

6. Economic Outlook

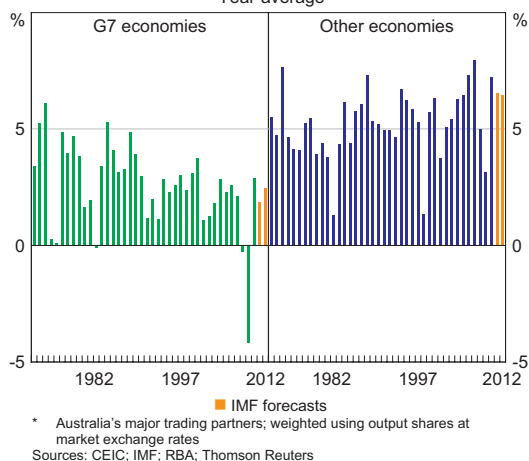
The International Economy

The IMF forecasts published in June are for global growth to be a little above trend at around 4¼–4½ per cent over the forecast period, although since then downside risks have become more prominent (Graph 6.1). The forecast for GDP growth for Australia’s major trading partners is higher, reflecting Australia’s trade links with Asia, where strong growth is expected to continue. In contrast, fiscal consolidation is expected to weigh on growth in Europe and the United States. This central forecast is based on the assumption that the resolution of sovereign debt issues in a number of countries proceeds in an orderly manner. A more disorderly resolution is a key risk to these forecasts and is discussed in more detail below.

After rising earlier in the year, global commodity prices are mostly a little off their recent peaks, in line with the moderation in the pace of global growth and reflecting the easing of supply disruptions for some commodities. Nonetheless, following the run-up over 2010 and early 2011, prices for most commodities remain at elevated levels. The recent easing of commodity prices has reduced the upward pressure on headline rates of inflation globally, though core rates still appear to be trending higher.

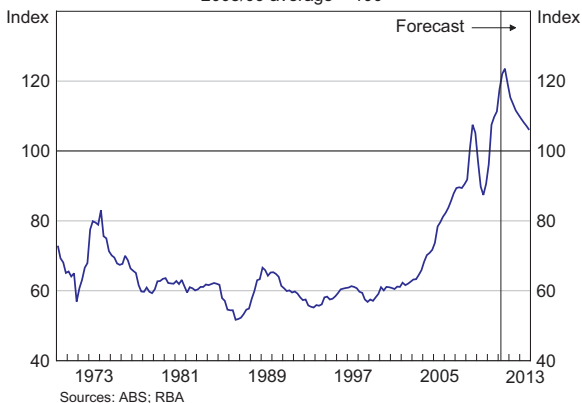
Australia’s terms of trade for the June quarter are estimated to have been at their highest level on record (Graph 6.2). This reflects the increase in contract prices for iron ore and coal over the first half of 2011, driven by ongoing strength in global steel production and supply disruptions in Australia and elsewhere. A further modest increase in the terms of

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
2008/09 average = 100



Sources: ABS; RBA

trade is expected for the September quarter, with a gradual decline thereafter as more global capacity in iron ore and coal comes on line.

Domestic Activity

Growth over 2011 has been revised downwards since the *May Statement*, due to a slower-than-expected recovery in coal production and, to a lesser extent, a downward revision to consumer spending as domestic and international concerns have weighed on sentiment. The medium-term outlook continues to be characterised by the significant pipeline of resources-sector investment – with a number of large projects already underway – and by strong growth in resource exports. There is a large divergence between the mining and related sectors and the rest of the economy, with the cautious behaviour of households, the unwinding of the fiscal stimulus and the high exchange rate weighing on a number of industries.

As usual, a number of technical assumptions are employed in the preparation of the domestic forecasts. The exchange rate is assumed to remain at its current level over the forecast horizon (A\$ at US\$1.07, TWI at 77), broadly similar to the assumption in the *May Statement*. The price of Tapis oil – which is the most relevant for Australian fuel prices – is assumed to remain at US\$118 per barrel over the forecast period, a little lower than in May. The cash rate is assumed to be unchanged over the forecast period; this compares with the technical assumption in May of a 50 basis points rise by mid 2013. The forecasts also assume a slightly lower rate of population growth than was expected in May, with growth averaging around 1½ per cent per year 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. Finally, as discussed below, the forecasts assume that a price for carbon is introduced from July 2012.

The profile of GDP growth over 2011 and early 2012 is being significantly affected by the flooding of late 2010 and early 2011. The decline in GDP in the March quarter was larger than earlier anticipated, with coal and iron ore exports estimated to have subtracted around 1¾ percentage points from growth. While iron ore exports have since rebounded to be around earlier highs, difficulties in removing water from flood-affected mines continue to hinder coal production. The recovery in coal exports has been slower than earlier expected by the staff and a range of external analysts, with the Queensland Resources Council now suggesting that a return to full production is not expected until early 2012. As a result, the boost to GDP growth from the recovery of coal production is now forecast to be spread into early 2012.

The updated central forecasts are summarised in Table 6.1. Growth over 2011 is forecast to be 3¼ per cent, which is a downward revision relative to May. This revision largely reflects the slower-than-expected recovery in coal exports, as well as slower forecast growth in consumption reflecting ongoing evidence of household caution. There is little change to the forecasts over 2012 and 2013, with growth still expected to be a little above trend, reflecting the strong medium-term outlook for the resources sector. The net effect of the revisions, including to population growth, is to lower the cumulative rise in GDP over the three years to end 2013 by around 1 percentage point. Overall, the build-up in the resources sector (both the growth in resource exports and the growth in mining investment, net of imports) is expected to contribute around two-thirds of GDP growth over the next few years. The risks around these forecasts are discussed below.

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

	Year-ended						
	Dec 2010	June 2011	Dec 2011	June 2012	Dec 2012	June 2013	Dec 2013
GDP growth	2.7	1¼	3¼	4½	3¾	3¾	3¾
Non-farm GDP growth	2.2	1	3¼	4½	3¾	3¾	3¾
CPI inflation	2.7	3.6	3½	2½	3½	3¾	3¼
Underlying inflation	2¼	2¾	3¼	3	3¼	3¼	3¼
CPI inflation excl carbon price	2.7	3.6	3½	2½	3	3	3¼
Underlying inflation excl carbon price	2¼	2¾	3¼	3	3	3	3¼
	Year-average						
	2010	2010/11	2011	2011/12	2012	2012/13	2013
GDP growth	2.7	1¾	2	4	4½	3¾	3¾

(a) Technical assumptions include A\$ at US\$1.07, TWI at 77 and Tapis crude oil price at US\$118 per barrel
Sources: ABS; RBA

Growth in household spending has been subdued over the first half of the year, despite solid growth in disposable income. There has been little growth in household net wealth given developments in the housing and equity markets, and measures of consumer confidence have fallen, with both domestic and international factors apparently weighing on households' perceptions of current and future conditions. With recent data pointing to an increase in housing and credit card repayments, the household saving ratio is assumed to increase a little over the second half of the year, implying that the profile for the saving ratio over the forecast period is higher than in May. However, with the medium-term outlook for the economy remaining positive, consumption growth is expected to strengthen gradually over the forecast period, although it will remain below the strong rate seen in the decade to the mid 2000s.

The outlook for investment in the mining sector remains very strong, with prices received for the bulk commodities remaining at high levels and further announcements that mining projects in the pipeline have been approved. Overall, mining investment is expected to rise from around 4 per cent of GDP in 2009/10 to more than 6 per cent in 2012/13.

Outside of the mining sector, business surveys suggest that, in aggregate, conditions are around long-run average levels while measures of confidence have recently fallen to below-average levels. However, this masks considerable divergence across industries. Conditions in the retail sector remain very weak due to subdued consumer spending, and parts of the construction industry not exposed to the mining boom are feeling the effects of weak residential and non-residential building as well as the fading of the fiscal stimulus. Liaison suggests that conditions in the trade-exposed parts of the manufacturing sector and tourism are also relatively soft. In contrast, conditions are stronger in many services industries, such as professional & administrative services, healthcare and education, consistent with employment growth in those areas. Overall, the forecast is for growth in non-mining investment to remain weak in the near term, but gradually pick up later in the forecast period.

Resource exports are expected to grow strongly over the next couple of years, as significant new capacity comes on line. Assuming no additional problems with weather, there will also be a boost in the near term as Queensland coal exports continue to recover. However, the high level of the exchange

rate is having a dampening effect on many non-resource exports, with growth in these categories expected to be subdued. In contrast, imports growth is expected to be very strong, reflecting the large pipeline of mining investment and the appreciation of the exchange rate. Recent information from liaison suggests that the imported component of some of the major mining projects underway is likely to be a little higher than previously expected; if so, there would be somewhat less pressure on resource utilisation in the domestic economy.

The downward revision to the forecasts for domestic demand and output implies that employment growth is likely to be somewhat slower than previously forecast. The forecasts also incorporate a continuation of the trend increase in participation rates (particularly among older workers). The unemployment rate is forecast to remain around current levels for some time and then decline a little near the end of the forecast period.

Inflation

The various measures of underlying inflation were in the $2\frac{1}{2}$ – $2\frac{3}{4}$ per cent range over the year to the June quarter. The effects of the easing in domestic demand and in capacity pressures associated with the late 2008 slowdown and the subsequent slowing in wage growth appear to have mostly passed, and the inflation data for the first two quarters of 2011 suggest more upward pressure on prices than in 2010. While this is partly the result of the spike in the prices of a number of volatile items, it is also likely to reflect some combination of the pick-up in the international prices of traded goods, second-round effects from increases in prices of utilities and oil, and the effect of ongoing poor productivity outcomes on unit labour costs.

The forecasts for inflation incorporate the planned introduction of a price on carbon (at \$23 per tonne of carbon dioxide equivalent emissions) from July 2012.¹ The major effect of this policy would be

an increase in the price level in 2012. The Federal Treasury estimates that the CPI will be boosted by 0.7 per cent, with around half of this effect representing the direct effect of higher electricity and gas prices for households and the remainder representing indirect effects on a wide range of goods and services. While the carbon price would increase again in mid 2013 by 5 per cent, the effect on overall inflation would be small. The forecasts assume that the full effect from the initial introduction of the carbon price occurs over the second half of 2012, implying that year-ended CPI inflation would be around 0.7 percentage point higher than otherwise in the December quarter 2012 through to the June quarter 2013, and unaffected thereafter. The price effects will also be reflected to varying degrees in a temporary increase in measures of underlying inflation. As the Bank has noted previously, monetary policy will look through any once-off effects and focus on the outlook for inflation in the medium term.

Overall, the medium-term outlook for underlying inflation is similar to that in the *May Statement*. Ongoing subdued retail trading conditions and the exchange rate appreciation are likely to exert some dampening effect over the period ahead. Further out, these effects are likely to wane and inflationary pressures are expected to increase a little as capacity in the domestic economy tightens. Accordingly, underlying inflation is expected, on the basis of the assumptions made, to be around or slightly above the medium-term target band over the period ahead.

It is likely that there will be significant volatility in headline CPI inflation over the next few years. In the near term, several volatile items – fruit, vegetable and fuel prices – are continuing to have a large influence on the headline inflation profile, with year-ended CPI inflation likely to remain above the target band for the remainder of 2011, before falling sharply in early 2012. There would subsequently be a temporary effect from the introduction of the carbon price. As in the past, measures of underlying inflation will be much less affected by large movements in particular items in the CPI.

¹ The Bank has previously discussed the economic effects and monetary policy implications of carbon pricing in 'Box C: Climate Change Mitigation Policy and the Macroeconomy' in the February 2009 *Statement*.

Risks

As always, there are both upside and downside risks around the central outlook described above. In the international economy, the upside risks relate mostly to the ongoing accommodative macroeconomic policies in many emerging economies in Asia and elsewhere, implying that growth could be stronger than in the central forecast, with further pressure on commodity markets and on inflation rates globally. The downside risks relate to the fiscal problems in many advanced economies, and have become more prominent over the past three months. Overall it seems easier to envisage significantly worse outcomes for global growth than it is for significantly stronger outcomes. The domestic risks, however, appear more balanced.

The central outlook incorporates an orderly resolution of the fiscal problems that a number of advanced economies are facing. However, for Greece, and some other euro area countries, it remains to be seen if the debt dynamics are stable. And in the case of the United States, there are still many hard decisions to be made following the debt ceiling agreement, for fiscal sustainability in the long run to be ensured.

Accordingly, there remains a probability that the fiscal problems in some advanced economies could play out in a disruptive way over the next year or so, which would have flow-on effects to global financial markets and economic activity. This remains a key downside risk to the forecasts. In the case of the problems in the euro area, the economic effects would be largest in Europe, where the banking sector has very significant exposures to the relevant countries, but these effects would spill over into other economies, particularly those where governments' financial positions are weak or where growth is heavily dependent on trade with Europe. One difference relative to the events following the collapse of Lehman Brothers in late 2008 is that markets for some time have been attaching a significant probability to further problems in Europe,

and sovereign debt exposures are better known, so banks, supervisors and markets should be more prepared. However, for most advanced economies there is very limited scope for easing of fiscal and monetary policy, given the low level of official interest rates and the stretched financial positions of many governments.

Outside these global risks, the risks stemming from domestic factors appear broadly balanced. As noted previously, there is some uncertainty over the pace of the expansion in the resources sector, which is expected to account for a significant share of the growth in the domestic economy. However, the main domestic uncertainty surrounding the forecasts concerns the behaviour of households. The central forecast assumes that the caution in the household sector continues for some time, with a modest increase in the saving ratio in the near term. However, it is certainly possible that there could be a more significant increase in the saving ratio, with households continuing to reduce debt or rebuild wealth. On the other hand, some of the factors affecting consumer confidence could abate and household spending could pick up pace faster than anticipated in the forecasts. These risks to demand mean that, other things equal, the path of inflation could be lower or higher than the central forecasts.

Another risk stems from the outlook for productivity. Growth in both labour and multifactor productivity over the past 5–10 years has been well below longer-run average rates and has contributed to the pick-up in the rate of growth of unit costs. Looking ahead, a risk is that continued weak productivity growth will put more upward pressure on costs and hence domestic inflation, possibly at a time when global inflation pressures are less benign than they have been over the past couple of years. On the other hand, a period of heightened structural adjustment could see productivity improve at a faster pace than has been the case in the recent past. ▽

