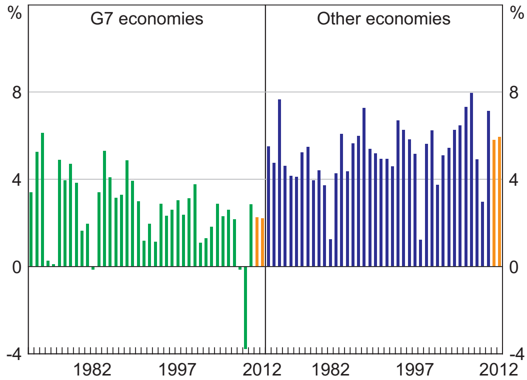
6. Economic Outlook

The International Economy

The outlook for the global economy is a little stronger than at the time of the November *Statement*, with world output expected to expand at a slightly above-trend annual pace of 4¼ per cent in both of the next two years. In the central scenario, growth is projected to remain strong in China and India, and to be firm elsewhere in Asia (excluding Japan) over the forecast period (Graph 6.1). Recovery is forecast to continue at a moderate pace in the United States and in the euro area as a whole, while growth in Japan is expected to be slower than in 2010. Considerable excess capacity is likely to remain in most of the advanced economies, in contrast to most emerging economies. The main uncertainties around the central scenario arise from the sovereign debt problems in Europe and the rate at which the current accommodative policy stance in much of Asia is tightened.

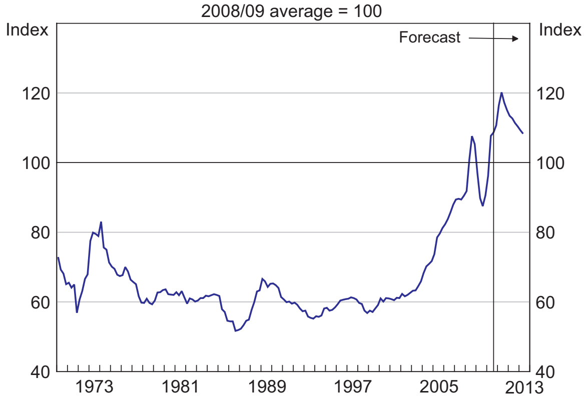
Commodity prices have increased since the November *Statement*, reflecting continued solid demand from Asia as well as weather-related disruptions to supply. Spot prices for coking and thermal coal have increased sharply, amid significant disruption to production as a result of flooding in Queensland. Unusually cold weather in the Northern Hemisphere has also contributed to the increase in prices. Iron ore spot prices have also moved higher, on strong demand from China and tight global supply. In addition, food prices globally have increased significantly in recent months. This generalised increase in commodity prices has led to a further upward revision to the near-term outlook for Australia's terms of trade (Graph 6.2). Most commodity prices are forecast to remain at a higher level over the next couple of years than expected at the time of the November *Statement*, although the forecasts still envisage a gradual decline in bulk commodity prices over the medium term as more supply comes on line.

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

Domestic Activity

While the recent floods in eastern Australia are expected to have a material effect on the near-term quarterly profile of economic activity, the medium-term outlook for the economy is broadly unchanged from the time of the November *Statement*, with strong growth in mining investment and higher commodity prices boosting national income and demand. The risks around the forecasts are discussed below.

The central forecasts were finalised before an assessment of the damage from Cyclone Yasi in north Queensland was possible. They are based on the technical assumption that the exchange rate remains at its current level – which is little changed since the November *Statement* – and that the cash rate moves broadly in line with market pricing. As noted in previous *Statements*, the latter assumption does not represent a commitment by the Board to any particular path for policy. The WTI oil price assumption is US$96 per barrel, which is 10 per cent higher than at the time of the November *Statement*. The Tapis oil price assumption – which is more relevant for Australian fuel prices – is 14 per cent higher at US$103, and assumes that the current large spread to the WTI oil price narrows somewhat over the forecast period.

The central forecasts are summarised in Table 6.1 and the impact of the floods on GDP and inflation are discussed further in 'Box A: The Impact of the Recent Floods on the Australian Economy'. Growth in the December quarter and for 2010 as a whole is likely to have been weaker than was expected in November, with retail spending in late 2010 relatively subdued and heavy rain in central Queensland leading to a fall in coal production in December. The forecast for the March quarter has also been revised down, reflecting the impact of the floods on the coal industry and reduced spending by households and businesses amid the disruption of the floods in south-eastern Queensland and in Victoria. However, growth in the June quarter is forecast to be boosted as coal production recovers and as households and firms in flood-affected areas begin to replace damaged household items and machinery and equipment. There will also be a boost to activity from the rebuilding of flood-damaged dwellings as well as the public spending on repairing and rebuilding of public infrastructure, although this is likely to occur gradually over a couple of years. Overall, by the June quarter the level of GDP is expected to be back close to where it would have been in the absence of the floods and, over the remainder of the forecast period, to be slightly above where it would have been.

GDP is expected to grow by around 4¼ per cent over 2011, boosted by the recovery in coal production from the effect of the floods. Growth is expected to remain at an above-average pace of around 3¾–4 per cent over the rest of the forecast period. In year-average terms, GDP is forecast to grow by 2¾ per cent in 2010/11, 4¼ per cent in 2011/12 and 4 per cent in 2012/13. There is likely to be considerable variation across industries, with growth expected to be strongest in the mining industry, and some related service industries also experiencing

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

Per cent, over year to quarter shown

	June 2010	Dec 2010	June 2011	Dec 2011	June 2012	Dec 2012	June 2013
GDP growth	3.1	2¾	3¼	4¼	3¾	4	4
Non-farm GDP growth	3.2	2½	3¼	4¼	3¾	4	4
CPI inflation	3.1	2.7	2½	3	2¾	3	3
Underlying inflation	2¾	2¼	2¼	2¾	2¾	3	3

(a) Technical assumptions include A$ at US$1.00, TWI at 74, WTI crude oil price at US$96 per barrel and Tapis crude oil price at US$103 per barrel

Sources: ABS; RBA

strong conditions. In contrast, the high level of the Australian dollar will weigh on a number of other industries.

For some time, the Bank has been expecting very strong growth in resources sector investment. The information received over recent months has provided greater confidence in this forecast, with announced plans to date at least as strong as had been expected. A number of large LNG and iron ore projects are now under way; the $43 billion Gorgon LNG project is under construction, while two large coal-seam methane projects in Queensland (together worth around $31 billion) have recently received final investment approval. Overall, the profile for mining investment projects has been revised slightly higher since the November *Statement*. Outside of the mining sector, however, liaison and survey measures suggest that firms remain cautious in their investment decisions.

Household spending and borrowing have remained subdued, with the household saving ratio now estimated to have risen back to around its level in the mid 1980s. There have been few signs of households becoming less cautious recently, with retailers continuing to report that sales have been quite soft. However, the central forecast does not envision that the saving ratio will continue to rise; growth in household consumption over the forecast period is expected to be around its trend rate, supported by solid growth in income. Dwelling investment is expected to gradually pick up, underpinned by solid population growth.

After some near-term volatility in coal exports as a result of the floods, resource exports are expected to grow solidly over the forecast period as significant new capacity comes on line. Growth in non-resource exports is expected to be modest, reflecting the high real exchange rate and policy changes in the education export sector. Import growth is expected to be strong, reflecting firm growth in domestic demand, particularly mining investment, which has a significant imported component.

The medium-term outlook for the labour market is little changed since November, although year-ended employment growth has been revised up modestly in the near term reflecting the stronger-than-expected outcome seen in the December quarter and some additional employment related to the recovery from the floods. Employment is expected to grow at an above-average pace over the forecast period, consistent with the forecast for GDP. While growth in the labour force is also expected to remain above average over the forecast period, labour market conditions are expected to tighten gradually, with the unemployment rate declining from its current rate of 5 per cent to 4½ per cent by mid 2013. The forecasts imply that growth in labour productivity will pick up over the forecast period, but remain below average.

Inflation

The medium-term outlook for inflation is largely unchanged, although the near-term forecast for year-ended underlying inflation has been revised down since the November *Statement*, following the lower-than-expected December quarter outcome.

Underlying inflation eased to around 2¼ per cent over the year to the December quarter – which was a little lower than had been expected at the time of the November *Statement* – and has now declined by around 2¼ percentage points since its peak in September 2008. Much of this overall decline has been due to the easing in domestic demand and capacity pressures in late 2008 and 2009 and the subsequent slowing in wage growth. More recently, the appreciation of the exchange rate and ongoing soft consumer spending have continued to exert downward pressure on inflation. While the exchange rate appreciation is expected to continue to have some effect in coming quarters, the forecast strengthening in private demand and the tightening labour market are expected to lead to a pick-up in year-ended inflation later this year. The floods are expected to have a noticeable effect on fruit and vegetable prices in coming quarters (as discussed in Box A), although the forecasts have been prepared on the assumption that this does not flow through to a sustained pick-up in inflation expectations.

Overall, year-ended underlying inflation is forecast to remain in the bottom half of the target range in the first half of 2011, before picking up gradually to 3 per cent by late 2012. Inflation is expected to be strongest for non-tradable items, with significant contributions from rent, utilities and other housing costs, while tradables inflation is expected to remain moderate for the next year or so, reflecting the ongoing effects of the exchange rate appreciation on imported consumer goods prices.

Headline CPI inflation was 2.7 per cent over the year to the December quarter. Year-ended CPI inflation is expected to remain above underlying inflation in the near term, at around 2½–2¾ per cent, largely reflecting the tobacco excise increase in 2010 and high inflation in utilities, fruit and vegetable prices. These forecasts do not incorporate any effects from Cyclone Yasi in north Queensland. Based on previous experience, an increase in fruit and vegetable prices can be expected, particularly for bananas. However, at the time of writing not enough information was available to form a quantitative assessment of the likely effects.

Risks

As always, there are risks around the central forecasts.

For the international economy, one ongoing downside risk is the possibility of further escalation in the sovereign debt problems of some euro area economies. If this were to be accompanied by a generalised retreat from cross-border risk-taking, it could have a significant contractionary effect on the global economy.

A further set of risks concerns the accommodative settings of policies in much of Asia and some other parts of the emerging world. Economic growth in many of these economies is strong, property market conditions have been buoyant in some countries, and inflation pressures are building. A continuation of strong growth would see further strong increases in commodity prices and income gains for Australia. The experience of 2007 and early 2008 suggests that – notwithstanding the insulating role of a floating exchange rate – the combination of rising global inflationary pressures, large increases in commodity prices and a domestic economy close to full employment could lead to domestic inflation rising more quickly than envisaged in the central scenario. On the other hand, if overheating in these economies prompted a significant tightening of policies, there could be a sharper-than-anticipated slowing in growth in these economies, with flow-on effects to commodity markets. This would be contractionary for Australia and would result in some easing in the outlook for the resources sector.

The impact of extreme weather events on the macroeconomy is an important source of short-term uncertainty for the forecasts, as the full extent of damage to public infrastructure and private property is yet to be determined. On the downside, there is the risk that damage to infrastructure is larger than currently estimated with coal production taking longer to recover than in the central forecast. In addition, given the La Niña weather pattern, there is the possibility of further extreme weather events over the next few months. There is, however, also the possibility that the process of rebuilding and repair draws in more resources than is currently assumed, with more broad-based pressure on price and wage inflation than in the central forecast.

As noted in previous *Statements*, the resources sector is an important element of the outlook for the economy. The recent announcements that some large projects have obtained final investment approval provide greater confidence in the pick-up in resources investment that the Bank has been expecting for some time. Nevertheless, there is still uncertainty surrounding other projects that are in earlier stages of planning and could be delayed. On a broader perspective, as resources investment and exports grow in relative importance, developments in the resources sector will have a greater impact on the domestic economy, whether from supply-side factors or from swings in global demand.

A final uncertainty relates to the behaviour of Australian households. Household spending in recent years has been subdued compared with income growth, resulting in a significant increase in the household saving ratio. It is possible that this trend will continue, reflecting an ongoing change in households' attitudes to spending and debt as well as the current mildly restrictive monetary policy settings. On the other hand, there is a possibility that household spending, at some point, could pick up by more than is assumed in the forecasts, with households being prepared to spend more of their growing incomes after a period of balance-sheet consolidation. This would result in stronger pressures on domestic resource utilisation and an increased risk of higher inflation outcomes.