PART 2: ECONOMIC OUTLOOK

OVERVIEW

Global growth has weakened since Budget and the international outlook remains highly uncertain. The euro area has fallen back into recession, the recovery in the United States remains subdued and weakness in the major advanced economies is bearing on growth in the large emerging market economies, including China and India.

Against this challenging global backdrop, the fundamentals of the Australian economy remain strong and the outlook remains positive. Economic activity is expected to grow at around its trend rate over the next two years, the unemployment rate is forecast to remain low and inflation is expected to be well-contained.

Australia's favourable economic growth prospects are supported by a surge in business investment, strong growth in non-rural commodity exports and solid growth in household consumption.

The challenging global environment, high Australian dollar, household deleveraging, changed household spending patterns and subdued expectations for asset price increases are weighing heavily on some parts of the economy, consistent with forecasts for moderate employment growth and a slight rise in the unemployment rate.

Weaker global demand has also contributed to larger-than-anticipated declines in global iron ore and coal prices and in Australia's terms of trade. As a result, Australia's nominal GDP growth is expected to be a percentage point weaker in 2012-13 than forecast at Budget, with marked consequences for revenue collections.

While the outlook for the emerging market economies of Asia remains favourable, continued uncertainties about how the European sovereign debt crisis and the impending legislated fiscal contraction in the United States (the 'fiscal cliff') will unfold are undermining global confidence.

While crystallisation of these risks could result in a more pronounced slowdown in the emerging market economies of Asia, the central forecasts are for Australia's major trading partners to record solid growth in aggregate.

Australia's linkages to the still fast-growing Asian region and strong economic fundamentals support our favourable economic growth prospects.

DOMESTIC ECONOMIC OUTLOOK

The Australian economy continues to outperform every major advanced economy. The pace of economic growth accelerated in the first half of 2012, driven by a surge in resources investment and robust growth in household consumption. Above-trend real GDP growth supported rising employment and a low unemployment rate, while underlying inflation remains contained.

Despite a weaker global outlook, Australia's economic growth prospects are favourable, with real GDP forecast to grow 3 per cent in both 2012-13 and 2013-14, underpinned by growth in new business investment, non-rural commodity exports and household consumption. Compared with Budget, the growth forecast has been downgraded slightly (by ¼ of a percentage point) in 2012-13, following stronger-than-anticipated growth in 2011-12 and reflecting recent company announcements to defer or cancel some resources projects.

While real GDP is still forecast to grow around trend, sharp falls in the prices of some of Australia's key non-rural export commodities — particularly iron ore and coal — and a more moderate outlook for domestic price inflation have driven a significant downward revision to forecast growth in nominal GDP in 2012-13. Nominal GDP is now forecast to grow 4 per cent in 2012-13 and 5½ per cent in 2013-14.

Recent falls in global commodity prices have led to some scaling back of investment plans in the coal and iron ore sectors. Still, resources investment is expected to reach unprecedented levels, driving new business investment to record highs as a share of GDP over the forecast period. Australia's resources investment pipeline is dominated by LNG projects, where investment decisions are taken over long time horizons and are underpinned by projections of the energy needs of large Asian economies over a period of decades (see Box 2.3).

In value terms, over two-thirds of the large resources projects included in the economic forecasts have received final investment approval, with the majority already under construction. Following 75 per cent growth in 2011-12, the latest capital expenditure survey suggests a further 45 per cent increase in resources investment in 2012-13.

The domestic growth outlook is also supported by strong forecast growth in non-rural commodity export volumes. The surge in investment in the resources sector will drive expansions in production, which will lead to a ramp-up in export volumes as major resources projects increasingly move from the investment phase to the production phase. Australia's non-rural commodity exports are expected to grow 15 per cent over the next two years, notwithstanding a modest downgrade to forecast growth in coal exports since Budget, partly reflecting the early closure of a few high cost mines.

Solid growth in household consumption is also expected to underpin economic growth across the forecast period. Over the past year, the combination of robust growth in disposable income and weak consumer price inflation enabled households to enjoy above-trend growth in real consumption, while maintaining high rates of saving. Looking ahead, the pace of household consumption growth is expected to remain solid, albeit moderating slightly, consistent with forecasts for moderate employment and wages growth, and subdued expectations for asset price growth. Reflecting this, the household saving ratio is expected to remain elevated across the forecast period.

Conditions in some parts of the economy remain difficult, reflecting weak global conditions, the continued high exchange rate, shifting patterns of household demand and the more restrained approach of households and businesses towards taking on new debt since the global financial crisis. These factors have placed downward pressure on prices and profitability in some sectors, despite solid growth in sales volumes. The retail sector is a case in point, with strong growth in sales volumes over the past year coinciding with below-trend growth in revenue and falling profits across much of the sector.

Notwithstanding these pressures, domestic demand remains solid in aggregate and there are tentative signs that residential building activity may be starting to improve. As resources investment as a share of the economy passes its peak, the forecasts are for low interest rates and rising incomes to support modest growth in dwelling construction and non-mining business investment in 2013-14.

Employment growth is expected to pick up over the forecast period, but is forecast to remain below trend, as the above-mentioned pressures on parts of the domestic economy and the uncertain global outlook continue to weigh on hiring decisions. Through-the-year employment growth is forecast to strengthen to 1 per cent to the June quarter 2013 and to 1¼ per cent to the June quarter 2014.

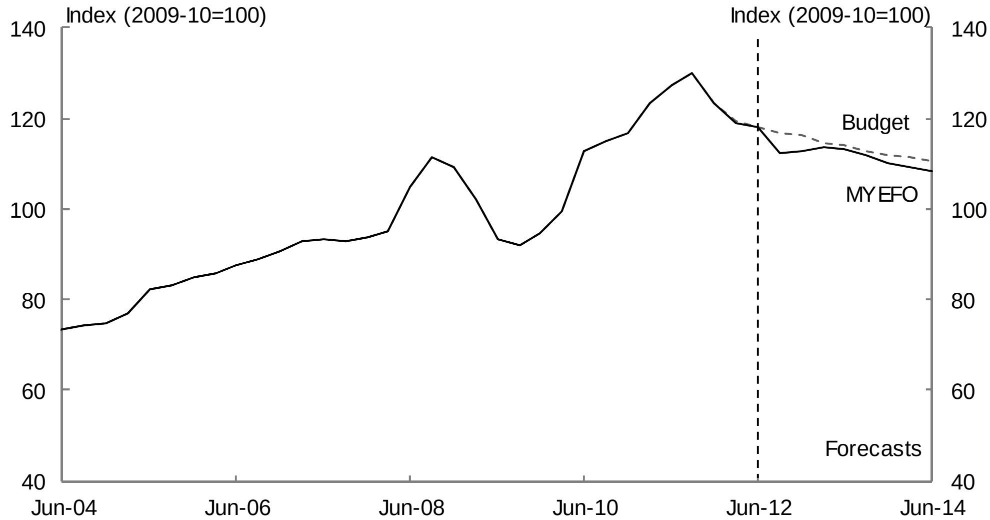
Australia's unemployment rate is forecast to remain low, albeit rising slightly from 5¼ per cent in the September quarter 2012 to 5½ per cent by the June quarter 2013, unchanged from Budget. The outlook for the unemployment rate is consistent with forecasts for below-trend employment growth and a stable workforce participation rate, which remains high in historical terms despite recent falls. Australia's low unemployment rate stands in stark contrast to most major advanced economies, at around half the rate in the euro area and significantly less than the almost 8 per cent unemployment rate in the United States.

The outlook for trend growth in the Australian economy over the next two years factors in the fiscal consolidation being undertaken by the Commonwealth and state governments. As is standard practice, the forecasts assume policy interest rates move broadly in line with market expectations at the time that the forecasts are finalised, with the market expectation at that time being that policy interest rates would be lower over the coming year. The planned fiscal consolidation should continue to provide scope for monetary policy to be eased, if appropriate, without generating price and wage pressures. The impact of the fiscal consolidation, particularly in 2012-13, should be more than offset by growth in private demand, with the aggregate economy growing around trend.

Domestic inflationary pressures have eased in recent quarters, with underlying consumer price inflation falling to the bottom of the Reserve Bank's target band and investment prices growing at a subdued rate in aggregate. Headline inflation is forecast to rise to 3 per cent through the year to the June quarter of 2013 (including an estimated one-off ¾ of a percentage point increase from the introduction of the carbon price), before easing to 2¼ per cent through the year to the June quarter of 2014. Likewise, underlying inflation is expected to be moderate, at 2½ per cent through the year to the June quarter of 2013 (including a one-off ¼ of a percentage point addition stemming from the carbon price) and 2¼ per cent through the year to the June quarter of 2014.

While the Budget factored in a decline in Australia's terms of trade, the fall in global commodity prices over recent months has been larger than anticipated (see Box 2.1). Global commodity prices have been highly volatile in recent months, with spot prices for Australia's key non-rural commodity exports (iron ore and thermal and metallurgical coal) falling between 15 and 33 per cent since Budget. A partial recovery has been built into the near-term forecasts for iron ore and coal prices, largely reflecting an anticipated recovery in iron ore demand as the destocking process in China runs its course. The increase in iron ore prices since mid-September also suggests that prices had fallen below levels consistent with market fundamentals. Even allowing for this near-term recovery, the forecasts for non-rural commodity prices are lower than at Budget, consistent with the weaker economic outlook globally, and for China in particular. Consequently, Australia's terms of trade are expected to be lower over the forecast period than expected at Budget, albeit remaining high by historical standards (Chart 2.1).

Chart 2.1: Terms of trade



Source: ABS cat. no. 5206.0 and Treasury.

The terms of trade are now expected to fall 8 per cent in 2012-13, a larger fall than the decline of 5¾ per cent forecast at Budget. In line with the ongoing expansion in global supply of Australia's key non-rural commodity exports, the terms of trade are expected to continue to ease in 2013-14, with a forecast fall of 2¾ per cent, similar to that forecast at Budget. Notwithstanding these expected falls, Australia's terms of trade are projected to remain above their long-term average in the medium term, consistent with the projected resources needs of the large emerging market economies in the Asian region.

While Australia's economic outlook is positive, the external environment remains fragile and the risks to the global economy are firmly on the downside. The outlook for the euro area remains uncertain, with fears that the sovereign debt crisis could escalate into a major monetary and financial crisis. The impending fiscal cliff in the United States also remains a downside risk to the global economic outlook, with the possibility of a recession in the United States economy if no resolution is reached. In China, the prospects of a weaker contribution from the export sector to economic growth and the risks to global economic and financial stability emanating from the major advanced economies complicate the authorities' already challenging macroeconomic management task, raising the prospect of a sharper-than-planned slowdown in economic growth. In this context, there is a risk that non-rural commodity prices and Australia's terms of trade could decline more rapidly than currently forecast, with attendant risks to nominal GDP growth.

Table 2.1: Domestic economy forecasts(a)

	Outcomes(b)	Forecasts			
		2012-13		2013-14	
	2011-12	Budget	MYEFO	Budget	MYEFO
Panel A - Demand and output(c)					
Household consumption	3.7	3	3	3	3
Private investment					
Dwellings	-3.3	0	0	2 1/2	4
Total business investment(d)	21.3	12 1/2	11	8	6 1/2
Non-dwelling construction(d)	39.0	14	14	7 1/2	5 1/2
Machinery and equipment(d)	10.6	12 1/2	9	8 1/2	7 1/2
Private final demand(d)	6.7	5	4 3/4	4 1/4	4
Public final demand(d)	1.1	- 1/2	- 1/2	0	- 1/4
Total final demand	5.3	3 3/4	3 1/2	3 1/4	3
Change in inventories(e)	0.2	0	0	0	0
Gross national expenditure	5.5	4	3 3/4	3 1/2	3 1/4
Exports of goods and services	3.7	4 1/2	4 1/2	4 1/2	4
Imports of goods and services	11.8	7 1/2	7	5 1/2	5
Net exports(e)	-1.8	- 3/4	- 3/4	- 1/2	- 1/4
Real gross domestic product	**3.4**	**3 1/4**	**3**	**3**	**3**
Non-farm product	3.3	3 1/4	3 1/4	3	3
Farm product	7.5	2	-3	1	6
Nominal gross domestic product	5.0	5	4	5 1/4	5 1/2
Panel B - Other selected economic measures					
External accounts					
Terms of trade	1.8	-5 3/4	-8	-3 1/4	-2 3/4
Current account balance (per cent of GDP)	-2.8	-4 3/4	-5	-6	-5 3/4
Labour market					
Employment(f)	0.7	1 1/4	1	1 1/2	1 1/4
Unemployment rate (per cent)(g)	5.1	5 1/2	5 1/2	5 1/2	5 1/2
Participation rate (per cent)(g)	65.3	65 1/4	65	65 1/4	65
Prices and wages					
Consumer price index(h)	1.2	3 1/4	3	2 1/2	2 1/4
Gross non-farm product deflator	1.7	1 3/4	1	2 1/4	2 1/2
Wage price index(f)	3.7	3 3/4	3 1/2	3 3/4	3 1/2

(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.
Source: ABS cat. no. 5206.0, 5302.0, 6202.0, 6345.0, 6401.0, unpublished ABS data and Treasury.
Note: The forecasts are based on several technical assumptions. The exchange rate is assumed to remain around its recent average level — a trade-weighted index of around 75 and a United States dollar exchange rate of around 102 US cents. Interest rates are assumed to move in line with market expectations. World oil prices (Malaysian Tapis) are assumed to remain around US$118 per barrel. The farm sector forecasts are based on an assumed return to average seasonal conditions.

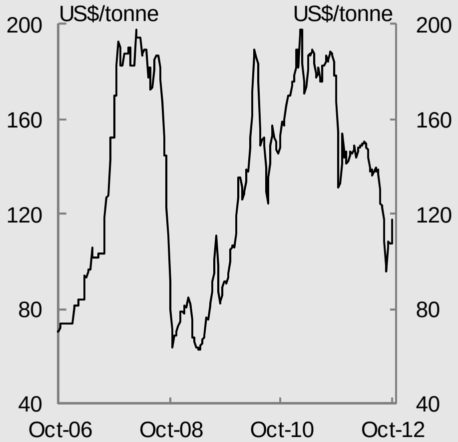
Box 2.1: Commodity prices

Spot prices for Australia's key non-rural commodity exports (iron ore, and thermal and metallurgical coal) have fallen between 15 and 33 per cent since Budget. While coal and iron ore prices remain high by historical standards, the recent falls exceed the declines forecast at Budget and are reflected in weaker forecasts for the terms of trade, nominal GDP and tax receipts.

Thermal coal prices have fallen 15 per cent since Budget, reflecting subdued global demand for coal use in electricity generation, including in response to low gas prices in the United States, and greater global coal supplies becoming available in the Asian market.

Metallurgical coal and iron ore prices, while highly volatile, have also fallen significantly since the start of the financial year. The iron ore spot price fell around 38 per cent in US dollar terms between Budget and the first week of September, before recovering around two thirds of this fall by the second week of October (Chart A).

Chart A: Iron ore spot price

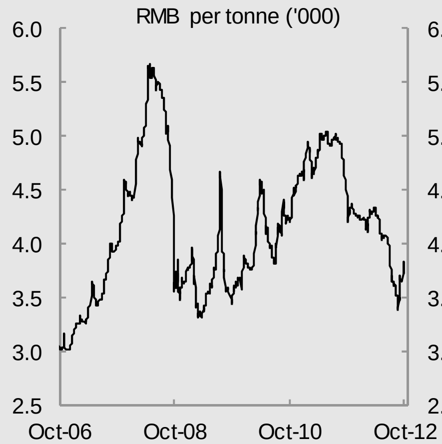


Source: Bloomberg.

Iron ore and metallurgical coal are the main inputs to steel production and the price falls largely reflect weaker demand for steel, consistent with subdued conditions in the major advanced economies and recent moderation of steel demand growth in the emerging market economies of Asia (Chart B).

Lower steel prices in China also reflect overcapacity in the Chinese steel industry, which has added to the seasonal destocking of iron ore and coal that takes place in the third quarter. Restocking generally picks up in the fourth quarter. Nevertheless, the outlook for steel demand is uncertain and sensitive to developments in the steel-intensive Chinese property market and the form and size of any further Chinese policy stimulus.

Chart B: China steel price



Source: Bloomberg.

Box 2.1: Commodity prices (continued)

Lower commodity prices are putting pressure on higher cost mining operations. The marginal sources of iron ore are largely overseas, with Australian mines generally having comparatively low costs of production.

Some Australian coal mines are under pressure at current prices, with isolated closures already taking place. While not the central forecast, a prolonged period of low prices could have a further impact on production.

A fall in supply and some recovery in demand are expected to generate a modest near-term recovery in prices for metallurgical coal and iron ore. However, iron ore and metallurgical coal prices are expected to remain below the Budget estimates across the forecast period, consistent with a more moderate outlook for China's economic growth and resources demand. Thermal coal spot prices have stabilised recently and are expected to remain around their current levels, although a large proportion of Australia's exports of thermal coal are priced using annual contracts that were set in March 2012 (Chart C). This contract price is significantly above the current spot price and will prevail until March 2013.

Chart C: Thermal coal spot price

Source: Bloomberg.

Considered from a medium-term perspective, commodity prices are still expected to be elevated by historical standards, and will still provide an incentive to continue the expansion of low cost supplies in Australia and around the world. In Australia, around $65 billion of coal and iron ore projects are committed or have already commenced construction. While substantial, this represents around a quarter of the advanced pipeline of resources investment, which is dominated by LNG projects (see Box 2.3). The medium-term projections for the terms of trade are based on a gradual decline in commodity prices as the supply of iron ore and coal steadily comes on line. This medium-term methodology has been retained from the 2012-13 Budget.

International economic outlook

The global financial crisis continues to cast a shadow over the international economy, with economic activity remaining weak in the major advanced economies and global financial conditions still highly volatile. An already subdued global outlook has weakened further since Budget, with the recession in Europe and soft recovery in the United States impinging on growth outcomes and prospects for emerging market economies. The European crisis continues to weigh on global confidence, despite a number of welcome policy announcements recently that have led to an easing in financial market turbulence.

Conditions in the major advanced economies have weakened further since Budget. While the contraction in the euro area is expected to be slightly less severe in 2012 than forecast at Budget, a weaker recovery in euro area growth is now forecast in 2013 as financial stress, ongoing fiscal consolidation, and bank deleveraging drag on growth. Although broadly in line with expectations, growth in the United States remains weak, amid concerns over the impending fiscal cliff. If new legislation to avert the fiscal cliff is not passed, the United States could fall back into recession in early 2013.

Since the end of the global recession, growth across emerging market economies, particularly in Asia, has been relatively robust on the back of strong domestic demand. While still strong, a number of major emerging market economies, including China and India, have recently experienced a slowing in their growth rates. This reflects the effect of previous policy tightening in some economies, particularly in China, as well as a reduction in export demand as growth in advanced economies has weakened.

The further weakening in the global economic outlook means that world GDP is now expected to grow 3¼ per cent in 2012 and 3¾ per cent in 2013, compared with Budget forecasts of 3½ per cent and 4 per cent respectively.

Table 2.2: International GDP growth forecasts[(a)]

	Actuals	Forecasts		
	2011	2012	2013	2014
United States	1.8	2	2 1/4	2 1/2
Euro area	1.5	- 1/2	1/4	1 1/4
Japan	-0.8	2 1/2	1 3/4	1 1/4
China(b)	9.3	7 3/4	8	7 3/4
India(b)	7.1	5 1/2	7	7 1/2
Other East Asia(c)	4.3	3 3/4	4 1/2	4 3/4
Major trading partners	4.4	4 1/4	4 3/4	4 3/4
World	3.8	3 1/4	3 3/4	4

(a) World, euro area and other East Asia growth rates are calculated using GDP weights based on purchasing power parity (PPP), while growth rates for major trading partners are calculated using export trade weights.
(b) Production-based measure of GDP.
(c) Other East Asia comprises the newly industrialised economies (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 agencies, IMF *World Economic Outlook* October 2012, Thomson Reuters and Treasury.

The global recovery remains vulnerable to shocks, most notably stemming from Europe, but also the threat of the fiscal cliff occurring in the United States. Growth in emerging market economies, while slowing, has the potential to be boosted by policy action, although the policy response in China to date has been modest. A sharper-than-expected deterioration in Europe or the United States would have spillover effects on emerging market economies, including through lower export demand, disruption in financial markets, and lower confidence.

Although growth in Australia's major trading partners (MTPs) is forecast to be lower than at Budget, it is nonetheless expected to remain solid. MTP growth is expected to be 4¼ per cent in 2012 and then forecast to be 4¾ per cent in both 2013 and 2014, as conditions in Europe and the United States gradually improve. This is expected to lead to an increase in external demand flowing through to China's growth, and to the global economy more broadly. The more robust growth prospects for Australia's MTPs compared with the global economy overall reflects the composition of our MTPs, which is increasingly weighted towards the fast-growing Asian emerging market economies.

Conditions in the euro area have continued to deteriorate, with output declining in the June quarter, credit markets remaining impaired, business and consumer confidence continuing to weaken, and the unemployment rate rising to new euro-era highs. Following recession in 2012, the euro area is assumed to make incremental progress towards resolving the crisis and gradually recover over the forecast horizon. However, growth over this period is expected to be anaemic, with remaining fiscal consolidation requirements and bank deleveraging expected to continue to drag on growth.

Uncertainty persists over Greece's European Union/IMF bailout program and its planned path to fiscal sustainability, notwithstanding the significant debt write-down negotiated with private creditors in early 2012. Throughout the year, Spain has come under increasing pressure as a result of its troubled banking sector and more recently from the fiscal difficulties of both its central and regional governments. Markets are also concerned about Italy, the third largest economy in the euro area, given its significantly larger sovereign debt and poor growth prospects.

The recent European Central Bank (ECB) announcement that it is prepared to purchase short-term sovereign debt of troubled euro area economies through Outright Monetary Transactions as long as governments commit to fiscal and structural reforms has, at least for now, eased financial market turbulence and appears to have bought the region much needed time. However, the ECB can only relieve the immediate funding pressures facing the troubled euro area sovereigns. A lasting resolution to the European sovereign debt crisis will only be achieved through a firm political commitment to a closer fiscal and banking union in the euro area. It will also require the euro area's economies to continue to implement structural reforms in order to boost their competitiveness and growth potential.

The forecasts for the euro area assume a gradual and partial adoption of policies sufficient to stem any further escalation in the crisis, but without enabling any significant improvement in economic growth in the near term. A more substantial and comprehensive policy response would be expected to impact on the region's growth prospects beyond the forecast horizon. However, the risk that progress toward a resolution fails to occur remains significant.

Unlike Europe, the United States economy continues to grow, albeit at a subdued rate by historical standards, with persistent underlying weaknesses in labour and housing markets constraining growth. Notwithstanding recent signs of improvement in the United States housing market, persistent oversupply and the impact of lower house prices on household wealth will continue to weigh on growth prospects. The United States continues to be dependent on very accommodative monetary policy, and is still yet to achieve a self-sustaining recovery. Consequently, it remains vulnerable to further negative shocks.

While the United States is assumed to avoid the fiscal cliff, it remains a key risk to the outlook. A variety of tax provisions, including the 'Bush' tax cuts, expire at the end of 2012, while discretionary spending cuts are currently legislated to commence at the end of 2012. If Congress is unable to come to an agreement to avoid the fiscal cliff, this would have a severely detrimental impact on the United States economy in 2013. Even if the fiscal cliff is avoided, the longer it takes for Congress to reach any agreement, the more likely businesses and households will defer investment and consumption decisions. It also remains crucial that the United States craft a credible medium-term fiscal consolidation plan.

Growth in economic activity in China has eased in recent months due to a weakening external sector and the effects of previous policy tightening. The larger-than-expected moderation in growth has led to a cautious shift in Government policy towards supporting growth. Chinese authorities have eased monetary policy, accelerated the approval of infrastructure projects, provided consumption incentives to households, and lowered taxes for small and medium-sized enterprises.

The magnitude of any policy stimulus is likely to be smaller than that undertaken in 2008-09, with Chinese officials mindful of avoiding the asset quality issues and substantial inflationary pressures that resulted from that round of stimulus. The more supportive policy settings being implemented this year are expected to see growth pick up later in the year and into early 2013.

Over the forecast horizon, China's growth is expected to remain relatively robust, albeit lower than anticipated at Budget. While the projected growth rates are more modest compared with those recorded over much of the past 30 years, the Chinese economy is now around 40 per cent larger than in 2008, and its growth is still making a very substantial contribution to global growth. Furthermore, the more moderate outlook is also more consistent with a maturing economy on a sustainable and balanced growth path and with the growth target under the 12th Five-Year Plan (as discussed in Box 2.2).

A further deterioration in economic conditions in Europe or a more significant slowing in growth in the United States poses the main risk to China's growth outlook. If global conditions were to deteriorate further, the Chinese authorities retain significant capacity to adopt further measures to support growth.

Elsewhere in the region, the boost to Japan's growth from earthquake reconstruction activity peaked in the first half of 2012, with Japan's growth in the medium term likely to return to very subdued rates with a reliance on exports. The weakening in external demand has adversely affected the highly trade-exposed newly industrialised economies (NIEs), particularly Taiwan and Hong Kong.

In contrast, the economies in the ASEAN-5 such as Indonesia, Thailand and the Philippines have generally continued to record more robust growth rates due to healthy domestic demand. A key risk across a number of East Asian economies is their vulnerability to the threat of a sharp outflow of capital if global conditions deteriorate.

In India, economic growth is forecast to be lower than expected at Budget, particularly for 2012, reflecting a slowing in investment and a delay in monsoon conditions. Over the remainder of the forecast horizon, India's growth is expected to improve, reflecting a gradual recovery in private investment and a return to normal seasonal conditions.

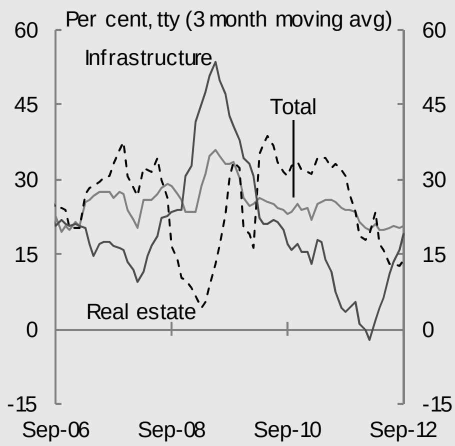
A lingering additional risk to the global outlook is the potential for a spike in global oil prices as political tensions in the Middle East remain unresolved. While global oil prices fell in the three months to June, they have since risen noticeably despite the softening in global economic conditions, suggesting that market concerns over geopolitical risks are a major factor. While the possibility of an oil price spike persists, if conditions in the euro area were to deteriorate and global growth was to slow sharply, then conversely oil prices could decline substantially.

Box 2.2: China's medium-term outlook

The slowdown in the Chinese economy has been more pronounced than expected at Budget, although growth remains relatively robust. In the September quarter, through-the-year (tty) growth decelerated for the seventh consecutive quarter to 7.4 per cent, reflecting a policy-induced slowdown in the property sector and deteriorating external demand. In response, the Chinese Government has enacted policies intended to stabilise growth.

Measures include the bringing forward of infrastructure projects and modest monetary policy easing. The percentage of Chinese bank deposits that must be held in reserve has been cut by 150 basis points since December and, since June, one-year benchmark lending rates have been cut by 56 basis points. In the short term, investment activity may receive a mild policy-induced boost from a pickup in construction, providing some support to broader economic activity (Chart A).

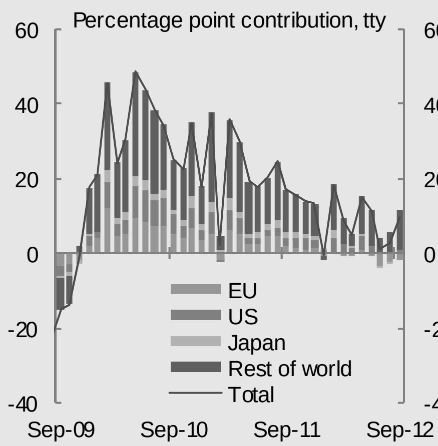
Chart A: Fixed asset investment



Source: CEIC China database and Treasury.

The recent shift towards policy easing is yet to gain traction and stimulus has not been as large as first anticipated by many analysts. China also remains vulnerable to further weakness in advanced economies (Chart B) and softness in the domestic property sector. Nevertheless, with inflation under control (and likely to remain subdued in the short term) and the Government's solid fiscal position, China retains the capacity to use macroeconomic policy to further support growth should conditions deteriorate markedly.

Chart B: Export growth



Source: CEIC China database and Treasury.

Over the medium term, a more moderate growth path is in line with the Chinese Government's target for sustainable and better quality growth. China is targeting an annual average growth rate of 7 per cent during the 12th Five-Year Plan (FYP) (2011-2015), down ½ a percentage point from the 11th FYP (2006-2010).

Box 2.2: China's medium-term outlook (continued)

This lower target provides China with greater space to take a more measured approach to supporting growth while addressing longer-term challenges associated with the structural biases of its export- and investment-reliant growth model.

Australia is not immune to slower growth in China due to our strong trade links. The recent slowing in Chinese growth has been accompanied by a weakening in the Chinese steel market, which has led to sharper-than-expected declines in prices for Australian exports of iron ore and metallurgical coal.

However, Australia's sensitivity to economic conditions in our major trading partners is not new. The Australian economy has a track record of coping with slowing growth in key export markets (such as Japan) and other external shocks (such as the global financial crisis).

Notwithstanding short-term cyclical developments, China's economic expansion will continue to make an important contribution to the Australian economy. Rapid urbanisation and continuing efforts to promote economic and industrial development outside the relatively wealthy coastal regions will raise China's energy consumption and require ongoing investment in metals-intensive projects, supporting demand for Australian coal and iron ore.

Furthermore, as Chinese consumers grow wealthier they will also demand increased levels of goods and services, with opportunities extending well beyond the resources sector. This will open up new markets for Australian producers and service providers across a broad range of sectors, including in the tourism, education, agriculture and food industries.

Detailed domestic forecasts

Australia's real GDP is forecast to grow 3 per cent in both 2012-13 and 2013-14. Compared with Budget, the growth forecast has been downgraded by ¼ of a percentage point in 2012-13, but is unchanged in 2013-14. The downgrade to growth in 2012-13 mainly reflects stronger-than-expected resources-related investment activity in 2011-12, along with recent announcements to defer or cancel resources projects. Australia's favourable real GDP growth outlook is underpinned by a surge in business investment, strong growth in non-rural commodity exports and solid growth in household consumption.

Household consumption is forecast to grow 3 per cent in both 2012-13 and 2013-14, unchanged from Budget. While solid, growth in household consumption is expected to ease from the strong growth recorded in 2011-12, consistent with the outlook for moderate employment and wages growth, continued subdued growth in household wealth and the impact of continued global volatility on consumer confidence. Consistent with this, the household saving ratio is expected to remain elevated over the forecast period, as households continue to rely on saving rather than capital gains to strengthen their balance sheets.

Dwelling investment is forecast to be flat in 2012-13, before growing 4 per cent in 2013-14. Dwelling investment declined 3.3 per cent in 2011-12 on the back of continued weakness in the detached housing market. Conditions across the sector are expected to improve gradually over the remainder of 2012, consistent with the solid growth in dwelling approvals and commencements seen in the June quarter. The recovery is expected to gather momentum into 2013-14, driven by a pickup in homebuyer demand, improved affordability following declines in house prices over the past two years and the assumption that interest rates will remain below average across the forecast period.

New business investment is expected to grow 11 per cent in 2012-13 and 6½ per cent in 2013-14, reflecting strong forecast growth in resources investment and modest growth in investment in other sectors of the economy. **New engineering construction** is expected to grow 19 per cent in 2012-13 and 7 per cent in 2013-14, underpinned by LNG and iron ore projects. The resources sector is also expected to drive higher levels of investment in **new machinery and equipment**, with growth forecast to be 9 per cent in 2012-13 and 7½ per cent in 2013-14. Weakness in the retail sector and the expectation of below-trend employment growth, and therefore subdued demand for new office space, is expected to be reflected in weak growth in **new non-residential building** activity, with growth of just 1 per cent forecast in 2012-13 and 1½ per cent in 2013-14.

Public final demand is forecast to fall ½ of a per cent in 2012-13 and ¼ of a per cent in 2013-14, consistent with the planned fiscal consolidations of the Commonwealth and state governments.

Exports are forecast to grow 4½ per cent in 2012-13 and 4 per cent in 2013-14. While the growth outlook remains strong, weaker-than-expected outcomes in 2011-12, coupled with recent coal mine closures and announcements to not proceed with planned expansions, mean that the expected volume of non-rural commodities exports is lower over the forecast period than anticipated at Budget. Manufactured exports are expected to rise only modestly over the next two years and services exports are expected to fall slightly, reflecting the high Australian dollar and forecasts for continued weak external demand. Farm production and rural exports surged to record levels in 2011-12, reflecting favourable weather conditions. In 2012-13, rural output and exports are expected to decline moderately, in line with an assumed return to average weather conditions.

Import growth forecasts have been downgraded slightly for 2012-13 and 2013-14, consistent with lower forecast growth in business investment. Import volumes are forecast to grow 7 per cent in 2012-13 and 5 per cent in 2013-14. Net exports are expected to detract ¾ of a percentage point from real GDP growth in 2012-13 and ¼ of a percentage point in 2013-14.

The **terms of trade** have declined more sharply than anticipated at Budget, reflecting recent sharp falls in the global prices of Australia's key non-rural commodity exports. Following growth of 90 per cent over the past decade, the terms of trade are now expected to decrease 8 per cent in 2012-13 and 2¾ per cent in 2013-14, remaining high by historical standards.

The **current account deficit** is forecast to widen over the next two years. This reflects an expected turnaround in the trade balance from a surplus to a deficit, driven by the decline in the terms of trade. The current account deficit is expected to be 5 per cent of GDP in 2012-13 and 5¾ per cent of GDP in 2013-14. This compares with a long-run average for the current account deficit of 4 per cent of GDP. Considered from a net lending perspective, the key driver of the rising current account deficit is the inflow of capital needed to finance the resources investment boom, with the household sector and Australian Government expected to be net lenders over the forecast period.

Following solid growth in the first half of 2012, **employment** growth has moderated in recent months, with weak global conditions, the high Australian dollar, uneven patterns of demand and continued deleveraging by the household and corporate sectors weighing on employment conditions in many industries. Employment is expected to increase 1 per cent through the year to the June quarter 2013 and 1¼ per cent through the year to the June quarter 2014. The **unemployment rate** is forecast to increase slightly from 5¼ per cent in the September quarter 2012 to 5½ per cent by the June quarter 2013, and remain around that level throughout 2013-14.

Wages growth is expected to slow, consistent with moderate employment growth. Aggregate wages have grown solidly over the past year, with the low unemployment rate supporting solid growth in private sector wages. This has been balanced by weakness in public sector wages growth, which has eased in line with ongoing fiscal consolidation at the state and federal levels of government. Looking ahead, the Wage Price Index is forecast to grow 3½ per cent through the year to the June quarters of both 2013 and 2014, slightly weaker than forecast at Budget.

Inflation is expected to increase in 2012-13 due to the one-off effect of introducing the carbon price, but remain within the Reserve Bank's target band. While the high exchange rate is expected to exert less downward pressure on domestic prices over the forecast period than in the recent past, it is expected that solid productivity growth and subdued wages growth will continue to hold down domestic price pressures. Headline inflation (including the carbon price impact) is expected to be 3 per cent through the year to the June quarter of 2013 and 2¼ per cent through the year to the June quarter of 2014. Underlying inflation (including the carbon price impact) is expected to be 2½ per cent through the year to the June quarter of 2013, and 2¼ per cent through the year to the June quarter of 2014.

Nominal GDP is forecast to grow 4 per cent in 2012-13 and 5½ per cent in 2013-14. Compared with Budget, the growth forecast for nominal GDP in 2012-13 has been downgraded by 1 percentage point. The lower forecast for 2012-13 reflects the ¼ of a percentage point downward revision to real GDP growth, softer expected growth in domestic prices and a sharper forecast decline in the terms of trade.

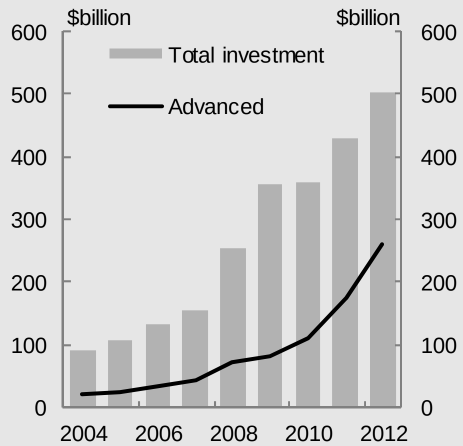
Box 2.3: Resources investment

Over the past two decades, rapid urbanisation and industrialisation in China has driven strong growth in demand for Australia's key non-rural commodity exports. This strong demand, and expectations that it will continue, have driven commodity prices to high levels and underpinned record investment intentions in Australia's resources sector.

The outlook for resources investment remains strong despite recent falls in commodity prices. Resources investment decisions are taken over a longer-term horizon where the outlook for the resources and energy needs of Australia's key export markets remains very positive.

Around $260 billion of resources projects are at an advanced stage (either under construction or scheduled to commence) and are unlikely to be affected by recent falls in commodity prices (Chart A).

Chart A: Investment pipeline



Source: Bureau of Resource and Energy Economics (BREE).

Of the advanced pipeline, around 70 per cent of the projected capital spending is on petroleum and LNG projects, with seven major LNG projects currently under construction across Western Australia, Queensland and the Northern Territory (Table A).

These projects are underpinned by long-term supply contracts with Asian customers. The completion of these projects will see LNG production in Australia quadruple by 2017, with Australia becoming the world's largest LNG exporter.

Table A: LNG projects under construction

Project		CAPEX ($bil)
Gorgon	A	43.0
Ichthys	US	34.0
Wheatstone	US	29.0
Australia Pacific LNG	A	23.0
Queensland Curtis Island LNG	US	20.4
Gladstone LNG	US	18.5
Prelude	A	12.0

Source: Company statements, Deloitte Access Economics and BREE.
Note: Capital expenditure (CAPEX) estimates reflect amounts and denominations at the time of announcement.

In addition to LNG investment, iron ore investment is expected to continue to increase over the next two years, building on previous robust growth.

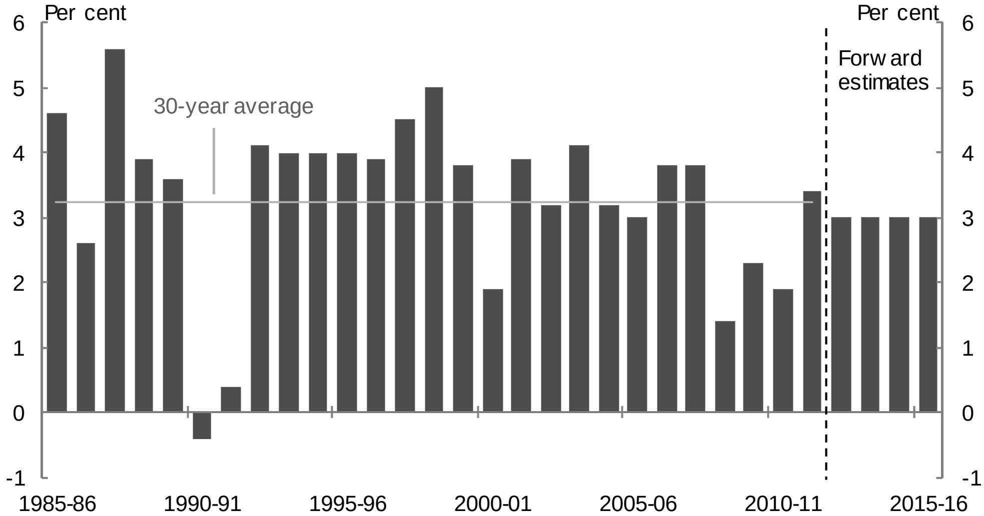
While resources investment as a share of GDP is expected to peak over the forecast period, resources investment is expected to remain at a high level through to the middle of this decade. As investment projects are completed, there will be a significant contribution to economic growth from the ramp-up in resources production and export volumes.

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.

Real GDP is projected to grow at its trend rate of around 3 per cent a year over the medium term based on analysis of underlying trends in employment and productivity (Chart 2.2). Trend growth in real GDP is projected to slow from around the end of this decade as the participation rate declines in line with Australia's ageing population profile.

Chart 2.2: Real GDP growth over the forward estimates period



Source: ABS cat. no. 5206.0 and Treasury.

The unemployment rate is projected to be 5 per cent over the medium-term, consistent with Treasury's estimate of the non-accelerating inflation rate of unemployment. Inflation is projected to be 2½ per cent, consistent with the Reserve Bank of Australia's medium-term target band.

The terms of trade are projected to decline by a total of around 20 per cent over a 15-year period, settling around their mid-2000s level. This reflects an expectation that commodity prices will ease in the longer term as supply increases gradually bring down prices over time.

The exchange rate is assumed to remain around its recent average level during the forecast period. Over the projection period, the exchange rate is assumed to move in line with the long-term historical relationship between the terms of trade and the real exchange rate. The terms of trade projections imply a fall in the real exchange rate of 0.9 per cent per annum over the projection period.