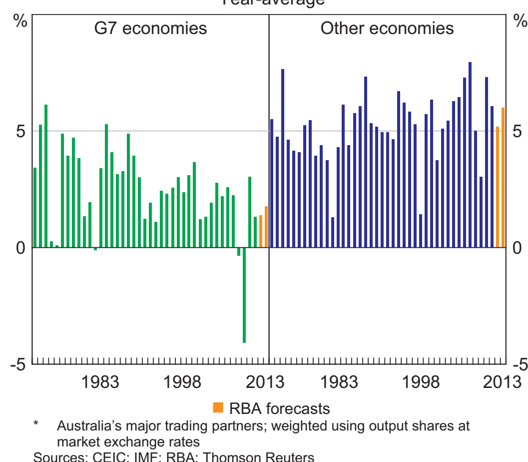
This combination of outcomes affected the path of inflation. A year ago, underlying inflation looked to have reached a low point of about 2¼ per cent, and was starting to rise. The forecast of strengthening output and a tightening labour market meant that inflation was forecast to increase further, to be close to 3 per cent in underlying terms by December 2011, and to stay around that level over the remainder of the forecast period. While inflation did initially pick up a bit further in the June quarter, it then began to moderate in the second half of the year, as a high exchange rate and ongoing changes in household behaviour put pressure on profit margins in some key domestic sectors. The fall in prices for fruit and vegetables, which had been affected by flooding and cyclones in early 2011, occurred more or less as expected. Hence headline CPI inflation fell very sharply, from about 3½ per cent at its peak in mid 2011, to a little over 1½ per cent in early 2012.

In summary, some components of the economy exceeded expectations while others underperformed over the past year, but overall, economic growth was weaker than expected. The generally softer outcomes translated into weaker price pressure in key sectors of the economy. Some of the forces that shaped the performance of particular parts of the economy, such as the strength in mining investment, will continue to be important over the current forecast period, while others, such as the disruption to coal production, will pass.

The International Economy

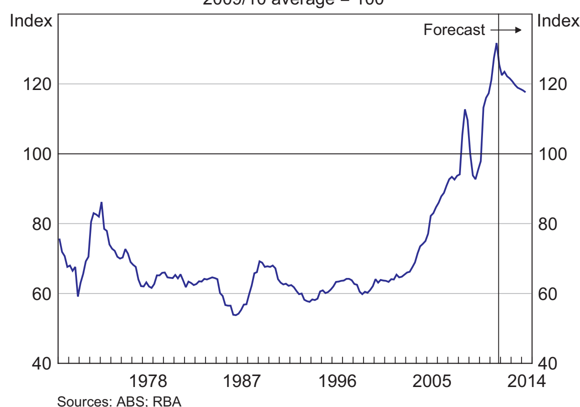
The global economy is expected by most forecasters to grow at a below-trend pace in 2012. Fiscal consolidation and private sector deleveraging, as well as the continued uncertainty stemming from the sovereign debt and competitiveness problems in Europe, are expected to weigh on growth in the advanced economies (Graph 6.1). Global growth is expected to pick up to around trend in 2013. The Bank's central outlook, for world output to expand by around 3½ per cent in 2012 and by around 4 per cent in 2013, is in line with the forecasts from the International Monetary Fund (IMF) published in mid April. Economic conditions remain weak in Europe, with the negative feedback loop between fiscal consolidation and growth still evident in a number of countries in the region. The US economy has continued to expand at a moderate pace, and growth is expected to increase slowly to around its trend pace over the next year. In China, output growth is expected to grow at a slower, and more sustainable, pace in 2012 than in recent years, while growth in much of the rest of Asia is expected to pick up a little, but to remain somewhat constrained by subdued trade with the advanced economies.

Graph 6.1
Global GDP Growth*
Year-average



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

After falling by around 5 per cent in the December quarter, the terms of trade are estimated to have declined further in the March quarter. The Bank continues to assume that the terms of trade will decline gradually, with the significant amount of investment under way globally boosting production of the bulk commodities over the forecast period (Graph 6.2).



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 period (A$ at US$1.03, TWI at 76), which is around 3 per cent lower than assumed in the February *Statement*. The price of Tapis oil is assumed to remain at US$125 per barrel over the forecast period, similar to the assumption in February. The cash rate is assumed to be unchanged over the forecast period at 3.75 per cent. Finally, the forecasts assume that growth in the working-age population will pick up slightly and average 1½ per cent over the forecast period.

The available indicators for the March quarter suggest that the economy grew at a modest pace. Measures of business and consumer sentiment are at, or slightly below, long-run average levels, while indicators of future building activity remain at low levels. Employment growth picked up modestly in the March quarter, but outside of the mining industry, growth in labour demand remains subdued. Mining production has been temporarily disrupted in early 2012 by a range of factors, including adverse weather. Work has continued, however, on the very large pipeline of committed mining projects.

The domestic economy is expected to grow by about 3 per cent over 2012 and 2013, and around trend over the year to mid 2014 (Table 6.1). This profile is marginally softer than forecast at the time of the February *Statement*. Over the forecast period, domestic demand is expected to grow at a slightly stronger pace than its long-run average, with rapid growth in mining investment not completely offset by weak building activity and soft government spending. Export growth has been revised lower, although it is still expected to be at an above-trend pace, as a result of high current and future investment in mine and transport infrastructure.

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	2.3	2¾	3	2½–3½	2½–3½	3–4
Non-farm GDP growth	2.5	2¾	3	2½–3½	2½–3½	3–4
CPI inflation	3.1	1¼	2½	2½–3½	2–3	2–3
Underlying inflation	2½	2	2¼	2–3	2–3	2–3
CPI inflation (excl carbon price)	3.1	1¼	1¾	2–3	2–3	2–3
Underlying inflation (excl carbon price)	2½	2	2	2–3	2–3	2–3
	Year-average					
	2011	2011/12	2012	2012/13	2013	2013/14
GDP growth	2.0	2¾	3	3–3½	3–3½	3–4

(a) Technical assumptions include A$ at US$1.03, TWI at 76, Tapis crude oil price at US$125 per barrel
Sources: ABS; RBA

The outlook for mining investment has been revised higher since the February *Statement*. Information from liaison indicates that some projects previously considered only possible now look more likely to go ahead than had been previously assumed, and that work on some other projects is progressing at least as fast as was expected. Data for the December quarter 2011 also suggest that there is a larger pipeline of work yet-to-be-done in iron ore and coal projects, and surveyed mining investment intentions for 2012/13 also highlight the strong outlook for mining investment (even accounting for the likelihood that not all of this intended investment will occur). Putting all this together, mining investment is expected to rise to around 9 per cent of GDP in 2012/13 compared with a 50-year average of 2 per cent.

At the same time as the upward revision to mining investment, the Bank's expectation for total export growth has been revised lower over the forecast period. This partly reflects a softer outlook for manufacturing exports, and a reassessment of the extent to which resources companies can utilise new port and transport capacity over the next few years. In particular, liaison indicates that it will take coal companies longer than originally envisaged to fully utilise the higher port capacity, due to coordination issues affecting rail networks and port facilities and differences in the timing of the expansion of transport and mine capacity. Despite the lower profile for export growth, it is still expected to be well above average over the forecast period. Exports are likely to continue to record strong growth beyond the forecast horizon as LNG projects under way will increase capacity significantly.

The near-term outlook for residential building activity has been revised lower, with recent data suggesting that there are few signs of an imminent turnaround in demand. Liaison contacts cite three main reasons for subdued housing activity: poor sentiment regarding job security, notwithstanding recent low levels of unemployment; softness in established housing markets, consistent with expectations of flat or declining house prices; and relatively tight credit conditions for developers. It is expected that residential building activity will in time pick up, as lower purchase costs, higher rental yields, population growth and pent-up demand following an extended period of weak growth in building activity combine.

Outside of the mining sector, survey measures and liaison suggest that business investment intentions remain weak at present. Public final demand is also expected to grow at well below-trend rates over the forecast period as both Federal and state governments undertake fiscal consolidation. Growth in household spending moderated a little in late 2011 and early 2012, in line with softer income growth and concerns about unemployment. However, there has been little change to the consumption profile since the February *Statement*, and the saving ratio is expected to remain at around its current level.

Employment growth is forecast to be fairly subdued in the near term, as it has been over the past year. Despite relatively high vacancy rates, firms continue to express caution about hiring and many firms are indicating that they will need to reduce staffing levels to improve productivity and competitiveness.

Given the outlook for the labour market, growth in the wage price index is expected to moderate slightly from the current pace to average 3½ per cent over the forecast period, around ½ percentage point below the elevated rates seen over 2005–2008.

Inflation

The outlook for inflation is somewhat lower than that published in the February *Statement*.

Data for the March quarter indicate that year-ended underlying inflation fell to around 2–2¼ per cent. Inflation is expected to remain close to this rate over the next year before picking up a little later in the forecast period. The forecasts anticipate that domestically generated inflation will moderate

owing to slower growth in unit costs, as a result of softer growth in nominal wages and an assumption that productivity growth picks up as firms, particularly in the non-mining sectors, respond to heightened competitive pressures in an environment of relatively subdued demand and the high exchange rate. This will largely be offset by the disinflationary pressure from tradables prices abating as the effect of the earlier appreciation of the Australian dollar on import prices dissipates.

The profile for headline CPI inflation will be affected by a number of one-off factors over the first half of the forecast period. Reflecting sharp falls in fruit prices in the December and March quarters, year-ended headline inflation will remain below underlying inflation at least until the second half of 2012. Following this, the introduction of the carbon price from the start of the September quarter will boost headline inflation by around 0.7 percentage points over the year to June 2013, for which most households will have received compensation in mid 2012. Measures of underlying inflation will be less affected by the introduction of the carbon price and are expected to be around ¼ percentage point higher than otherwise over the year to June 2013.

Risks

Although the near-term risk of a severe contraction in global activity from an intensification of the sovereign debt problems in Europe has eased somewhat over recent months, it remains the most obvious risk to the global growth forecasts. Since February, the restructure of Greek government debt held by the private sector and the second 3-year longer-term refinancing operation by the European Central Bank have helped to support global business and consumer sentiment a little after some deterioration at the end of 2011. Nevertheless, the situation in Europe remains fragile and, in the past few months, periods of heightened uncertainty have increased demand for safe assets and pushed spreads on some European sovereign bonds higher. As has been the case for some time, the central forecast assumes that a severe contraction in activity in Europe is avoided, but that episodes of heightened uncertainty and financial market volatility will continue to occur for some time.

Persistently high oil prices resulting from supply disturbances are also a downside risk to growth. IMF modelling suggests that a 50 per cent increase in oil prices from a reduction in global supply would lower global output by around 1¼ per cent, although the short-run effect could be larger if it also affected financial conditions and confidence more broadly.

Risks to output growth in the rest of the world are more balanced, but probably slightly tilted to the downside. In the United States, the forecasts assume that only part of the substantial fiscal consolidation that is legislated for 2013 actually occurs, although a larger consolidation would seem to be a downside risk to growth. In Asia, the cycle in information and communication technology (ICT) goods, which dampened growth in the region in the second half of 2011, could turn around more quickly than anticipated. In China, the government's intention is to engineer a further moderation in property prices and maintain a strong overall growth rate, albeit at a lower rate than in recent years. This is a difficult balance to strike, and so Chinese growth could easily be either above or below the central outlook.

For Australia, there are both upside and downside domestic risks to the outlook for activity. Labour shedding in a number of relatively employment-intensive industries, including manufacturing, retail trade and residential construction, may accelerate as firms continue to adjust to the higher level of the exchange rate, shifting patterns in consumption demand and the weak near-term outlook for dwelling investment. Further out, there is a risk that the demand for labour exceeds forecasts in 2013 given the very large pipeline of mining investment projects.

Downside risks to the inflation forecasts primarily reflect the risks of lower global and domestic growth. Weaker employment growth could also result in a sharper slowing in wage growth than anticipated.

On the other side, there is also a risk that the easing in underlying inflation over recent quarters will not be sustained. Over the past couple of years, the inflation outcomes have benefited from the disinflationary effect of lower tradables prices associated with the sharp appreciation of the exchange rate in 2009 and 2010. With the exchange rate broadly unchanged over the past year, tradables deflation is not expected to continue to subtract from overall inflation to the same extent.

While inflation in non-tradables prices eased somewhat in the March quarter, prices of many non-traded items are still increasing at a firm rate. Sustained moderation in domestic cost pressures will therefore be necessary to keep non-tradables inflation contained. This is likely to require a further easing in growth in labour costs and other costs and/or a pick-up in productivity growth. If the anticipated productivity benefits associated with structural adjustment take longer than expected to flow through to lower domestic cost pressures, or are offset by other costs, then activity would be weaker and inflation higher than otherwise. Inflation may also turn out to exceed the forecast if demand growth is higher than expected and firms use this as an opportunity to rebuild margins after a period of margin compression in some industries. ✠