

Economic Outlook

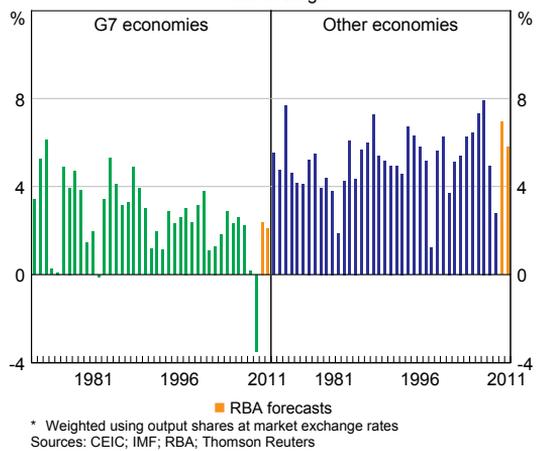
The International Economy

Conditions in the world economy have continued to improve since the February *Statement*. The recovery in Asia remained strong in the March quarter, representing a fourth consecutive quarter of rapid and broad-based expansion across the region. The recovery is less advanced in other parts of the world, although output has recently grown strongly in both North and South America, maintaining the momentum developed in the latter part of last year. In contrast, activity remains weak across the euro area.

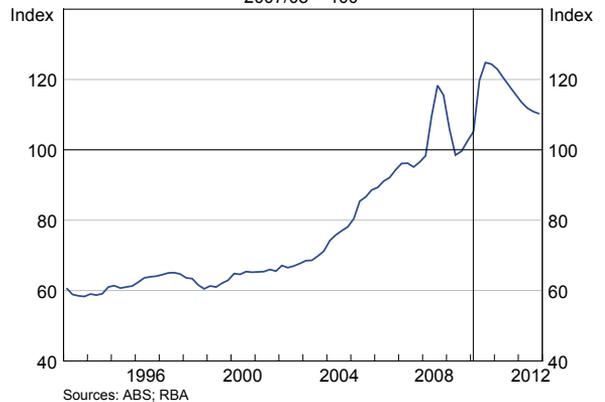
The domestic forecasts are based on the expectation that global output will grow by just under 4½ per cent in year-average terms in 2010 and by around 4 per cent in 2011, with the forecast modest slowing in growth in 2011 reflecting the expectation of some withdrawal of policy stimulus in both the advanced and emerging economies (Graph 82). These forecasts are a little stronger than three months ago, particularly for 2010, reflecting the generally stronger-than-expected run of data over the past three months, especially in Asia. If achieved, they would be modestly above the average rate of global growth recorded during the decade prior to the recent global downturn. Risks to these forecasts are discussed below.

Australia's terms of trade are increasing strongly, and this year will probably regain the peak seen in 2008 (Graph 83). This is primarily due to higher prices for coal and iron ore, supported by an

Graph 82
Australia's Trading Partner GDP Growth*
Year-average



Graph 83
Terms of Trade
2007/08 = 100



increase in demand from China as well as the ongoing recovery in demand from other trading partners such as Japan and Korea. Although the recent upward momentum in spot prices suggests that contract prices could increase further, the forecasts assume a medium-term decline in prices and the terms of trade, as supply expansions come online and rising prices of steel products dampen end-user demand.

Domestic Activity

As discussed in earlier chapters, growth in the economy over the past year has been stronger than expected, supported by stimulatory settings for fiscal and monetary policy, the rebound in Asia, and a high rate of growth in the population. Business conditions are at above-average levels and employment is growing solidly, supporting household spending. Activity in the construction sector has been boosted by fiscal measures, although this boost will be wound back over the period ahead, with private demand becoming a more important driver of growth.

The central forecasts are summarised in Table 14 and are based on the technical assumption of some further rise in the cash rate over the forecast period, with the assumed path broadly consistent with market expectations. As noted in previous *Statements*, this technical assumption does not represent a commitment by the Board to any particular path for policy.

In year-ended terms, GDP growth is forecast to be around 3¼ per cent over 2010 and to strengthen to around 3¾–4 per cent over the remainder of the forecast period. In year-average terms, GDP is expected to grow by 2¼ per cent in 2009/10, 3½ per cent in 2010/11 and 3¾ per cent in 2011/12. Growth in the economy outside of the mining sector would be slower, reflecting the reallocation of resources within the economy. This is partly due to the high level of the real exchange rate, which is reducing the international competitiveness of import-competing and other exporting sectors such as manufacturing and tourism.

The rise in the terms of trade is expected to increase domestic incomes by around 4 per cent this year (although the boost to national income – the income accruing to Australian residents – will be smaller) and nominal GDP is expected to rise by close to 10 per cent over 2010. The high level of commodity prices and the terms of trade are contributing to a strong outlook for investment in the mining sector over the forecast period. The strength in the terms of trade will also have broader stimulatory effects on the economy via a number of channels. However, compared to a few years ago, a higher share of the income gain from the terms of trade is expected to be saved, reflecting both the difference in the Government's budget position and the current relative cautiousness of households. Growth is likely to be driven less by consumption than in earlier periods, with a modest increase in the

Table 14: Output Growth and Inflation Forecasts^(a)
Per cent, over year to quarter shown

	Dec 2009	June 2010	Dec 2010	June 2011	Dec 2011	June 2012	Dec 2012
GDP growth	2.7	2½	3¼	3¾	3¾	3¾	4
Non-farm GDP growth	2.5	2½	3¼	3¾	3¾	3¾	4
CPI inflation	2.1	3¼	3¼	3	2¾	3	3
Underlying inflation	3¼	2¾	2¾	2¾	2¾	3	3

(a) Technical assumptions include A\$ at US\$0.91, TWI at 71, WTI crude oil price at US\$87 per barrel and Tapis crude oil price at US\$90 per barrel.

Sources: ABS; RBA

saving rate expected, reflecting households being more cautious about the amount of debt they take on.

While the central forecast is for GDP growth in 2011 and 2012 to be above its longer-run average rate, this partly reflects the forecast above-average growth in the capital stock and the labour force. Nevertheless, the labour market is expected to tighten gradually over the forecast period, with solid employment growth and a gradual fall in the unemployment rate.

Inflation

Underlying inflation slowed to around 3 per cent over the year to the March quarter – down from a peak of just over 4½ per cent in September 2008 – and a further modest easing in the year-ended rate is expected in the near term, to around 2¾ per cent. This moderation reflects the significant easing in wage growth, capacity utilisation and demand pressures in late 2008 and over 2009, as well as the substantial appreciation of the exchange rate since early 2009.

Underlying inflation is then expected to gradually trend higher, to around 3 per cent in 2012, reflecting a gradual increase in capacity utilisation and demand pressures in the economy and some pick-up in wage growth as the labour market tightens. Inflation for a range of non-tradable items is expected to remain firm, and the dampening influence of the exchange rate appreciation on inflation for tradable items is also likely to wane through the forecast period. Overall, this forecast represents an upward revision since February, reflecting the slightly stronger-than-expected outcome for underlying inflation in the March quarter, the higher terms of trade and the upwardly revised outlook for domestic activity, offset somewhat by the further appreciation of the exchange rate.

CPI inflation is expected to be higher than underlying inflation in the near term, largely reflecting the recent increase in tobacco excise. Further out, CPI inflation is assumed to move in line with underlying inflation.

Risks

As always, there are risks in both directions around the forecasts.

Domestically, it is possible that the fading of the fiscal stimulus and the increase in interest rates to normal levels might have a larger effect on demand than has been incorporated in the forecasts. The tax allowances for investment spending and payments to first-home buyers both provided significant incentive to commit to spending decisions before the end of 2009, and government spending on infrastructure is expected to ease later in 2010. However, an upside risk is the possibility that the surge in commodity prices has more of an effect on demand than assumed in the central forecasts, with the current cautiousness among consumers and firms outside the mining sector not persisting. Firms in the mining sector could also attempt to push ahead with investment projects more rapidly than assumed in the central forecast, and there is some possibility that non-residential construction might pick up more quickly than currently expected as credit constraints ease. If this were to occur, capacity constraints, particularly in the construction sector, would be likely to emerge and wages would accelerate more quickly than currently expected. Growth in household consumption would be stronger and there could be further increases in housing prices. Overall, this scenario would result in growth and inflation both being higher than expected, though this would be more likely to occur in 2011 rather than the current year.

Internationally, it is possible that growth in the global economy will again surprise on the upside. Over the past year, the upside risks noted a year ago, resulting from the effects of synchronised policy responses and higher confidence, were those that materialised. However, the risks that are getting most attention at present are some specific ones on the downside. One of these is the challenge that rising public debt ratios in a number of advanced economies pose for the global economy. The central forecast is for a gradual fiscal consolidation that results in some dampening effect on global growth in the medium term. However, investors might become increasingly concerned about the medium-term fiscal situation, resulting in renewed high

levels of risk aversion. If this were to occur abruptly it could prompt another period of global economic weakness and falls in commodity prices. Australia's good fundamentals would help, but the experience of late 2008 suggests that the willingness to invest abroad declines in such circumstances. The other major international risk for Australia is that rising inflation in Asia prompts a significant tightening of financial policies in the region, including in China. This could result in a significant slowing in activity in that region in the medium term, especially in sectors such as construction. This would lead to a reduction in the demand for steel-related and energy commodities and a reassessment of prospects for the resources sector in Australia. ✦