

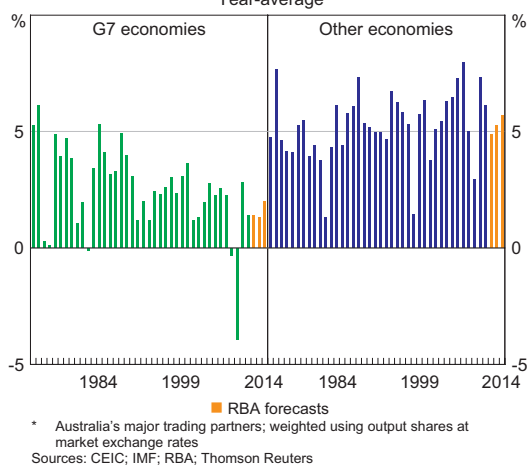
# 6. Economic Outlook

## The International Economy

Since the August *Statement*, the forecasts for global growth in 2012 and 2013 have been revised down a little. World GDP growth is now expected to be around 3¼ per cent in 2012 and a little over 3½ per cent in 2013, broadly in line with forecasts from the International Monetary Fund (IMF) (Graph 6.1). For the euro area, the forecasts assume a gradual recovery in economic conditions beginning around mid 2013. The Bank's forecasts assume, along with most forecasters, that the full extent of the large fiscal consolidation currently legislated in the United States for the beginning of 2013 does not occur. On this basis, moderate US growth is expected to continue. A recovery in the euro area and ongoing moderate growth in the United States are expected to help boost growth in east Asian economies to around trend. In China, there are now signs that growth may have stabilised in response to the earlier easing in financial conditions and a further modest easing in fiscal policy.

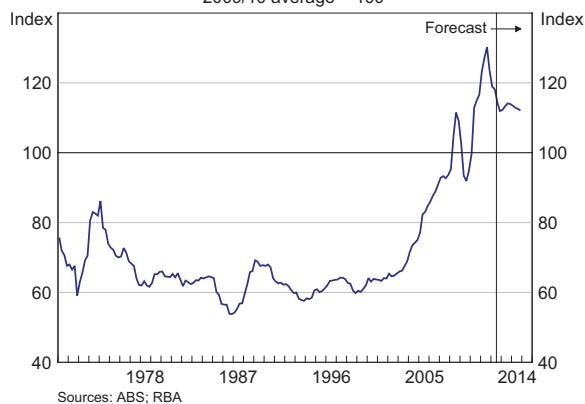
Spot prices of iron ore and coking coal fell sharply over July and August, as Chinese demand for steel continued to moderate and steel mills ran down their inventories. Since then, iron ore prices have partially recovered, but spot prices for coking coal have declined further. Prices of most other commodities are largely unchanged over recent months, though the spot price for thermal coal has fallen significantly since the middle of the year.

**Graph 6.1**  
**Global GDP Growth\***  
Year-average



While earlier forecasts embodied a gradual decline in bulk commodity prices, the large fall in recent months was faster than had been assumed, resulting in a downward revision to the terms of trade profile in the near term. By the end of 2012, the terms of trade are expected to have fallen by around 15 per cent from their September 2011 peak; this decline is slightly larger than expected at the time of the August *Statement* (Graph 6.2). In line with other forecasters, some recovery in prices for bulk commodities is expected in the first half of 2013, assuming that Chinese demand for steel picks up somewhat. Further out, prices are expected to gradually ease as the current resource investment boom adds to global supply (notwithstanding some scaling back of global mining investment intentions in recent months).

**Graph 6.2**  
**Terms of Trade**  
 2009/10 average = 100



## 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\$1.04, TWI at 77), which is a 2 per cent depreciation since the August *Statement*. The forecasts are based on the price for Brent oil remaining at US\$104 per barrel, a little lower than the assumption in August. The cash rate is assumed to be unchanged over the rest of the forecast period at 3.25 per cent, following the cut of 25 basis points since the August *Statement*. (This profile is higher than market expectations, which currently imply a further 50 basis points reduction in the cash rate by mid 2013.) The cash rate assumed for the forecasts is 185 basis points lower than its post-1996 average, while borrowing rates are currently 75–135 basis points below average. Finally, the forecasts assume that annual growth in the working-age population over 2013 and 2014 is 1.7 per cent, unchanged from the previous forecasts and in line with the recent pick-up in the rate of immigration.

The available data suggest that growth in the domestic economy has slowed over the second half of 2012 from the above-trend pace recorded earlier in the year. This slowing is evident in consumption growth, whereas growth in business investment is expected to have continued at a relatively

strong pace, led by investment in large-scale resource projects. The Australian Government's fiscal consolidation appears to be weighing on growth over the second half of the year, while survey measures and liaison indicate that non-mining investment has remained subdued. Overall, GDP growth over 2012 is forecast to be around 3½ per cent, which is unchanged from the August *Statement* forecast (Table 6.1).

GDP growth is expected to be a little below 2¾ per cent over 2013 before picking up to just under 3 per cent over 2014. The forecasts have been revised down slightly since the August *Statement*, largely reflecting a downward revision to mining investment, which reduces expected GDP growth over 2013 by around ½ percentage point (net of imports).

The downward revision to mining investment reflects the effect of the recent decline in bulk commodity prices on mining companies' cash flows and their plans for spending. Spending plans of iron ore and coal miners have also been affected by the still high level of the exchange rate, rising costs and a softer outlook for world growth. Based on mining company announcements, liaison and market analysts' assessments, it appears that mining companies are more reluctant to commit to iron ore and coal projects still under consideration. Spending on mining machinery & equipment investment and exploration activity has also been scaled back. Further, work on some committed projects has been delayed or slowed. Notwithstanding the general conservatism in previous Bank forecasts about the likelihood of uncommitted projects going ahead, the profile of capital spending on iron ore and coal in 2013 and 2014 has now been revised lower. At the same time, and for unrelated reasons, the profile for spending on liquefied natural gas (LNG) projects over the next two years has also been revised lower. This change in the LNG investment profile reflects new information about some investment work, leading to the profile for investment spending being pushed out.

**Table 6.1: Output Growth and Inflation Forecasts<sup>(a)</sup>**  
Per cent

	Year-ended					
	June 2012	Dec 2012	June 2013	Dec 2013	June 2014	Dec 2014
GDP growth	3.7	3½	2¾	2¼–3¼	2¼–3¼	2½–3½
Non-farm GDP growth	3.6	3½	3	2¼–3¼	2¼–3¼	2½–3½
CPI inflation	1.2	2½	3¼	2–3	2–3	2–3
Underlying inflation	2	2½	2¾	2–3	2–3	2–3
	Year-average <sup>(b)</sup>					
	2011/12	2012	2012/13	2013	2013/14	2014
GDP growth	3.4	3¾	3	2¼–3¼	2¼–3¼	2¼–3¼

(a) Technical assumptions include A\$ at US\$1.04, TWI at 77 and Brent crude oil price at US\$104 per barrel

(b) Based on the quarterly national accounts release rather than the recent annual release

Sources: ABS; RBA

The outlook for the rest of the economy is mixed. After contributing to growth over the past year, public demand is expected to subtract from growth over the year to June 2013, as both the Australian and state governments embark on significant fiscal consolidation. A range of public estimates suggests that the move from a Federal budget deficit to surplus may subtract around ¾–1½ percentage points from growth in real GDP in 2012/13.

The effect of the unwinding of the earlier government stimulus has been clearly evident in the construction sector over the past year, with public construction declining significantly. Private residential and non-residential investment activity also remain weak. Non-residential construction is likely to recover gradually over the next two years due to the low level of investment in recent years and lower interest rates, though business surveys and liaison suggest that this recovery is likely to be relatively muted, particularly over the next year.

There are some tentative signs that investment in residential construction may have troughed in mid 2012, as lower interest rates, rising rental yields and an improvement in conditions in the established housing market have begun to create a more favourable environment for investment. For non-mining investment overall, the forecasts embody a gradual recovery over the forecast period.

The outlook for consumption is little changed since the *August Statement*. After strong growth earlier in the year, consumption is expected to grow at around trend pace, or a little below, given slower growth in labour income and the fading impetus from government payments to households in May and June. The consumption profile in the forecasts assumes that the saving ratio remains broadly unchanged at high levels.

Weaker employment growth in the September quarter, largely owing to the drag from the cyclical downturn in construction employment, has resulted in a small rise in the unemployment rate. For some time, the forecasts had contained a small rise in unemployment. The current forecasts anticipate only modest employment growth in the near term, given the softer outlook for demand growth, the high exchange rate and the resulting pressure on firms to boost competitiveness.

The unemployment rate is expected to rise a little further, with softer employment growth and a further small decline in the participation rate. Thereafter, employment growth is expected to gradually increase, as growth in activity in more labour-intensive sectors picks up and the cyclical upswing in productivity growth runs its course.

With labour market demand a little softer than in recent years, growth in the wage price index is expected to slow slightly to around 3½ per cent over the forecast period. This is around ½ percentage point below the elevated rates seen over 2005–2008 when the unemployment rate declined below 5 per cent.

## Inflation

The outlook for inflation is largely unchanged from that published in the August *Statement*, reflecting offsetting influences. In light of the recent CPI data, the starting point for inflation is a little higher than had previously been expected, with underlying inflation assessed to be around 2½ per cent over the year to the September quarter. Working in the other direction, it appears that the current higher productivity growth will help to hold down unit labour costs in the near term. The slightly weaker outlook for domestic economic activity and demand for labour is also expected to help contain domestic inflationary pressures over the course of the next two years. At the same time, while tradables prices have increased a little over the past two quarters, they are expected to remain broadly flat in line with the stability of the exchange rate over the past year.

The introduction of the carbon price, which had an impact on headline inflation in the September quarter, is expected to make a further modest contribution to both headline and underlying inflation over the coming few quarters. However, most, if not all, of the direct effect of the carbon price on utilities prices was captured in the September quarter inflation data. CPI inflation, in year-ended terms, is expected to increase in the near term to over 3 per cent, before falling back to around the middle of the target range in a year's time when the September quarter increase in utility prices drops out of the year-ended inflation rate.

## Risks

The risks to the global outlook remain tilted to the downside, primarily reflecting the risks associated with the banking and fiscal problems in the euro area. The recent policy announcements in Europe appear to have reduced somewhat, but by no means eliminated, these downside risks. The announcement of the European Central Bank's Outright Monetary Transactions program has improved sentiment and conditions in financial markets, particularly in the euro area.

Elsewhere, the risks are more balanced. In the United States, the Congress needs to pass legislation to avoid the sharp contractionary effects of the so-called 'fiscal cliff' (see 'Box B: Fiscal Consolidation in the United States'). The Bank's forecasts assume that not all of the legislated consolidation occurs, but the actual consolidation could be larger or smaller than assumed. In China, there is general uncertainty surrounding future policy settings given that the leadership transition in the government and state-owned enterprises will still take a couple of quarters to play out. While property controls in China are unlikely to be relaxed significantly, and could even be tightened following the recent improvement in property prices and sales, other pro-growth policies could be enacted by the new leaders next year. On balance, however, uncertainties over the near-term economic outlook in China have probably diminished somewhat. There are also challenges faced by policymakers in some economies in dealing with internal and external balance in light of the expansions in liquidity in advanced economies associated with quantitative easing.

Uncertainty around the extent and impact of public and private deleveraging in many economies around the world remains a risk to the outlook. It is possible that deleveraging will weigh on economic growth more than is forecast. Indeed, consistent with this the IMF recently revised up its estimates of

fiscal multipliers, which are relevant for considering the impact of public deleveraging, to take account of the exceptional nature of the current economic environment. At the same time though, the extent of further deleveraging by the household sector in the United States may be lessened if house prices rebound more quickly than is currently expected. If household wealth increases noticeably, and the number of people in negative equity declines, then consumer spending could be stronger.

Economic activity in Australia will be influenced by the path of growth in China and the likely consequences for the price of bulk commodities and, therefore, the terms of trade. Given the sensitivity of investment plans of iron ore and coal miners to prices, slower growth in China could see announcements of further cuts to mining investment plans while faster growth could lead to approval of projects that have recently been delayed or are currently considered unviable. If commodity prices declined further than expected, and the exchange rate did not depreciate, the traded goods and services sectors would not receive the boost that would otherwise be expected. Lower commodity prices would also reduce the revenue received by the Australian and state governments, and their response to this could have implications for domestic growth.

As usual, there is considerable uncertainty regarding the exact timing of capital spending on major mining projects given the lumpiness of spending and potential delays on these projects. This makes the task of predicting the timing and magnitude of the peak in mining investment particularly difficult. Another key risk to the forecasts is the profile for non-mining investment. The forecasts embody a recovery in both dwelling investment and non-mining business investment, after a period of considerable weakness. While the underlying drivers of investment suggest that such an outlook is warranted, the timing and strength of a pick-up in non-mining investment is uncertain.

The risks around the outlook for inflation reflect the usual uncertainty surrounding the outlook for demand and employment, and the possibility of a material change in the exchange rate. Recently, soft demand in some parts of the economy had put downward pressure on some prices. It is possible that this effect has dissipated, given the apparent pick-up in underlying inflation in the September quarter. Moreover, to date, nominal wage growth in the private sector has proved resilient to the slowing in employment growth. Some further slowing in wages is likely to be necessary to maintain inflation around its current rate. A strong pick-up in demand could add to inflationary impetus just as the disinflationary impact of the earlier exchange rate appreciation wanes, resulting in higher-than-expected inflation. Also, while productivity growth appears to have picked up substantially over the past year, there is considerable uncertainty around the prospects for ongoing productivity growth. If productivity growth were to slow, adding to pressure on unit costs, inflation could be higher than forecast. ✎