

PART 2: ECONOMIC OUTLOOK

OVERVIEW

The Australian economy is growing solidly as a self-sustaining private sector recovery takes hold. Output and incomes growth are strengthening and unemployment is falling. However, these positive developments are taking place against the backdrop of an uncertain global economic environment. The potential for a renewed deterioration in the major advanced economies and transmission of weakness to the developing world presents considerable risks to the domestic economic outlook.

Notwithstanding these risks, the world economy is forecast to continue growing at a solid pace. While growth in the major advanced economies is expected to slow, the emerging economies of Asia are continuing to grow strongly. As a result, Australia's major trading partners are expected to grow at their fastest pace in over 20 years. This is boosting global demand for non-rural commodities and driving Australia's terms of trade to around record highs. This is expected to provide substantial impetus to domestic growth, supporting rising incomes and activity, underpinned by strong growth in exports and business investment.

The Australian economy is expected to grow above trend over the forecast horizon and, with an already tight labour market, reach capacity within the next year or so. Consequently, inflation is forecast to rise over the forecast horizon, although the withdrawal of monetary and fiscal stimulus and appreciation of the Australian dollar are helping to contain demand and inflationary pressures.

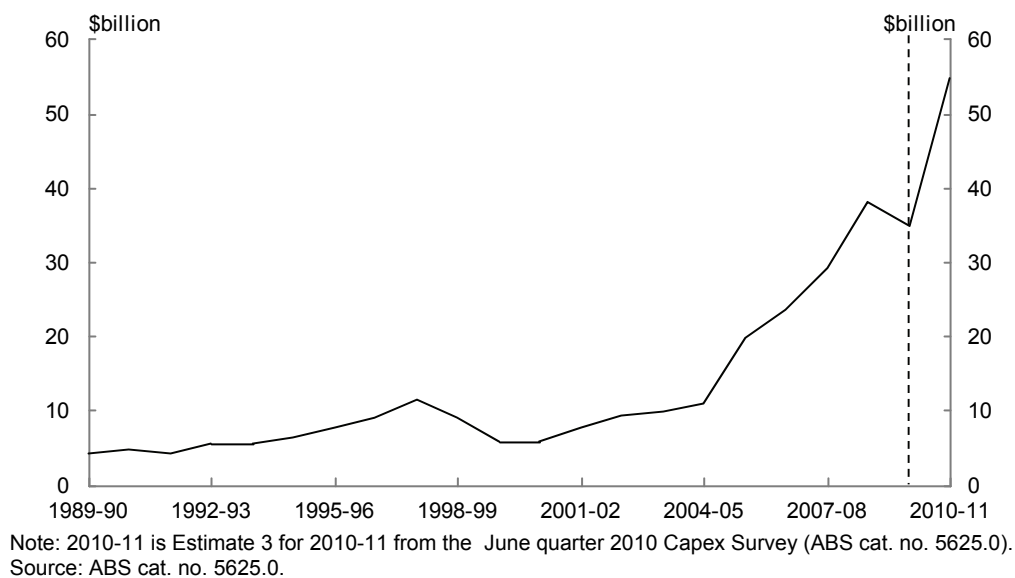
DOMESTIC ECONOMIC OUTLOOK

Australia's GDP is forecast to grow by $3\frac{1}{4}$ per cent in 2010-11 and $3\frac{3}{4}$ per cent in 2011-12, reflecting strong business investment, rising commodity exports and robust income growth supporting household consumption.

The solid growth in the economy has been reflected in strong employment growth and this is expected to continue. Around 360,000 jobs were created in the past year and employment is forecast to grow by $2\frac{1}{2}$ per cent in 2010-11 and a further 2 per cent in 2011-12. The unemployment rate, already low, is expected to fall further, to $4\frac{3}{4}$ per cent in the June quarter 2011 and $4\frac{1}{2}$ per cent in the June quarter 2012.

The high terms of trade are supporting stronger growth in real activity, driving up business investment and exports in both 2010-11 and 2011-12, particularly in the mining sector (Chart 2.1). The mining industry alone is planning \$55 billion of investment in 2010-11, pushing business investment to near 40-year highs as a percentage of GDP. New engineering construction is expected to grow by over 16 per cent in 2010-11 and 21 per cent in 2011-12, underpinned by Liquefied Natural Gas projects. The strength in the mining sector is also expected to drive higher levels of investment in new machinery and equipment. The expected surge in investment will expand the economy's capacity over time and underpin a projected increase of around \$80 billion in the value of non-rural commodity exports over the next five years to more than \$200 billion per annum.

Chart 2.1: Mining investment (current price, original)



The tight labour market and the pick-up in aggregate demand associated with the higher terms of trade will also have implications for inflation, with Treasury's most

recent estimates of the non-accelerating inflation rate of unemployment (NAIRU) — the rate of unemployment at which inflation pressures start to emerge — ranging between 4½ and 5 per cent.

Headline and underlying inflation are expected to rise over the forecast horizon, reaching 3 per cent in through-the-year terms in the June quarter of 2012. With the economy expected to be operating at around capacity, inflation risks remain on the upside.

Demand and inflationary pressures, while building, will be moderated through tighter macroeconomic policy settings and the stabilising effects of the exchange rate (Box 2.1). The Reserve Bank of Australia has withdrawn monetary stimulus and the Australian Government's withdrawal of the fiscal stimulus is expected to reduce GDP growth by 1 percentage point in 2010-11 and ½ of a percentage point in 2011-12. The significant appreciation of the Australian dollar is expected to be a contractionary influence on the economy, further dampening price pressures.

Notwithstanding this positive domestic outlook, risks surrounding the global economy have heightened in recent months. Were the global economy to falter, it is likely that Australia would be affected through both financial and trade channels, including through lower prices for our key commodity exports. Australia's terms of trade and income growth are heavily influenced by the prices of several key non-rural commodities that are currently trading around record levels and which are highly sensitive to demand from the Asian region. While demand is expected to remain strong, a sudden decline in these commodity prices would have major negative implications for national income and activity.

Part 2: Economic outlook

Table 2.1: Domestic economy forecasts^(a)

	Outcomes(b)	Forecasts			
	2009-10	2010-11		2011-12	
		Budget	MYEFO	Budget	MYEFO
Panel A - Demand and output(c)					
Household consumption	2.1	3 1/2	4	4	3 1/2
Private investment					
Dwellings	1.1	7 1/2	4 1/2	4	3
Total business investment(d)	-4.7	7	8	12 1/2	13
Non-dwelling construction(d)	-7.8	8	8	14 1/2	13 1/2
Machinery and equipment(d)	-4.4	6	7	13	15
Private final demand(d)	0.7	4 1/2	4 3/4	6	5 3/4
Public final demand(d)	7.1	1	1 1/2	- 1/2	- 1/4
Total final demand	2.2	3 3/4	4	4 1/2	4 1/4
Change in inventories(e)	0.2	1/2	0	0	0
Gross national expenditure	2.4	4 1/4	4 1/4	4 3/4	4 1/4
Exports of goods and services	5.5	5	7	6	5
Imports of goods and services	5.3	9	11	8 1/2	8
Net exports(e)	0.1	-1	-1	- 3/4	- 3/4
Real gross domestic product	2.3	3 1/4	3 1/4	4	3 3/4
Non-farm product	2.3	3 1/2	3 1/4	4	4
Farm product	-1.5	1	10	2	-6
Nominal gross domestic product	2.3	8 1/2	9	5 3/4	5
Panel B - Other selected economic measures					
External accounts					
Terms of trade	-4.8	14 1/4	15 1/2	-3 3/4	-4 1/2
Current account balance (per cent of GDP)	-4.3	-3 3/4	-2 3/4	-5	-4 1/4
Labour market					
Employment (labour force survey basis)(f)	2.4	2 1/4	2 1/2	2	2
Unemployment rate (per cent)(g)	5.2	5	4 3/4	4 3/4	4 1/2
Participation rate (per cent)(g)	65.3	65 1/2	65 1/2	65 1/2	65 1/2
Prices and wages					
Consumer price index(h)	3.1	2 1/2	2 3/4	2 1/2	3
Gross non-farm product deflator	0.1	5	5 3/4	1 3/4	1 1/4
Wage price index(f)	3.0	3 3/4	3 3/4	4	4

(a) Percentage change on preceding year unless otherwise indicated.

(b) Calculated using original data unless otherwise indicated.

(c) Chain volume measures except for nominal gross domestic product which is in current prices.

(d) Excluding second-hand asset sales from the public sector to the private sector.

(e) Percentage point contribution to growth in GDP.

(f) Seasonally adjusted, through-the-year growth rate to the June quarter.

(g) Seasonally adjusted, rate for the June quarter.

(h) Through-the-year growth rate to the June quarter.

Note: The forecasts for the domestic economy are underpinned by several technical assumptions. The exchange rate is assumed to remain around levels seen at the time the forecasts were prepared (a trade weighted index of around 74 and a US\$ exchange rate of around 98½c). The policy interest rate is assumed to rise in line with market expectations. World oil prices (Tapis) are assumed to remain at around US\$88 per barrel. Farm sector forecasts assume average seasonal conditions over the remainder of the forecasting period.

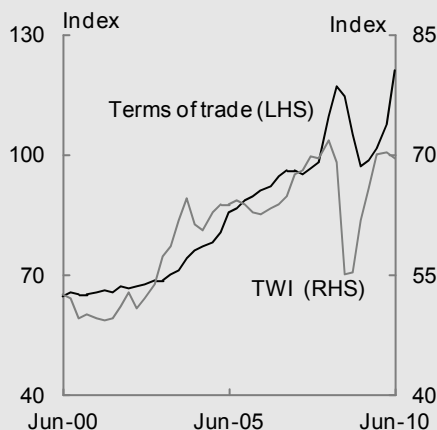
Source: ABS cat. no. 5204.0, 5206.0, 5302.0, 6202.0, 6345.0, 6401.0, unpublished ABS data and Treasury.

Box 2.1: The role of the exchange rate in helping to balance the macroeconomy

Since late August, the Australian dollar has risen around 8 per cent against the trade weighted index (TWI), and nearly 13 per cent against the US dollar, reaching parity for the first time since 1982.

The appreciation of the Australian dollar reflects the relatively strong outlook for the Australian economy and our high terms of trade (Chart A).

Chart A: Terms of Trade and the TWI



Source: ABS cat. no. 5302.0.

The dollar's appreciation is also symptomatic of US dollar weakness, reflecting market perceptions that the US economic outlook has softened and the recently-announced second round of quantitative easing by the US Federal Reserve.

In the context where the terms of trade are boosting demand in an economy approaching full capacity, the appreciation of the exchange rate helps to moderate inflationary pressures.

The higher dollar directly reduces import prices and also dampens the income effects from higher commodity prices, which are contracted in US dollars (with flow-through consequences for budget revenues).

A higher dollar also eases demand pressures by shifting some spending from domestic to foreign goods and services, moderating the extent to which spending butts up against domestic supply constraints.

It is also a key channel by which the benefits of high resource prices are spread more widely through increased consumer purchasing power. Without this appreciation more of the gains would accrue to the resources sector and less to the general community.

However, the higher dollar can also have significant impacts on trade exposed sectors of the economy, which become less competitive and which are not benefiting from higher prices for their exports.

The budget forecasts have been prepared on the technical assumption that the exchange rate remains constant.

As near-term factors fade and if the projected decline in commodity prices and the terms of trade were realised, it is likely that the exchange rate would also fall over time. This would work to moderate the forecast decline in Australian dollar prices and earnings, and its flow-through implications to the Budget.

INTERNATIONAL ECONOMIC OUTLOOK

World outlook

World growth is expected to remain at or above 4 per cent over the next two years, although the outlook has become more uncertain and downside risks remain elevated. While the emerging economies of Asia remain strong, the outlook for the euro area is weak, prospects for Japan are worsening, and there are increasing concerns that the economic recovery in the United States may be faltering.

Table 2.2: International GDP growth forecasts^(a)

	Actuals	Forecasts		
	2009	2010	2011	2012
United States	-2.6	2 3/4	2 1/4	2 1/2
Euro area	-4.1	1 1/2	1 1/4	1 1/4
Japan	-5.2	3	1 1/4	1 1/4
China(b)	9.1	10	9	9
India	5.7	9 1/4	8	8 3/4
Other East Asia(c)	-0.3	8	4 3/4	5 1/4
Major trading partners	0.0	6	4 1/4	4 1/2
World	-0.6	4 3/4	4	4 1/4

(a) World and euro area growth rates are calculated using GDP weights based on purchasing power parity (PPP), while growth rates for major trading partners and Other East Asia are calculated using export trade weights.

(b) Production-based measure of GDP.

(c) Other East Asia comprises the NIEs of Hong Kong, South Korea, Singapore and Taiwan and the Association of Southeast Asian Nations group of five (ASEAN-5), which comprises Indonesia, Malaysia, the Philippines, Thailand and Vietnam.

Source: National statistical publications, IMF and Treasury.

While the outlook for global growth has become more uncertain, the central forecast is for world GDP to grow by a solid 4¾ per cent in 2010. Outcomes in East Asia and the euro area (led by Germany) in the first half of 2010 were generally stronger than expected, offsetting weaker-than-expected outcomes in the US and Japan. Global growth is forecast to be 4 per cent in 2011. The easing reflects an expected moderation in US and Chinese growth, due in part to the fading of temporary factors (fiscal stimulus and the inventory cycle), which helped boost growth in 2010. Global growth is expected to rise to 4¼ per cent in 2012 as most economies outside the euro area return to around trend growth rates. Nevertheless, many advanced economies are likely to continue to operate well below capacity for some time (Box 2.2).

Australia's major trading partners are forecast to grow 6 per cent in 2010 and over 4 per cent in each of the next two years, underpinned by robust growth in China, India and other key Asian economies. This strong regional growth should provide strong support for the Australian economy even as the rest of the global economy struggles.

Notwithstanding this, downside risks surrounding the outlook remain prominent, particularly due to increased concerns over the durability of the US recovery, a weakening in prospects for Japan and the potential for renewed stress in the euro area.

Among some major advanced economies there is a risk that planned fiscal consolidations in 2011 could threaten recovery given that growth in these countries has largely been driven by policy stimulus, an inventory rebound, and exports. Further, the capacity of advanced economies to respond to any substantial slowing in growth is constrained by weak fiscal positions and monetary policy interest rates that are already effectively zero.

China continues to grow strongly, albeit at a moderating pace, as authorities attempt to engineer a 'soft landing' in response to fears of overheating in some sectors of the economy. Large and volatile capital inflows also pose some risk.

The ongoing uncertainty surrounding the global outlook is also reflected in financial markets. Global stock markets rose strongly in the September quarter, but also experienced periods of heightened volatility. Government bond yields in a number of advanced economies, most notably the US, remain around historically low levels, due to a significant degree of pessimism regarding their medium-term growth prospects, and the impact of quantitative easing. Meanwhile, in the euro area periphery (Greece, Portugal, Ireland and Spain), government bond yield spreads over the German bond benchmark remain elevated, suggesting continued concerns about sovereign credit worthiness in these countries.

Country summaries

In the **United States** growth is expected to moderate as the effects of fiscal stimulus and the inventory cycle fade, notwithstanding some support from the recent depreciation in the US dollar. Modest consumer spending, weak jobs growth, a slowing industrial cycle and continued housing market strains raise the risk that the slowing in growth may be more pronounced than anticipated. GDP is forecast to grow by $2\frac{3}{4}$ per cent in 2010 and $2\frac{1}{4}$ per cent in 2011, before rising slightly to $2\frac{1}{2}$ per cent for 2012. The slowing in activity, concerns about deflation, and near record high unemployment has prompted the US Federal Reserve to undertake further 'quantitative easing' in an effort to push down long-term interest rates, and lower the cost of borrowing across private markets to support demand.

In the **euro area**, the outlook remains weak, although recent outcomes have been better than expected. Growth is expected to moderate as an easing in world growth slows foreign trade. Fiscal consolidation across the region from 2011 is likely to weigh on the labour market and household consumption, and tight credit conditions are likely to continue to restrain investment. The recovery is expected to remain sluggish, with GDP forecast to grow $1\frac{1}{2}$ per cent in 2010 before slowing slightly to $1\frac{1}{4}$ per cent in both 2011 and 2012.

Box 2.2: International comparisons

Australia's economy outperformed other advanced economies during the global financial crisis and continues to do so.

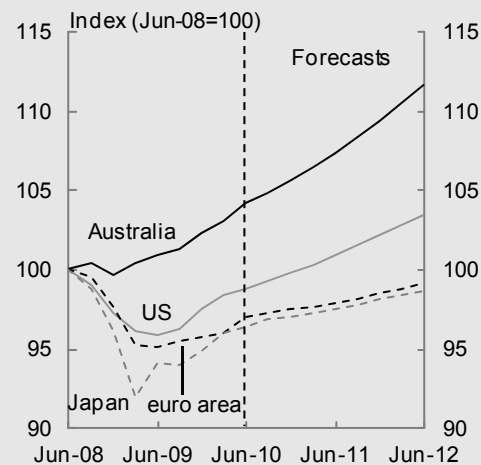
Although growth has resumed in the major advanced economies, it is starting from low levels of output and the pace of recovery is tepid.

Australia's economy held up well during the global recession – underpinned by policy support and other factors – and so did not suffer the same loss of output that other advanced economies experienced. As a result it also did not suffer the more permanent loss of productive capacity that occurred in other countries as a result of large scale business closures and rising levels of long-term unemployment.

Australia's GDP is significantly higher than before the global financial crisis, while many other advanced economies suffered deep contractions with the level of output in the US, euro area and Japan still below pre-crisis levels. Based on the latest growth forecasts, the Australian economy is also likely to grow more quickly than the major advanced economies over the next couple of years, further widening the GDP gap (Chart A).

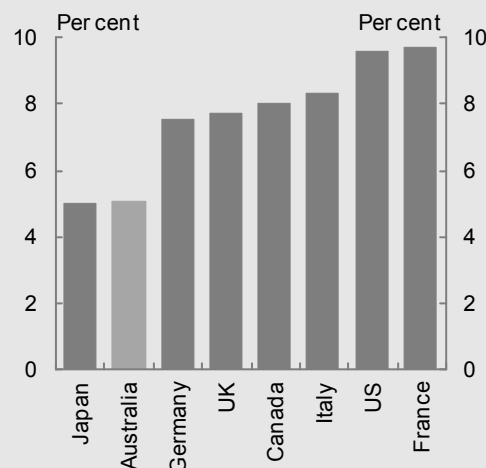
The relative strength of economic activity in Australia is also reflected in its lower unemployment rate (Chart B). Australia's unemployment rate is around 5 per cent. Around 360,000 jobs have been created over the past year. In contrast, unemployment in the US and the euro area is around 10 per cent. In the US around 7¾ million jobs have been lost since December 2007.

Chart A: GDP level — advanced economies



Source: ABS cat. no. 5206.0, national statistical agencies, Thomson Reuters and Treasury.
Note: US forecasts begin in December 2010.

Chart B: Unemployment rates: Australia and G7



Source: ABS cat. no. 6202.0 and national statistical agencies.

China's economy is expected to grow strongly over the forecast horizon. GDP is forecast to grow by 10 per cent in 2010 before easing to 9 per cent in both 2011 and 2012 as the authorities withdraw fiscal and monetary stimulus and continued advanced economy weakness weighs on export growth. This largely government-engineered moderation is expected to provide more stable and sustainable growth for the Chinese economy, although China is facing increasingly complex reform challenges in areas including energy, the financial sector and state-owned enterprises.

The **Japanese** economic outlook is weak. While the recovery was initially export-driven, a weaker-than-expected June quarter 2010 GDP outcome has confirmed that the export rebound is easing, domestic demand remains weak and deflationary pressures are entrenched – with prices falling almost continuously since the late 1990s. While Japanese economic growth is expected to be 3 per cent in 2010, reflecting a bounce back from a record fall in 2009, it is forecast to ease significantly to 1¼ per cent in both 2011 and 2012.

The economic outlook for **India** has improved in recent months. Private consumption has strengthened, mirroring a run-up in manufacturing output. Consumer price pressures are receding, owing to a favourable monsoon season. Indian economic growth is expected to be 9¼ per cent in 2010, before slowing to 8 per cent in 2011 and 8¾ per cent in 2012.

For the **rest of Asia**, economic growth is strong but expected to moderate. After recovering strongly from the global recession, the Newly Industrialised Economies (South Korea, Singapore, Hong Kong and Taiwan) are expected to slow on the back of softening export demand and tightening fiscal positions. In Southeast Asia, while growth is expected to slow for similar reasons, solid economic growth is expected to continue to be supported by the underlying strength in domestic demand.

DETAILED DOMESTIC FORECASTS

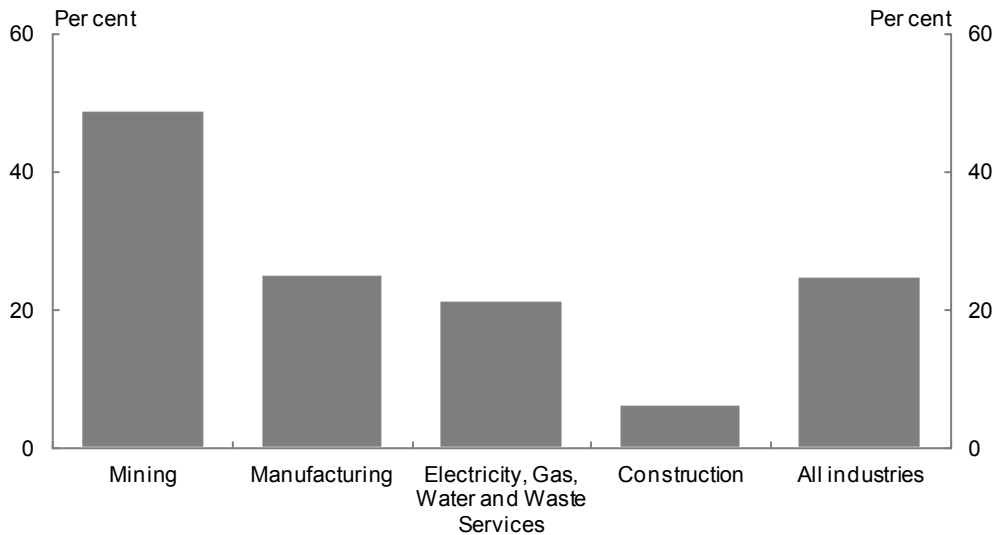
Australia's real GDP is forecast to grow by $3\frac{1}{4}$ per cent in 2010-11 and $3\frac{3}{4}$ per cent in 2011-12. The main contributors to economic growth are expected to be business investment, household consumption and commodity exports. Public sector demand is forecast to slow sharply as the fiscal stimulus continues to be withdrawn.

Household consumption is expected to grow above trend in 2010-11, at 4 per cent, and $3\frac{1}{2}$ per cent in 2011-12. This reflects solid growth in employment and wages, recent increases in wealth from rising asset prices, and high levels of consumer confidence. Notwithstanding strong growth in consumption, the household saving ratio is expected to remain above levels observed prior to the global financial crisis, consistent with subdued growth in household credit.

Dwelling investment growth forecasts have been revised down, reflecting the recent weakness in housing finance and approvals data. The number of finance commitments for the construction of new dwellings is down nearly 28 per cent through the year, while trend growth in building approvals has fallen in each of the past six months. Nonetheless, the outlook is for dwelling investment to continue growing, consistent with interest rates currently at around neutral levels, a positive employment outlook and a pipeline of construction activity arising from the strength of population growth in recent years. Dwelling investment is expected to grow by $4\frac{1}{2}$ per cent in 2010-11 and 3 per cent in 2011-12.

New business investment is expected to increase significantly over the forecast period, returning to around 40-year highs as a proportion of GDP. In the mining sector, rapid growth in profits is supporting strong capital expenditure intentions (Chart 2.2). More broadly, investment intentions have also improved as the outlook for the economy has strengthened. With a large pipeline of investment, the main risks centre around capacity constraints and timing. **New engineering construction** is expected to grow by a strong $16\frac{1}{2}$ per cent in 2010-11 and 21 per cent in 2011-12, underpinned by Liquefied Natural Gas projects. The strength in the mining sector is also expected to drive higher levels of investment in **new machinery and equipment**, with growth forecast to be 7 per cent in 2010-11 and 15 per cent in 2011-12. In contrast, **new non-residential building** activity is forecast to remain subdued, declining by $2\frac{1}{2}$ per cent in 2010-11 before growing by 2 per cent in 2011-12, reflecting high office vacancy rates and the phase-down of the Building the Education Revolution program.

Chart 2.2: Investment intentions for selected industries
Implied growth rate for 2010-11



Note: Original data. Implied annual growth rate for 2010-11 is based on ABS one-year realisation ratios.
Source: ABS cat. no. 5625.0.

Public final demand is forecast to grow 1½ per cent in 2010-11, before falling by a ¼ of a per cent in 2011-12 as fiscal stimulus continues to be withdrawn. The withdrawal of fiscal stimulus (which affects not only public final demand, but also household consumption and business investment) is expected to detract around 1 percentage point from GDP growth in 2010-11 and ½ of a percentage point from GDP growth in 2011-12.

Export growth forecasts have been upgraded for 2010-11, reflecting an improved outlook for both rural and non-rural commodity exports. Favourable weather conditions in eastern Australia are currently expected to support a large wheat crop. For non-rural commodity exports, strong growth is being driven by expanding mining production and port capacity in response to strong demand from Asia and high international prices. Partially offsetting this strength, forecast growth in exports of services and manufactured goods has been reduced, largely due to the higher exchange rate. Total exports are forecast to grow by a solid 7 per cent in 2010-11 and by 5 per cent in 2011-12.

Import growth forecasts have been upgraded for 2010-11, reflecting stronger domestic demand and a higher Australian dollar. Imports are expected to grow by 11 per cent in 2010-11 and by 8 per cent in 2011-12. The growth in imports is expected to be broadly based, although the contribution of capital goods imports — driven by the capital expenditure on major mining projects — is expected to be substantial. Net exports are expected to detract 1 percentage point from real GDP growth in 2010-11 and ¾ of a percentage point in 2011-12.

Part 2: Economic outlook

The **terms of trade** are forecast to rise by 15½ per cent in 2010-11, underpinned by high prices for Australia's non-rural bulk commodity exports. Record levels of steel production in China earlier in the year led to historically high iron ore contract prices for the September quarter 2010. December quarter contract prices, while lower, also remain well above historical levels. The terms of trade are expected to decline by 4½ per cent in 2011-12, as significant increases in global mining capacity place downward pressure on non-rural commodity prices.

The **current account deficit** is forecast to narrow in 2010-11 and then expand in 2011-12 in line with the rise and subsequent decline in the terms of trade. The current account deficit is expected to be 2¾ per cent of GDP in 2010-11 and 4¼ per cent of GDP in 2011-12. The net income deficit is expected to widen over the forecast period, as improved export earnings generate increased equity income outflows.

The **unemployment rate** is expected to continue to fall, reaching 4¾ per cent by the end of 2010-11 and 4½ per cent by the end of 2011-12. **Employment** is expected to grow by 2½ per cent through the year to the June quarter 2011 and 2 per cent through the year to the June quarter 2012, consistent with the strong outlook for activity.

Wages growth is expected to pick up, driven by the ongoing tightening of the labour market. The Wage Price Index is expected to grow by 3¾ per cent through the year to the June quarter 2011 and 4 per cent through the year to the June quarter 2012.

Inflation is also expected to rise over the forecast horizon, reflecting the strength in domestic demand, a buoyant labour market and anticipated increases in administered prices. Underlying and headline measures of inflation are expected to be 2¾ per cent through the year to the June quarter 2011 and 3 per cent through the year to the June quarter 2012.

Nominal GDP is forecast to grow by 9 per cent in 2010-11, reflecting strong growth in the GDP deflator of 5½ per cent, largely driven by the higher terms of trade. Nominal GDP is forecast to grow by 5 per cent in 2011-12.

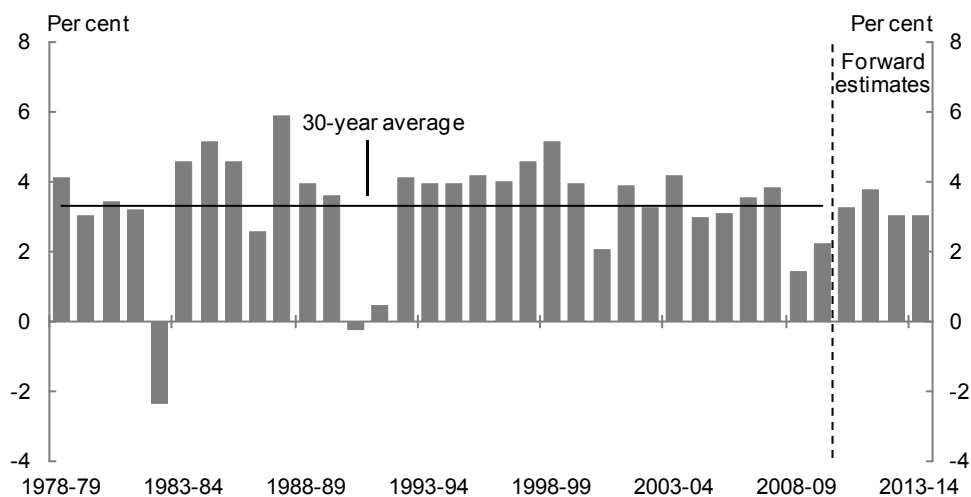
Medium-term economic projections

The fiscal aggregates in the MYEFO are underpinned by a set of forward estimates consisting of short-term economic forecasts and projections based on medium-term assumptions.

The 2010-11 MYEFO forecasts imply that the economy will return to full capacity within the forecast period. The unemployment rate is expected to have peaked at 5.8 per cent during 2009, before continuing to trend down over the forecast period to reach 4½ per cent in late 2011-12.

With the economy expected to be back to potential during the forecast period, real GDP is projected to grow at its trend rate of around 3 per cent per annum over the two projection years of the forward estimates (Chart 2.3).

Chart 2.3: Real GDP growth over the forward estimates period



Source: ABS cat. no. 5204.0 and Treasury.

Beyond the forward estimates, trend GDP continues to grow at around 3 per cent until 2018-19 when growth slows to around 2¾ per cent as population ageing generates a gradually falling participation rate.

Part 2: Economic outlook

In the medium term, the unemployment rate is expected to be 5 per cent, in line with current estimates of the NAIRU.¹ Inflation is projected to be 2½ per cent, consistent with the Reserve Bank of Australia's medium-term target band.

In the projection period the terms of trade are projected to decline by a total of around 20 per cent over a 15-year period, settling just above their 2005-06 level. This reflects an expectation that current levels of commodity prices will not be sustained in the longer term, as increases in supply bring down prices over time.

The exchange rate is assumed to remain constant at its current level over the medium term. However, if the projected decline in commodity prices and the terms of trade were realised, it is likely that the exchange rate would fall, moderating the decline in Australian dollar prices and earnings.

1 In Australia, estimates of the NAIRU are around 5 per cent, with recent Treasury estimates ranging between 4½ and 5 per cent. Treasury's estimates of the NAIRU are based on a methodology detailed in Gruen, Pagan and Thompson (1999), 'The Phillips curve in Australia', *The Journal of Monetary Economics*, and updated in Kennedy and Goldbloom (2008), 'Examining full employment in Australia using the Phillips and Beveridge curves', *The Australian Economic Review*.