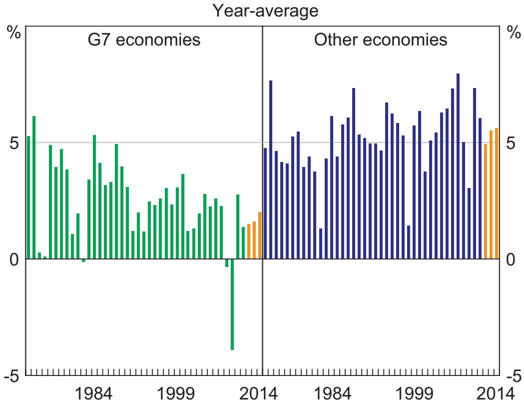
6. Economic Outlook

The International Economy

Concerns about the sustainability of sovereign debt and the solvency of the banking sector in some European countries, and the long-term viability of the euro area itself, continue to weigh heavily on perceptions of the global outlook. Conditions are expected to remain weak in the euro area for some time. The US economy is expected to continue to experience only modest growth, in part because of the uncertainty about fiscal consolidation in early 2013. As a result of the trade and confidence linkages from the below-trend growth in Europe and the United States, growth may be dampened in much of Asia. In China, much of the slowing to date reflects domestic policy actions and, accordingly, growth is expected to pick up slightly in the second half of the year as recent easings in fiscal and monetary policies start to take effect. Global growth is expected to be around 3½ per cent in 2012, which is close to its long-run average (Graph 6.1). Growth is then expected to pick up to be close to 4 per cent in 2013, broadly in line with the latest forecasts from the International Monetary Fund (IMF). These forecasts are marginally lower than at the time of the May *Statement*.

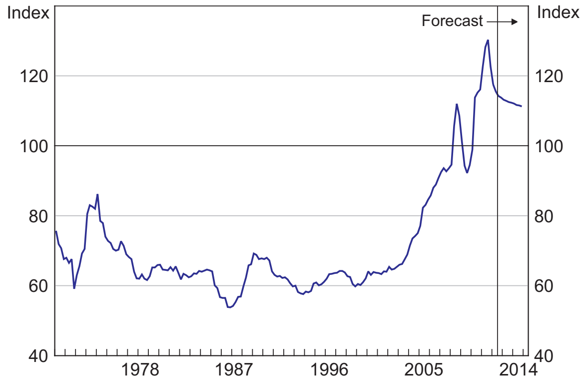
Commodity prices have been mixed over the past three months. The deterioration in sentiment in global financial markets and weaker outlook for the global economy led to falls in prices for crude oil, coal, base metals and iron ore. The spot price for coking coal was held up by disruptions to Queensland coal production stemming from industrial disputes, but has fallen more recently. Some rural prices, notably corn and wheat, have risen sharply due to droughts in the United States and Black Sea region, both large grain producers. Overall, commodity prices have fallen more sharply than was expected at the time of the May *Statement*. The terms of trade are estimated to have declined in the June quarter, to be more than 10 per cent lower than the September quarter 2011 peak. They are expected to gradually decline over the forecast horizon, as the current resource investment boom expands global supply in bulk commodities and demand for commodities increases more slowly than in previous years (Graph 6.2).

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

Graph 6.2
Terms of Trade
2009/10 average = 100



Sources: ABS; RBA

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$1.06, TWI at 79), which is a little higher than that assumed in the May *Statement*. The forecasts are based on a price assumption for Brent oil remaining at US$108 per barrel over the forecast period, effectively US$8 lower than the assumption in May. The cash rate is assumed to be unchanged over the forecast period at 3.50 per cent. This profile is higher than market pricing, which currently implies a 50 basis point reduction in the cash rate by the end of 2012. Finally, the forecasts assume that annual growth in the working-age population over 2013 and 2014 is 1.7 per cent, slightly higher than in the previous forecasts and in line with the pick-up in immigration of late.

The data released since the May *Statement* suggest that the domestic economy had been growing more strongly since mid 2011 than previously indicated. GDP growth over the second half of 2011 was revised higher to be around trend pace, and GDP grew by a strong 1.3 per cent in the March quarter. Recent data suggest that the economy probably grew less rapidly than this in the June quarter. Overall, and notwithstanding the possibility that some of the strength in the March quarter GDP may be revised away, the data currently suggest that growth in activity may have been above trend over the first half of the year, led by continued strength in resource investment and, as measured, a strong pick-up in household consumption volumes.

The Bank's current assessment is that growth is likely to be at about trend pace in the second half of 2012, as the strong growth in domestic demand moderates (Table 6.1). Nonetheless, the firm pace in the first half of the year sees the forecast for GDP growth over 2012 rise to 3½ per cent (from 3 per cent in the May *Statement*). The economy is then expected to grow at around 3 per cent over 2013 and 2014, little changed from the May *Statement*.

The expected moderation in domestic demand in the near term reflects an easing in consumption growth from its recent pace, as well as the impact of the Australian Government's fiscal consolidation on public demand. Growth in household consumption is estimated as having been well above trend over the first half of 2012, driven in part by heavy discounting by retailers earlier in the year and supported more recently by various government payments to households in the June quarter. It is expected that consumption growth will ease in the second half of the year before gradually picking up over 2013 and 2014. The saving ratio is expected to remain around its current level over the forecast period.

The peak in resource investment is anticipated to occur during the forecast period, at about the same level that was expected in the May *Statement*. However, based on the latest available data and information from liaison regarding the progress of liquefied natural gas (LNG) projects, that peak is expected to occur somewhat earlier than previously thought. Some resource companies have adopted a more cautious approach to investment opportunities currently under consideration (but to which they are not yet committed) given the more uncertain global outlook. However, final investment decisions have been confirmed on a number of major resource investment projects over the past few months,

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

	Year-ended					
	June 2012	Dec 2012	June 2013	Dec 2013	June 2014	Dec 2014
GDP growth	3¾	3½	2½–3½	2½–3½	2½–3½	2½–3½
Non-farm GDP growth	3¾	3½	2½–3½	2½–3½	2½–3½	2½–3½
CPI inflation	1.2	2¼	2½–3½	2–3	2–3	2–3
Underlying inflation	2	2½	2–3	2–3	2–3	2–3
	Year-average					
	2011/12	2012	2012/13	2013	2013/14	2014
GDP growth	3¼	3¾	3–3½	2¾–3¼	2½–3½	2½–3½

(a) Technical assumptions include A$ at US$1.06, TWI at 79 and Brent crude oil price at US$108 per barrel
Sources: ABS; RBA

including the approval of the second liquefaction train for the Australia Pacific LNG project. In addition, recent announcements of cost overruns – which have tended to reflect both the need for additional work on projects as well as increases in the prices of inputs – are included in the investment profile.

The forecasts continue to embody reasonably conservative assessments of the likelihoods that large individual resource projects currently under consideration do proceed. These take into account global demand projections, cost comparisons of projects, and the foreshadowed expansion of global supply. Based on this, it is estimated that the peak in spending on resource investment will be sometime in 2013/14. However, despite the latest information, there remains considerable uncertainty around the timing of the peak and subsequent gradual decline in resource investment. Resource investment – once adjusted for its use of imports – is expected to subtract modestly from GDP growth over 2014 (after accounting for more than half of GDP growth over 2011).

It is expected that, as resource investment declines, growth in resource exports will increase given the ramp-up in productive capacity of the bulk commodities. Non-resource business investment is expected to remain relatively subdued over the next year, in line with survey measures of firms' investment plans, but is likely to strengthen further out in the forecast period. Recent leading indicators of dwelling investment suggest it may have troughed in mid 2012, with a gradual upswing likely in response to lower mortgage rates, rising rental yields and stabilising house prices.

Employment growth has picked up in 2012 to date, with employment in the June quarter a little stronger than anticipated, following very subdued growth over 2011. Despite the recent improvement, employment growth in the near term is expected to remain relatively modest as structural adjustment and pressure to improve productivity in many parts of the economy constrain firms' ability and willingness to employ more staff. However, employment growth is expected to strengthen later in the forecast period, as growth picks up in more labour-intensive sectors.

With the unemployment rate expected to edge higher in the near term, growth in the wage price index is expected to remain contained, averaging 3½ per cent over the forecast period, around ½ percentage point below the elevated rates seen over 2005–2008 when the unemployment rate was declining.

Inflation

The outlook for inflation is little changed from the May *Statement*. Data for the June quarter showed moderate underlying inflation, at around ½ per cent in the quarter and 2 per cent over the year. In the past two quarters, domestic non-tradables inflation has slowed to around the average of the inflation-targeting period. Given the outlook for the economy, and conditional on the assumption of a sustained improvement in productivity growth, non-tradables inflation is expected to remain contained. However, now that the exchange rate has been around its current level for over a year, tradables inflation is expected to pick up further as the lagged effect from the appreciation of the exchange rate continues to wane. This, together with the increase in prices from the introduction of the carbon price at the beginning of July, is expected to result in the published measures of underlying inflation picking up to be in the top half of the inflation target range by mid 2013. The carbon price effect on inflation will largely have passed by late 2013 and underlying inflation is forecast to be around the middle of the target range thereafter.

The Bank's forecasts rely on Treasury's modelling of the carbon price, which indicated that it would increase the CPI by 0.7 per cent in 2012/13. According to the Treasury modelling, increases in household electricity and gas prices will account for around half of the total increase in consumer prices attributable to the carbon price. Recent announcements by state regulatory authorities and energy retailers indicate that the increase in household energy prices as a result of the carbon price will be apparent in the September quarter CPI.

The other half of the carbon price impact is accounted for by 'indirect' price effects on other goods and services in the CPI basket. There is significant uncertainty about the timing of the indirect pass-through of the carbon price to final consumer prices. Based on liaison information suggesting that many firms' costs and prices are yet to respond to the carbon price, the Bank's current forecast assumes that indirect pass-through occurs over three quarters, which is slightly slower than in the May *Statement* forecasts. How quickly these cost increases are passed through to consumer prices is likely to depend on a range of factors including the strength of aggregate demand and contractual arrangements. The ABS has indicated that it will be unable to distinguish between changes in prices that are due to the introduction of the carbon price and those reflecting the usual variation in prices driven by other factors. The extent to which the carbon price will be reflected in trimmed mean and weighted median measures of inflation will be influenced by the concentration of carbon price-induced price changes in specific quarters and the distribution of price changes. These factors will determine whether some of the effects are excluded by these statistical measures of underlying inflation. While the impact of the carbon price on underlying inflation is uncertain, the Bank's forecasts assume that it adds around ¼ percentage point over the year to June 2013.

Risks

The economic and financial events in the euro area remain a significant downside risk to global economic growth. Policymakers seeking to remedy the underlying causes of the crisis have found it difficult to get member countries to agree to greater fiscal integration and the associated loss of national sovereignty. The sequence of policy responses to date, while often improving sentiment temporarily, has not been able to fix the underlying problems and so concerns have periodically intensified, and are likely to continue to do so. There are many possible scenarios in which growth in Europe could be substantially weaker than is forecast, including the exit of one or more economies from the euro area itself. Nonetheless, as has been the case for some time, the forecasts assume that a severe economic and financial disruption in the euro area is avoided, but that there is ongoing volatility in sentiment and financial markets. Other risks to the global economy are slightly tilted to the downside, though much less so than is the case for Europe.

A key risk for Australia is the rate of growth in China, which currently appears to have stabilised, but could be higher or lower than expected given the challenges the authorities face in keeping growth at a more sustainable rate in a rapidly changing economy. The more benign inflation environment, with commodity prices having trended down, enables the Chinese authorities to ease policy more aggressively in any marked slowdown.

In the United States, the key issue is the very large fiscal contraction legislated to commence at the beginning of 2013. The forecasts assume that part of this fiscal consolidation occurs, but the magnitude of the fiscal consolidation remains highly uncertain. However, if there is early clarity on exactly how big the consolidation will be, and how it will affect households and businesses, the reduction in uncertainty could actually boost sentiment and activity towards the end of this year.

The terms of trade are forecast to decline gradually over the forecast period, but they could fall more quickly if global demand is weaker than expected. This would lead to lower growth in domestic incomes, including government revenue, weakening domestic demand.

In the domestic economy, the timing and magnitude of the expected peak and subsequent decline in resource investment is quite uncertain. The current forecasts anticipate that resource investment will peak sometime in 2013/14, but the timing is dependent on global demand, the extent of delays and cost overruns of projects already under way, as well as the size of increased supply outside of Australia. The gradual decline in resource investment is expected to be roughly offset by a pick-up in resource exports and non-resource investment, including dwelling investment. However, the timing of these changes is clearly also uncertain.

The forecasts assume, as usual, that the exchange rate remains unchanged. Given that it has been at this high level for some time, it is possible that the lagged effect on the economy will be more contractionary than historical relationships might suggest.

As usual, there are risks around the inflation forecasts, relating to flow-on effects of stronger- or weaker-than-expected growth in activity or employment and movements in the exchange rate, as well as uncertainty surrounding the timing of price increases relating to the carbon price. The recent increase in global grain prices could also prove to be persistent, thereby increasing inflationary pressure on food prices. Conversely, the weakness in some economies, and potential downside risks to growth, could lead to softness in global prices and so in those of imported goods. Given the lags in the inflation process, the uncertainty regarding the timing of the peak in resource investment is, at this stage, not a material risk to the current inflation forecasts. The recent low outcomes are likely to reflect some combination of margin pressure and better productivity growth, although it is too early to be definitive about how enduring the pick-up in productivity will prove to be. These developments have been driven by heightened competitive pressure in some parts of the economy but, given the economy overall is still operating close to capacity, such restraints could lessen if there is a material pick-up in sentiment and demand. ✠