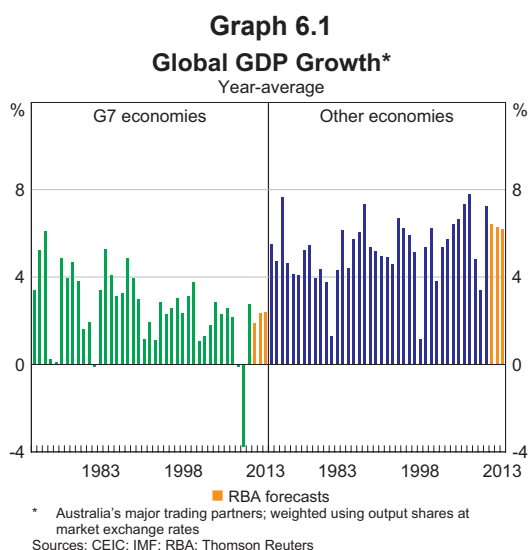


6. Economic Outlook

The International Economy

The global economy is expected to grow at an above-average pace over the next few years, albeit somewhat slower than the pace seen earlier in the recovery. The central scenario is for world output to expand by around 4½ per cent in 2011, 2012 and 2013, consistent with forecasts from the International Monetary Fund. The aggregate forecast for 2011 is unchanged from the February *Statement*, with a downward revision to the outlook for Japan following the earthquake and tsunami offset by upward revisions to other countries in Asia and Latin America (Graph 6.1). With above-average growth forecast for the next few years and commodity prices already elevated, one key risk to growth relates to a possible acceleration of global inflation and the subsequent monetary policy responses.

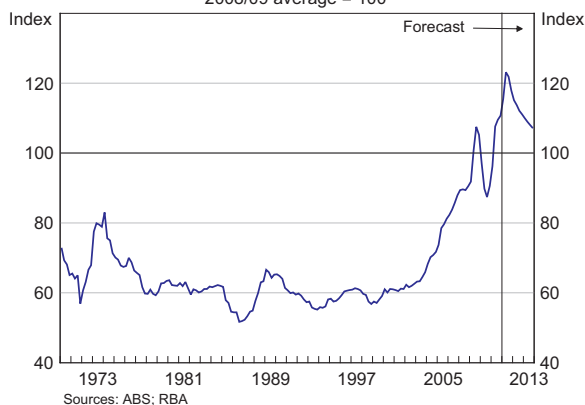
Global commodity prices have increased sharply since mid 2010, reflecting strong demand, particularly from the emerging economies of Asia, as well as some supply disruptions. Global food prices are now back around the peak levels they were at in mid 2008, reflecting the ongoing increase in per capita incomes in developing countries and the resulting changes in food consumption patterns, as well as weather-related disturbances that have affected production of some agricultural commodities. Industrial production in China and other emerging markets continues to grow at a rapid pace, while production in advanced economies, except for Japan, is also expanding. This



is contributing to upward pressure on the prices of raw materials such as base metals, coal and iron ore. Oil prices have also increased sharply in recent months, and the price of gold has recently reached a record high in nominal terms. While the strength in commodity prices primarily reflects strong global demand, for some economies it can be viewed as an adverse supply shock and is having a negative impact on real household incomes.

The increases in commodity prices, including the effect of the Queensland floods on coking coal production, are being reflected in a further increase in Australia's terms of trade, which are expected to rise to a new peak in the June quarter (Graph 6.2). The terms of trade are forecast to then gradually

Graph 6.2
Terms of Trade
 2008/09 average = 100



decline as the effects of weather-related disruptions to rural and coal production fade and more global capacity in iron ore and coal comes on line. Overall, there has been an upward revision to the forecast of the terms of trade, with the terms of trade expected to remain at historically high levels over the next few years: the forecasts imply that the terms of trade in 2011/12 will be at their highest level since at least 1870 (when the data begin).

Domestic Activity

The medium-term outlook for the economy continues to be dominated by the expected build-up in mining investment and the boost to incomes from the high terms of trade. Providing a partial offset to these factors, monetary policy is mildly restrictive, the exchange rate has appreciated substantially and fiscal policy will be contractionary over the next couple of years. Nevertheless, inflationary pressures are expected to build gradually over the forecast period as spare capacity is absorbed and the labour market continues to tighten. The risks around the forecasts are discussed below.

Extreme-weather events are likely to have resulted in a decline in GDP in the March quarter. This effect is larger than had been expected at the time of the February *Statement*, mainly reflecting a larger-than-expected loss of coal production in the March

quarter due to problems in removing water from flooded coal pits. Iron ore exports are also estimated to have declined in the March quarter as adverse weather (a greater than usual number of cyclones and tropical lows) disrupted port activity. However, these effects are expected to be temporary, with the anticipated recovery in production providing a boost to GDP growth over the rest of 2011.

As usual, the domestic forecasts have been prepared under the technical assumption that the cash rate moves broadly in line with market pricing; this implies an increase in the cash rate of $\frac{1}{4}$ percentage point by early 2012 and a further $\frac{1}{4}$ percentage point increase by mid 2013, a slower rise than suggested by the forecasts of market economists. The exchange rate is assumed to remain at its current level over the forecast horizon (TWI at 78, A\$ at US\$1.07, which is an appreciation of around 5 per cent and 7 per cent respectively since the February *Statement*). The assumption for the Tapis oil price – which is the most relevant for Australian fuel prices – is 22 per cent higher than in February at US\$126.

The updated central forecasts are summarised in Table 6.1. Taking into account the expected decline in GDP in the March quarter and the subsequent expected rebound as production of coal and iron ore recovers, growth over 2011 is forecast at $4\frac{1}{4}$ per cent. The forecasts for 2012 and 2013 have been revised down slightly, mostly reflecting the effects outside the mining sector of the appreciation of the exchange rate, although growth is expected to remain at an above-average pace over this period. In year-average terms, GDP is expected to grow by $2\frac{1}{2}$ per cent in 2010/11, $4\frac{1}{2}$ per cent in 2011/12 (reflecting the base effect of the impact of floods in 2011) and $3\frac{3}{4}$ per cent in 2012/13.

Mining investment is expected to rise from around 4 per cent of GDP in 2009/10 to over 6 per cent in 2012/13, with a number of large projects already underway. Non-mining investment is expected to expand more moderately over the forecast period,

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	2½	4¼	4¼	3¾	3¾	3¾
Non-farm GDP growth	2.1	2½	4½	4	3¾	3¾	3¾
CPI inflation	2.7	3½	3¼	2½	3	3	3¼
Underlying inflation	2¼	2½	3	3	3	3	3¼
	Year-average						
	2010	2010/11	2011	2011/12	2012	2012/13	2013
GDP growth	2.7	2½	3¼	4½	4¼	3¾	3¾

(a) Technical assumptions include A\$ at US\$1.07, TWI at 78 and Tapis crude oil price at US\$126 per barrel
Sources: ABS; RBA

remaining largely constant as a share of GDP. While private-sector surveys point to an increase in investment intentions in some sectors and the ABS capital expenditure survey suggests building activity should pick up in 2011/12, the high exchange rate, tight credit conditions for some borrowers and subdued consumer spending are weighing on conditions.

Households remain cautious in their spending behaviour, despite strong labour income growth and consumer sentiment being modestly above average levels. While income growth is expected to be solid over the next few years, the central forecast assumes that the household saving ratio remains at around its current level, reflecting above-average interest rates, some residual uncertainty stemming from the global financial crisis, and a desire for some further consolidation of balance sheets. Growth in dwelling investment is expected to be weak in the near term, and then to pick up modestly over the forecast period in line with solid population growth.

Resource exports are expected to grow strongly over the next few years, as significant new capacity, particularly in iron ore, comes on line. Rural exports are also expected to grow solidly, given the improved outlook for farm production. The high exchange rate is likely to weigh on growth in non-resource exports, offsetting the support from above-average major

trading partner growth. Import growth is expected to be very strong, reflecting the large pipeline of mining investment and the appreciation of the exchange rate.

The medium-term outlook for the labour market is little changed from that in February. Employment growth is expected to remain solid over the forecast period, consistent with the outlook for GDP growth. The forecasts incorporate a number of developments that are expected to contribute to labour supply growth, including a modest pick-up in population growth, a continuation of the trend increase in participation rates (particularly among older workers), and a stabilisation in average hours worked after a decline over the past decade. The labour market is expected to gradually tighten over the forecast period, with the unemployment rate forecast to reach 4¼ per cent by the end of the forecast period in December 2013.

Inflation

At present, a number of volatile items are simultaneously adding to headline inflation. The effect of the severe weather events on fruit and vegetable prices contributed significantly to inflation in the December and March quarters. Along with higher fuel prices, this is expected to see headline inflation above the medium-term target

over the year to June, but the pace of headline inflation is likely to slow by early next year following the unwinding of the recent spike in fruit and vegetable prices.

Abstracting from these volatile items, underlying inflation appears to have troughed at around 2¼ per cent in the December and March quarters, down from just over 4½ per cent in mid 2008. The appreciation of the exchange rate has led to significant declines in the prices of many traded manufactured goods, and inflation for non-traded items has also declined somewhat over the past year. Nevertheless, underlying inflation in the March quarter was slightly higher than anticipated at the time of the February *Statement*. Looking ahead, given the outlooks for both the world and domestic economies, year-ended underlying inflation is expected to pick up over the course of 2011.

In 2012, underlying inflation is expected to be around 3 per cent and, on the stated assumptions, to increase to 3¾ per cent by the end of 2013. This reflects a combination of factors, including a gradual further strengthening in labour costs as capacity utilisation and the labour market tighten, and the waning of the disinflationary effect of the recent appreciation. It is likely that inflation rates for a range of non-tradable items, including utilities (particularly electricity) and rents, will contribute significantly to overall inflation. Furthermore, global factors are likely to contribute more to inflation than over the past couple of years, given the recent strength in commodity prices and an expected modest acceleration in global manufactures prices.

Risks to the Forecasts

As always, there are risks and uncertainties around the central forecasts.

One set of risks on the international front concerns the effects of strong economic growth and accommodative global monetary policy on commodity prices. With global growth forecast to remain somewhat above trend, commodity markets

are likely to remain quite tight with implications for global inflation. In Asia, where economies are already operating close to capacity, both headline and core measures of inflation are increasing. Although some tightening of policy has occurred, including through exchange rate appreciation, real interest rates remain low. In the advanced economies where monetary policy is in most cases still at very accommodative settings, rising commodity prices are reducing purchasing power and dampening economic activity while also contributing to higher inflation expectations. Central banks in both groups of countries will face challenges in calibrating the appropriate response. If policy is too slow to respond, the result could be further pressure on commodity prices in the near term, further increases in inflation expectations, and then a sharp slowing in growth as policy is belatedly adjusted. This would be a scenario where growth in demand in the Australian economy would be stronger in the near term but weaker in the medium term if commodity prices subsequently fell significantly.

An additional ongoing downside risk stems from the fiscal challenges in some of the advanced economies. To date, this has mostly concerned some of the smaller economies in the euro area and the risk has been that any heightening or broadening of problems could be disruptive to markets and potentially also result in a retreat from cross-border risk-taking in international financial markets. More recently, there has also been greater attention on the fiscal challenges of the US economy. The risk here is of a flight from US dollar assets and a spike in bond yields. While it is hard to be sure how this would play out, it is likely that such a scenario would see weaker global and domestic growth.

The main uncertainty surrounding domestic demand concerns the behaviour of Australian households. The central forecast envisages that the saving ratio remains at around its current level over the forecast period, which is well above the average of the past two decades.

On the one hand, it is possible that households could continue to show significant restraint in their spending and the household saving ratio could rise further. Alternatively, with the labour market continuing to tighten and the unemployment rate expected to decline further, households may become more confident and consumption growth could pick up faster than envisaged in the central forecast.

A second important domestic uncertainty concerns the outlook for investment in the resources sector. One possibility is that the considerable complexity of some of the large planned projects results in the pick-up in resources investment occurring more slowly than is envisaged in the central forecasts. If so – or if the terms of trade were to weaken more rapidly than in the central forecast – domestic demand growth would be weaker and the tightening of the labour market and the pick-up in wage and inflation pressures would be slower than in the central forecast.

The greater risk, however, is that the significant pick-up in mining investment continues and that

companies compete aggressively for labour and other inputs, leading to more pressure on wages and other costs than is envisaged in the central forecast. The experience of the first stage of the resources boom in 2006–2008 was that labour market pressures in the affected sectors appeared to be relatively contained in terms of their spillover to the broader labour market. Nevertheless, in that episode with high levels of economy-wide capacity utilisation and strong growth in global commodity prices, domestic inflation picked up significantly.

A final uncertainty concerns prospects for the exchange rate and its effect on the economy. The significant appreciation of the exchange rate since February reflects both an improved outlook for Australia's exports and a range of financial factors. The forecasts incorporate the effect of the higher exchange rate on the economy, in terms of restraining growth in exchange rate sensitive sectors and holding down near-term inflation, although there is inevitably uncertainty as to how large these effects will be. ✎

