



**Australian Government**

**The Treasury**

# JOINT ECONOMIC FORECASTING GROUP

ECONOMIC OUTLOOK FOR 2012-13, 2013-14 AND 2014-15

MARCH 2013

This report incorporates Domestic and International data released up to 4 April 2013.

<b>Overview .....</b>	<b>3</b>
<b>Outlook for the domestic economy.....</b>	<b>3</b>
<i>Household consumption .....</i>	<i>7</i>
<i>Dwelling investment .....</i>	<i>7</i>
<i>Business investment .....</i>	<i>7</i>
<i>Public final demand.....</i>	<i>8</i>
<i>Exports, imports and the current account deficit .....</i>	<i>8</i>
<i>Employment, wages and inflation .....</i>	<i>10</i>
<b>Outlook for the international economy .....</b>	<b>12</b>

## OVERVIEW

While the near-term outlook has moderated following softer-than-expected recent outcomes, the outlook for the Australian economy in 2014-15 has strengthened since the December update. Real GDP growth was a little below trend in the December quarter, and total hours worked declined for a second consecutive quarter. Investment in the resources sector is expected to peak at a lower level than forecast at the December update and the near-term outlook for non-mining business investment remains subdued. Still, with exports now expected to grow more strongly and some additional resources investment expected toward the end of the forecast period, real GDP growth is forecast to pick up in 2014-15. Consistent with slightly below-trend growth in the near term, the unemployment rate is forecast to rise to 5¾ per cent by the June quarter of 2014, but then stabilise around that level as economic growth strengthens.

Global economic conditions have broadly improved since the December update. China's growth appears to be strengthening, the United States Congress reached an agreement to avert the majority of the 'fiscal cliff' and Japanese authorities announced more aggressive policy stimulus to boost the economy. However, recent events in Cyprus and Italy have highlighted that downside risks still remain in Europe, which are only partly offset by the upside risks in Asia and the United States.

**Table 1: Key Domestic Forecasts<sup>(a)</sup>**

	2011-12	2012-13		2013-14		2014-15	
	Outcome	December	March	December	March	December	March
Real GDP	3.4	3	2 3/4	2 3/4	2 3/4	2 3/4	3
Nominal GDP	5.0	3 1/4	3 1/4	5 1/4	5	4 1/4	5
Unemployment rate	5.1	5 1/2	5 1/2	5 3/4	5 3/4	6	5 3/4
Employment	1.1	1	1 1/4	1 1/4	1 1/4	1 1/4	1 1/2
CPI	1.2	3 1/4	2 3/4	2 1/4	2 1/4	2 1/4	2 1/4
Underlying inflation	2.1	2 1/2	2 1/2	2 1/4	2 1/4	2 1/4	2 1/4
WPI	3.7	3 1/2	3 1/2	3 1/2	3 1/2	3 1/2	3 1/2
Terms of trade	0.4	-8 3/4	-7 1/2	- 1/2	- 3/4	-3	-1 3/4

(a) Real GDP, nominal GDP and the terms of trade are year-average growth. Employment, CPI, underlying inflation and the WPI are through-the-year growth to the June quarter. The unemployment rate is the rate for the June quarter.

Economic growth in 2012-13 will be supported by rising investment in the resources sector, and a stronger increase in export volumes for non-rural bulk commodities. Real GDP is forecast to grow 2¾ per cent in 2013-14, and then accelerate to 3 per cent in 2014-15. As resources projects progressively move from the construction phase to the production phase, growth in non-rural bulk commodity export volumes will continue to strengthen. Non-rural commodity export volumes are expected to grow over 30 per cent over the next three years. This strong exports growth combined with solid growth in household consumption and a modest recovery in non-mining investment will support real GDP growth over the forecast period.

The lower peak in resources investment in 2013-14 and the more gradual decline in 2014-15 reflect both a shift in the timing of expected capital expenditure and a reassessment of the likelihood of some projects under consideration proceeding toward the construction phase. Outside the resources sector, the outlook for non-mining investment remains subdued, with near-term risks firmly to the downside. Recent business survey outcomes have pointed to continued weakness in business conditions and capacity utilisation rates across most industries. This, combined with a weaker-than-expected December quarter outcome and the most recent CAPEX estimate, has led to a downgrade in the forecast for new machinery and equipment investment in 2012-13 and 2013-14. A modest recovery is forecast in 2014-15 with the accommodative stance of monetary policy and improving economic conditions motivating firms to rebuild capital stocks.

Construction activity in the dwellings sector is expected to gain further momentum over the next two years, after signs of a recovery in dwelling investment in the first half of 2012-13. Over the forecast period, growth in dwellings investment will be supported by low interest rates, strong population growth, high rental yields and low vacancy rates. Nonetheless, household caution around debt accumulation coupled with ongoing supply constraints continue to pose downside risk to the outlook.

Household consumption will continue to support economic growth across the forecast period, although forecast growth for 2012-13 has been downgraded by a further  $\frac{1}{4}$  of a percentage point following another very weak outcome in the December quarter. Over the remainder of the forecast period, consumption growth is expected to remain solid, albeit slightly below trend at 3 per cent. This outlook is consistent with forecast softness in the labour market, below-trend wages growth, and improving but subdued growth in household wealth. Consistent with this, the household saving ratio is expected to fall gradually, but remain elevated.

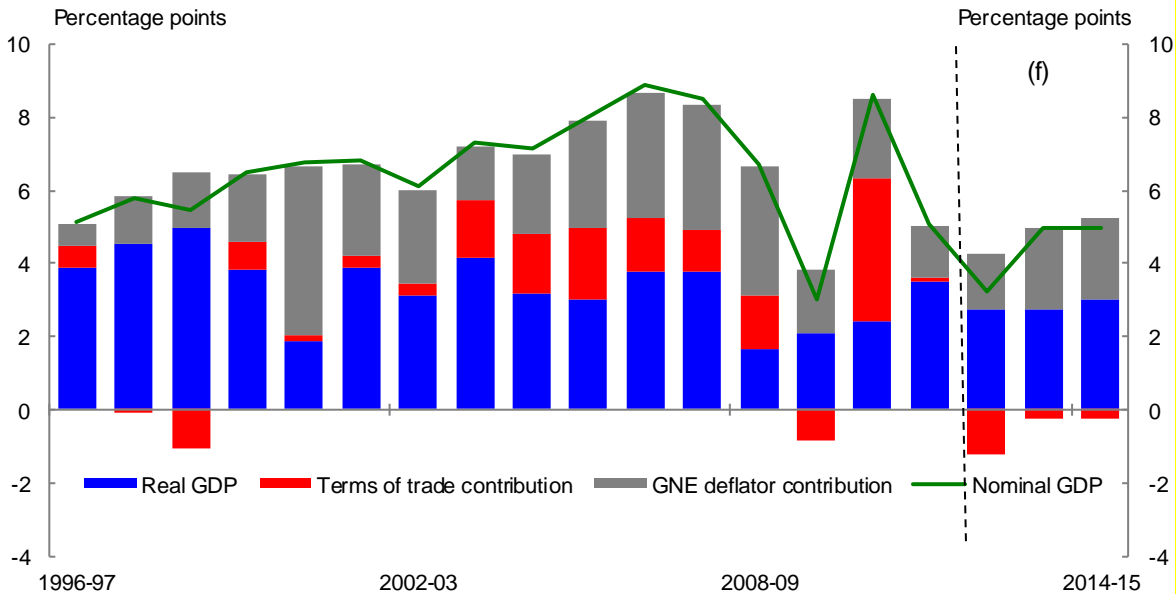
Strong non-rural commodity exports growth in the December quarter reflected relatively favourable weather conditions in the quarter and the better-than-expected progress of expansion plans at some sites. Export forecasts have been upgraded across the forecast period to reflect this progress, as well as the bring-forward of some expansions in the forecast period. The level of imports is forecast to remain high in 2012-13 and 2013-14, reflecting continued import-intensive LNG investment over those years. Growth in imports is expected to soften in 2014-15, but be slightly higher than expected at the December update consistent with the forecast for slightly stronger resources investment growth in that year.

Unforeseen strength in iron ore spot prices over the March quarter has led to an upgrade to the forecast terms of trade for 2012-13. The terms of trade are expected to decrease  $7\frac{1}{2}$  per cent in 2012-13, an upward revision of  $1\frac{1}{4}$  percentage points since December. Spot prices for iron ore are expected to decline further over the forecast period than expected at December, consistent with the outlook for stronger export volumes. Despite this softer outlook for iron ore spot prices, the terms of trade are expected to fall more gradually over the forecast period, with a higher expected average grade supporting stronger export prices for iron ore and a scaling back in some global suppliers expansion plans giving rise to an improved outlook for coal prices.

Notwithstanding the improved outlook for the terms of trade, nominal GDP growth is still expected to remain below average for some time. Forecast nominal GDP growth in 2012-13 is unchanged at  $3\frac{3}{4}$  per cent with weaker real GDP growth offsetting the upward revision to the terms of trade (Chart 1). Forecast nominal GDP growth in 2013-14 has been downgraded  $\frac{1}{4}$  of a percentage point since the December update to reflect a slight downgrade in the forecast for domestic prices growth. In 2014-15, nominal GDP growth has been upgraded by  $\frac{3}{4}$  of a percentage point to 5 per cent, supported by strengthening real GDP growth and a more modest fall in the terms of trade. Still, with the terms of trade expected to gradually decline for some time, nominal GDP is forecast to remain below its 20-year average annual growth rate of  $6\frac{1}{2}$  per cent throughout the forecast period and into the medium term.

Employment growth is forecast to remain below trend over the next two years at  $1\frac{1}{4}$  per cent. Reflecting the strengthening outlook toward the end of the forecast period, forecast employment growth has been upgraded by  $\frac{1}{4}$  of a percentage point to  $1\frac{1}{2}$  per cent in 2014-15. The unemployment rate is expected to gradually rise to  $5\frac{3}{4}$  per cent by the June quarter 2014, and stabilise at that level through to the June quarter 2015. The participation rate is forecast to remain at 65 per cent. The outlook for wages growth remains subdued, consistent with the outlook for below-trend employment growth. Forecasts of the Wage Price Index are unchanged from the December update at  $3\frac{1}{2}$  per cent through the year to the June quarters of 2013, 2014 and 2015. The forecast for underlying inflation is unchanged, remaining in the bottom half of the Reserve Bank's target band, consistent with the forecasts for below-trend employment and wages growth.

**Chart 1: Contributions to nominal GDP growth**



Source: ABS catalogue number 5206.0 and Treasury.

The main risks to the outlook continue to stem from the external environment. Clear signs of a global economic recovery are not yet apparent, and there are continuing risks from financial instability in Europe and fiscal uncertainty in the United States. The potential for further significant volatility in commodity prices presents a considerable risk to the forecasts for the terms of trade and nominal GDP. Additionally, the transition to resources-led export growth and a recovery in the non-mining economy may be less seamless than forecast.

**Table 2: Domestic economy forecasts<sup>(a)</sup>**

	Outcomes (b)	Forecasts		
	2011-12	2012-13	2013-14	2014-15
<b>Panel A - Demand and output(c)</b>				
Household consumption	3.2	2 1/2	3	3
Private investment				
Dwellings	-3.6	1/2	5	5 1/2
Total business investment(d)	20.8	10 1/2	4 1/2	1
Non-dwelling construction(d)	37.6	18 1/2	5	-2 1/2
Machinery and equipment(d)	10.1	1 1/2	2 1/2	5
Private final demand(d)	6.2	4	3 1/2	2 3/4
Public final demand(d)	2.3	- 1/2	0	1/2
Total final demand	5.3	3	2 3/4	2 1/4
Change in inventories(e)	-0.1	0	0	0
Gross national expenditure	5.2	3	2 3/4	2 1/4
Exports of goods and services	4.7	7	6 1/2	7
Imports of goods and services	11.8	5	6	3
Net exports(e)	-1.3	1/2	0	1
<b>Real gross domestic product</b>	3.4	2 3/4	2 3/4	3
Non-farm product	3.3	3	2 3/4	3 1/4
Farm product	9.0	-7	3	0
Nominal gross domestic product	5.0	3 1/4	5	5
<b>Panel B - Other selected economic measures</b>				
External accounts				
Terms of trade	0.4	-7 1/2	- 3/4	-1 3/4
Current account balance				
\$billion	-40.2	-55	-59 1/4	-53 3/4
Percentage of GDP	-2.7	-3 1/2	-3 3/4	-3 1/4
Labour market				
Employment (labour force survey basis)(f)	1.1	1 1/4	1 1/4	1 1/2
Unemployment rate (per cent)(g)	5.1	5 1/2	5 3/4	5 3/4
Participation rate (per cent)(g)	65.3	65	65	65
Prices and wages				
Consumer Price Index (h)				
- headline	1.2	2 3/4	2 1/4	2 1/4
- underlying	2.1	2 1/2	2 1/4	2 1/4
Gross non-farm product deflator	1.7	1/4	2	1 3/4
Wage Price Index(f)	3.7	3 1/2	3 1/2	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.

Note: The forecasts for the domestic economy are based on several technical assumptions. The exchange rate is assumed to remain around its recent average level – a trade-weighted index of around 77 and a \$US exchange rate of around 103 US cents. Interest rates are assumed to move broadly in line with market expectations. World oil prices (Malaysian Tapis) are assumed to remain around US\$120 per barrel. The farm sector forecasts are based on an assumption of average seasonal conditions.

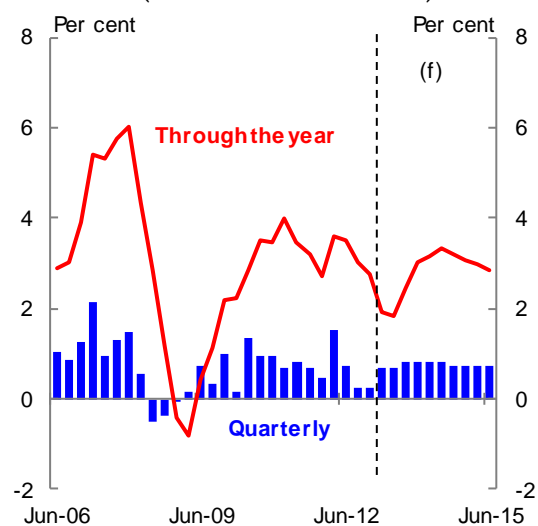
Source: ABS cat. no. 5206.0, 5302.0, 6202.0, 6345.0, 6401.0, unpublished ABS data and Treasury.

## OUTLOOK FOR THE DOMESTIC ECONOMY

### Household consumption

The forecast for **household consumption** growth in 2012-13 has been downgraded from  $2\frac{3}{4}$  per cent to  $2\frac{1}{2}$  per cent since December JIEFG. The downgrade reflects the weaker-than-expected outcome in the December quarter National Accounts. Consistent with the recent improvement in results from the monthly retail trade survey and improving consumer confidence, consumption growth is expected to pick-up in the near term. Over the remainder of the forecast period, consumption growth is expected to remain solid, albeit below trend at 3 per cent in 2013-14 and 2014-15. This outlook reflects below-trend growth in employment and wages, and improving but subdued growth in household wealth. Consistent with this outlook, the household saving ratio is expected to remain elevated over the forecast period, as households remain prudent and continue to rely on saving rather than capital gains to strengthen their balance sheets (Chart 2).

Chart 2: Household consumption  
(chain-volume measure)



Source: ABS cat. no. 5206.0 and Treasury.

### Dwelling investment

The near-term outlook for **dwelling investment** has strengthened slightly since December JIEFG, following the stronger-than-expected December quarter outcome. Dwelling investment grew 2.1 per cent in the December quarter, the strongest rise in over two years. While the

medium-to-high density sector has been a key source of growth over recent quarters, and is expected to remain so over the rest of the forecast period, there are tentative signs that conditions in the weaker detached housing sector are beginning to stabilise. In the December quarter National Accounts, detached housing investment recorded its second consecutive quarter of positive growth, growing at its strongest quarterly rate in over two years.

Consistent with these emerging signs of a recovery and favourable market fundamentals (such as low interest rates, strong population growth, low vacancy rates and high rental yields), dwelling investment is expected to grow  $\frac{1}{2}$  of a per cent in 2012-13, 5 per cent in 2013-14 and  $5\frac{1}{2}$  per cent in 2014-15.

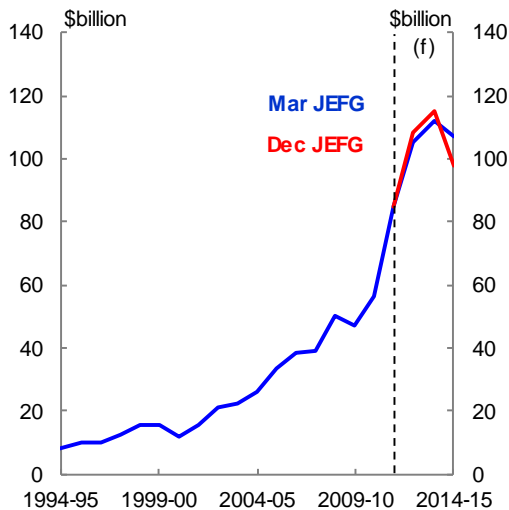
### Business investment

The outlook for **new business investment** has been downgraded in 2012-13 and 2013-14 but upgraded in 2014-15 compared with December JIEFG. The downgrades in 2012-13 and 2013-14 reflect the expectations that investment in the resources sector will peak at a lower level than previously forecast and that the recent weakness in non-mining investment will continue. The upgrade in 2014-15 reflects a softer decline from a lower peak in resources investment, revised expenditure plans for some key resource projects, and a modest recovery in non-mining investment. New business investment is forecast to grow  $10\frac{1}{2}$  per cent in 2012-13,  $4\frac{1}{2}$  per cent in 2013-14 and 1 per cent in 2014-15 as the mining investment peak passes.

Forecasts of **new engineering construction** growth have been downgraded in 2012-13 and 2013-14 reflecting a shift in the timing of expected capital expenditure and a reassessment of the likelihood of some projects under consideration proceeding toward the construction phase in the forecast period (Chart 3). However, recently revised expenditure plans for a number of major resource projects indicate the expected decline in investment following the peak in 2013-14 is likely to be more gradual than previously expected. New engineering construction is forecast to grow 24 per cent in 2012-13 and  $6\frac{1}{2}$

per cent in 2013-14, before falling 4½ per cent in 2014-15. The forecast fall in 2014-15 has been revised up from a decline of 15 per cent at December JIEFG.

**Chart 3: New engineering construction (chain-volume measure)**



Source: ABS cat. no. 5206.0 and Treasury.

Investment in **new machinery and equipment** has been downgraded since December JIEFG in line with the weaker-than-expected outcome for the December quarter, the lower peak in resources investment and continued weakness in non-mining investment intentions in the latest CAPEX survey. With capacity utilisation rates in the non-mining parts of the economy currently below their long-run average, investment in machinery and equipment is expected to remain subdued. A modest recovery is expected in 2014-15 as low interest rates and accelerating economic growth encourage firms to rebuild their capital stock. New machinery and equipment is forecast to grow 1½ per cent in 2012-13, 2½ per cent in 2013-14 and 5 per cent in 2014-15.

**New non-residential building** is forecast to grow 5½ per cent in 2012-13 following strength in recent quarters from some one-off projects. Beyond this, the outlook for investment growth remains modest due to above-average vacancy rates and a subdued labour market. New non-residential building is expected to grow 1½ per cent in 2013-14 and 3½ per cent in 2014-15.

## Public final demand

**Public final demand** is forecast to fall ½ of a per cent in 2012-13, remain flat in 2013-14 and grow ½ of a per cent in 2014-15. Growth has been upgraded by ¼ of a percentage point in 2013-14 and 2014-15 based on revised state and local government investment profiles in 2013-14 and modest increases in expenditure plans across all levels of government in 2014-15. The forecasts are consistent with announced expenditure plans at state Budget mid-year updates and Pre-ERC estimates of Commonwealth expenditure.

## Exports, imports and the current account deficit

Export forecasts have been upgraded since December JIEFG, reflecting both the strong outcome in the December quarter, and increases to a number of specific resource expansion projects in the forecast period. **Exports** are expected to grow 7 per cent in 2012-13, 6½ per cent in 2013-14 and 7 per cent in 2014-15.

The outlook for **non-rural commodity** export volumes has been upgraded since December JIEFG. This reflects the strong December quarter outcome; increases to specific iron ore expansions; and better-than-expected progress on some projects, particularly in the Pilbara. Growth has been upgraded in each of the forecast years with non-rural commodity exports expected to increase by over 30 per cent over the next three years (Chart 4).

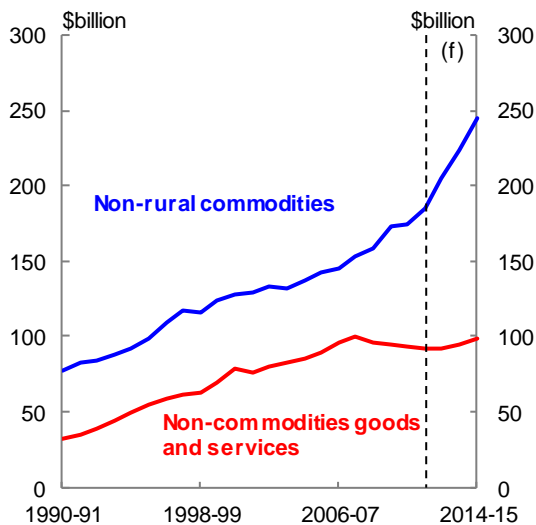
**Services** exports are forecast to grow 1 per cent in 2012-13, 1½ per cent in 2013-14 and 2½ per cent in 2014-15, reflecting ongoing strength in business services exports and a gradual return to trend growth in the international student sector.

In 2012-13, farm production is expected to decline from the record level of 2011-12, owing to less favourable weather conditions for the recent winter crop. Rural output is expected to increase moderately in 2013-14 before flattening in 2014-15, in line with an assumed return to average weather conditions. Despite the decline in production, **rural** exports volumes are forecast to be little changed in



2012-13, supported by a drawdown on inventories accumulated in 2011-12.

**Chart 4: Export volumes (chain-volume measure)**



Source: ABS cat. no. 5302.0 and Treasury.

**Import** growth forecasts have been downgraded in 2012-13, remain unchanged in 2013-14 and upgraded slightly in 2014-15 since December JIEFG, largely driven by the revision to forecast growth in LNG investment. Import volumes are forecast to grow 5 per cent in 2012-13 and 6 per cent in 2013-14. With the passing of the peak in resources sector investment, imports growth is expected to slow to 3 per cent in 2014-15.

The forecast for the contribution of **net exports** to GDP growth has been revised up across the forecast period, consistent with the expectation of stronger growth in non-rural bulk commodity exports. Net exports are expected to contribute ½ of a percentage point to real GDP growth in 2012-13, an upward revision of 1 percentage point since December. The forecast contribution of net exports to growth in 2013-14 has been revised up ¼ of a percentage point, to have no net effect on growth. Net exports are then expected to contribute 1 percentage point to growth in 2014-15.

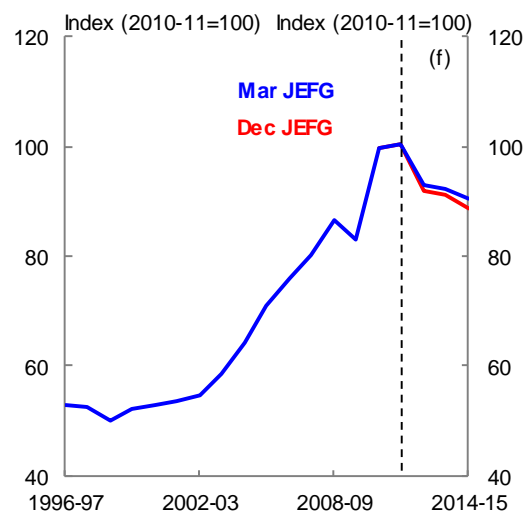
The **terms of trade** have been upgraded since December JIEFG and are expected to decrease 7½ per cent in 2012-13, ¾ of a per cent in 2013-14 and 1¾ per cent in 2014-15 (Chart 5). The near-term upgrade reflects the increase in iron ore prices since December. The forecast

for iron ore spot prices in 2013-14 and 2014-15 has been downgraded due to the expected increase in exports, which will move production down the cost curve to a lower cost marginal producer.

However, recent analysis suggests that the average grade of iron ore will be higher than previously expected. Higher grade iron ore is less costly to smelt and therefore attracts a higher price than lower grades. This has raised the profile of iron ore export prices over the forecast period.

Metallurgical coal prices have fallen significantly over the past two years, while thermal coal spot prices have fallen to a lesser extent. Both metallurgical and thermal coal prices now appear to reflect marginal producer costs and are expected to remain around their current level, with increasing production costs expected to lead only to a modest increase in prices over the forecast horizon.

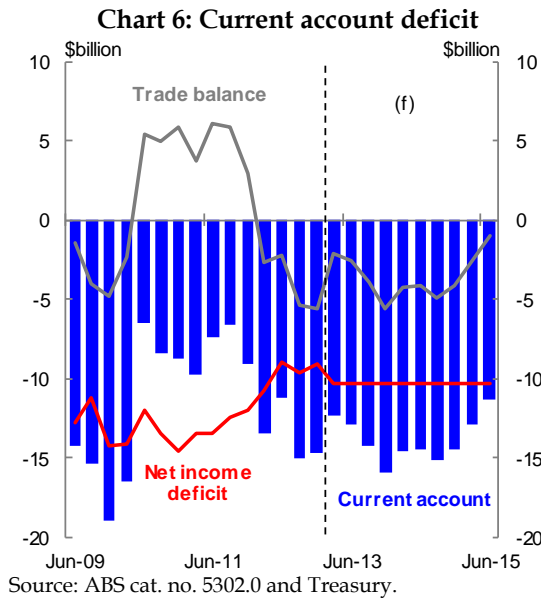
**Chart 5: The terms of trade**



Source: ABS cat. no. 5206.0 and Treasury.

Forecasts of the **current account deficit** have been upgraded significantly since December JIEFG as a result of the substantial improvement in the outlook for the trade balance and changes to the methodology for forecasting the net income deficit. The current account deficit is now expected to be 3½ per cent of GDP in 2012-13, 3¾ per cent of GDP in 2013-14 and 3¾ per cent of GDP in 2014-15 (Chart 6). The trade balance is expected to move toward surplus by the end of the forecast period in line with the better

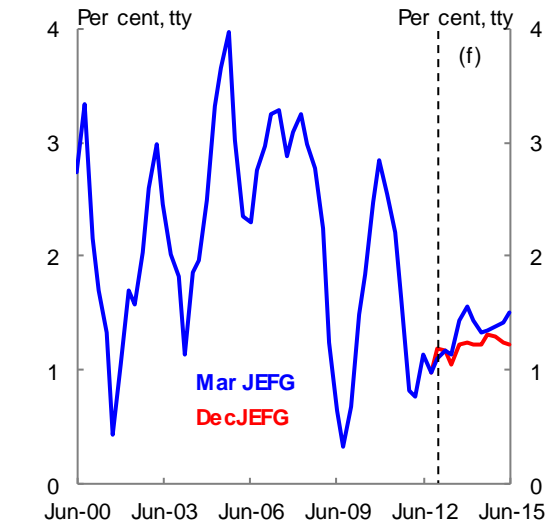
outlook for exports and weaker import growth, while the net income deficit is now expected to remain broadly flat at its current level over the forecast period.



## Employment, wages and inflation

**Employment** growth is forecast to remain below trend over the next two years at  $1\frac{1}{4}$  per cent in line with below-trend growth in real GDP (Chart 7). Reflecting the outlook for stronger real GDP growth toward the end of the forecast period, forecast employment growth has been upgraded since December JIEG by  $\frac{1}{4}$  of a percentage point to  $1\frac{1}{2}$  per cent in 2014-15. The **unemployment rate** is expected to gradually rise to  $5\frac{1}{2}$  per cent in the June quarter 2013 and then  $5\frac{3}{4}$  per cent in the June quarter 2014, but stabilise at that level through to the June quarter 2015.

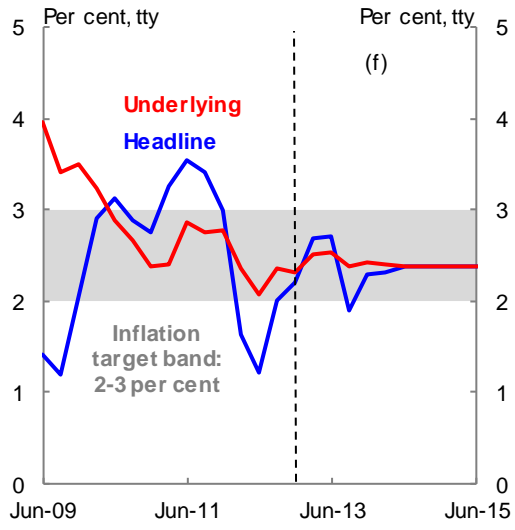
**Chart 7: Employment growth**



**Wages** growth is expected to remain subdued over the forecast period, consistent with the outlook for below-trend employment growth. Private sector wages growth has slowed to below its 10-year average, while fiscal consolidation continues to dampen public sector wages growth. The Wage Price Index is forecast to grow  $3\frac{1}{2}$  per cent through the year to the June quarters of 2013, 2014 and 2015, unchanged from December JIEG.

The outlook for **inflation** is broadly unchanged since the December JIEG. Headline inflation in through-the-year terms is expected to pick up slightly in 2012-13, partly reflecting the strong September quarter 2012 outcome which included the introduction of the carbon price and a number of one-off administered price rises. However, broader disinflationary pressures remain, with spare capacity in the labour market and solid productivity growth expected to hold down cost pressures and keep inflation within the lower half of the Reserve Bank's target band for the remainder of the forecast period. Headline inflation (including the carbon price impact) is expected to be  $2\frac{3}{4}$  per cent through the year to the June quarter 2013 and  $2\frac{1}{4}$  per cent through the year to the June quarters of 2014 and 2015 (Chart 8). Underlying inflation (including the carbon price impact) is expected to be  $2\frac{1}{2}$  per cent through the year to the June quarter 2013, and  $2\frac{1}{4}$  per cent through the year to the June quarters of 2014 and 2015.

**Chart 8: Inflation**



Source: ABS cat. no. 6401.0 and Treasury.

## OUTLOOK FOR THE INTERNATIONAL ECONOMY

**Table 3: International GDP growth forecasts<sup>(a)</sup>**

	2011	2012		2013		2014		2015	
	Actual	Dec JIEFG	Mar JIEFG	Dec JIEFG	Mar JIEFG	Dec JIEFG	Mar JIEFG	Dec JIEFG	Mar JIEFG
United States	1.8	2 1/4	2.2	2	2	2 1/2	2 1/2	2 1/2	2 1/2
Euro area	1.4	- 1/2	-0.6	0	- 1/4	1	1	1 1/2	1 1/2
Japan	-0.6	2	2.0	1	1 1/4	1	1	1	1
China <sup>(b)</sup>	9.3	7 3/4	7.8	8	8	7 3/4	7 3/4	7 1/2	7 3/4
India <sup>(b)</sup>	7.5	4	4.1	4 3/4	5 3/4	6 1/2	6 1/2	6 1/2	6 1/2
Other East Asia <sup>(c)</sup>	4.3	3 3/4	3.8	4 1/2	4 1/2	4 3/4	4 3/4	5	5
Major Trading Partners	4.5	4	4 1/4	4 1/4	4 1/2	4 1/2	4 3/4	4 1/2	4 3/4
World	3.9	3 1/4	3 1/4	3 1/2	3 1/2	4	4	4	4

(a) Calculations for World, euro area and other East Asia growth rates use GDP weights based on purchasing power parity (PPP). Calculations for Major Trading Partners use 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.

n.a. - Not available.

Source: National statistical publications, IMF *World Economic Outlook* January 2013, Thomson Reuters and Treasury.

### World outlook and risks

The global outlook remains subdued, and has evolved broadly in line with the December JIEFG round forecasts. Global financial markets have become more optimistic in recent months, although this likely reflects the avoidance of a worst-case scenario in the second half of 2012, rather than any substantial improvement in the global economic outlook.

The recession in Europe is deepening. Recent events in Cyprus and Italy have highlighted downside risks, suggesting that the region's outlook may be even weaker than previously anticipated. Nevertheless, there have been a number of positive developments since December JIEFG. China's growth appears to be strengthening, with the economy avoiding the 'hard landing' that some commentators had identified as a risk last year. Meanwhile, the Japanese government and the Bank of Japan have both announced more aggressive policy stimulus that is expected to provide a boost to the economy, at least in the short term. In the United States, a deal was struck on 1 January to avert the majority of the 'fiscal cliff', the threat of a government shutdown in late March was avoided, and a decision on the debt ceiling was extended to the middle of May.

Encouraging though such developments are, risks to the global outlook, while somewhat

more balanced than at December JIEFG, are still tilted to the downside.

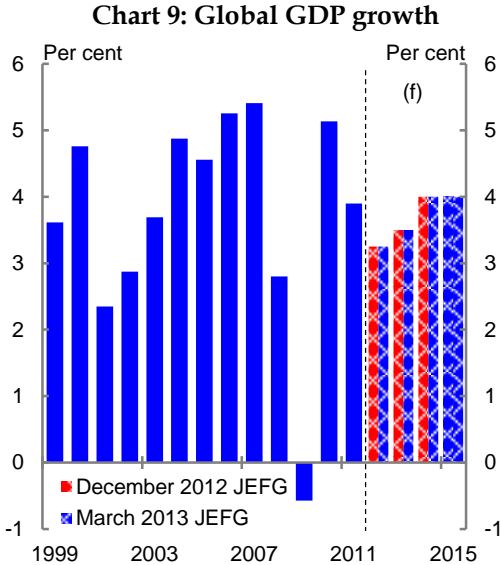
Fiscal policy issues continue to cloud the US and global outlooks. The expenditure cuts initially delayed until 1 March under the fiscal cliff agreement will now occur unimpeded and unchanged by Congress. A protracted debate on raising the debt ceiling in mid-May is a key near-term risk.

While financial conditions in the euro area are relatively stable at present, the crisis remains far from resolved and the region is firmly in recession. The bailout of Cyprus and the inconclusive Italian election are reminders that downside risks continue to dominate the region's outlook, including political risks to the implementation and maintenance of necessary structural reform measures.

Oil prices have eased over the past month or so. Nonetheless, political tensions in the Middle East linger, and accordingly so does the threat of an oil price spike.

Even assuming that the key risks as outlined are avoided, any improvement in global conditions over the course of 2013 is likely to be relatively modest. Forecasts for global growth are unchanged from December JIEFG, with the expectation of below-trend growth of 3½ per cent in 2013 (Chart 9). While the

euro area is now expected to contract slightly in year-average terms in 2013, this additional weakness is largely offset by a more favourable near-term outlook for Japan and India. Global growth is then expected to pick up to 4 per cent in 2014 and 2015 as US growth gradually gains further momentum, the euro area begins to grow again and India resumes a more robust rate of growth.



Source: IMF and Treasury.

Aggregate growth for Australia’s major trading partners (MTPs) has been revised up slightly across the forecast horizon by a ¼ percentage point for each year. This reflects slightly better-than-expected outcomes for a number of economies, including China and India. As with the global growth forecasts, the 2013 upgrade reflects improved near-term outlooks for Japan and India, with forecast growth in the ASEAN-5 also slightly higher as outcomes continue to surprise on the upside.

The forecasts for **China’s** growth for 2013 and 2014 are unchanged from December JIEFG, at 8 per cent in 2013 and 7¾ per cent in 2014.

While there are recent signs that the People’s Bank of China (PBC) will adopt a more neutral monetary policy stance in 2013, the accommodative credit conditions that prevailed during 2012 are likely to provide continued impetus for strong growth in investment, at least in the near term. Total social financing – a broad measure of new

finance activity – surged in the second half of 2012, supporting an investment-led recovery in economic growth. This saw through-the-year growth in GDP strengthen to 7.9 per cent in the December quarter 2012, consistent with the recovery in industrial production growth in the latter half of the year.

The solid near-term growth outlook is also consistent with the latest partial data for 2013. While interpreting these data has been made difficult by the timing of the Chinese New Year, taken as a whole, it suggests economic conditions remained solid in early 2013. While retail sales growth was weaker in January and February than in late 2012, investment and export growth remained strong.

Looking further ahead, the momentum generated during the second half of 2012 is expected to see economic growth rise to 8 per cent in 2013. This reflects solid growth prospects for domestic demand, with export demand expected to continue to make a more modest contribution to growth than in previous years, due to the weak growth outlook for many advanced economies in 2013.

The near-term risks to China’s outlook continue to stem mainly from possible developments in advanced economies, although – as discussed elsewhere – these risks appear to have eased since December JIEFG. Nonetheless, there is still the possibility that adverse developments in Europe or the US could weigh on China’s growth through weaker-than-expected export demand.

China’s stabilisation appears to be having flow-on effects to other economies in the region. Growth strengthened in the highly trade-exposed Newly Industrialised Economies (NIEs) during late 2012, following the noticeable slowdown in their growth reflecting the softening in China and the North Atlantic economies that occurred since late 2011.

Growth forecasts for the **United States** are unchanged from December JIEFG, with the effect of fiscal drag largely factored into the previous round’s forecasts. While the December quarter growth outcome was flat, this partly reflected temporary factors such as

a sharp fall in defence spending, as the private economy remained robust.

Fiscal developments have dominated the US outlook in recent months. The components of the 'fiscal cliff' that weren't avoided under the 1 January deal, such as the payroll tax expiration, in conjunction with the expenditure sequestration that commenced on 1 March, will provide some drag on already subdued growth. However, partial indicators of consumption and business investment (which have been key drivers of growth) appear to be holding up reasonably well.

A key risk is that the debt ceiling may not be raised in a timely manner in mid-May, and that this issue may not be resolved on a longer-term basis.

Abstracting from fiscal problems, there have been some positive developments. In mid-December the Federal Reserve announced further stimulus through an additional US\$45 billion per month in asset purchases and extended forward guidance on its very accommodative monetary policy. Payrolls growth has been relatively robust in recent months, and the S&P500 is only slightly below its October 2007 peak. If the housing sector recovery continues to accelerate at its recent pace, it could pose a welcome upside risk to the US growth outlook.

The **euro area** recession has deepened, with GDP contracting 0.6 per cent in the December quarter including a 0.6 per cent contraction recorded by Germany. Despite the weak December quarter, forward-looking indicators for Germany imply that activity may have already bottomed out. However, comparable measures for France show much less sign of improvement and the euro area periphery remains in deep recession. Accordingly, the euro area's recovery is expected to be even weaker than anticipated at December JIEFG, with euro area GDP now forecast to contract by  $\frac{1}{4}$  of a percentage point in 2013.

Somewhat in contrast to the recessionary conditions in the region, and with unemployment continuing to reach new euro-era highs, financial conditions have been relatively calm. The European Central Bank's

Outright Monetary Transactions (OMT) program has continued to relieve pressure on troubled sovereigns. While there is some concern over the political stalemate in Italy following the recent election, this has manifested only mildly in Italian bond yields so far. Furthermore, Spanish bond yields appear unaffected by any market anxiety over the Italian election, suggesting that contagion risks may have receded, at least for now. Nonetheless, the Italian election result highlights that political risks remain a major threat to resolving the crisis in the euro area. Market reaction to the bailout of Cyprus has also been relatively muted.

The short-term outlook for **Japan** has improved since December JIEFG. In January, the newly-elected Japanese government of Prime Minister Shinzo Abe announced a supplementary budget package worth around 2 per cent of annual GDP, focussed on public works. Prior to its election in December 2012, the then opposition stated its preference for the Bank of Japan (BoJ) to pursue a more aggressive monetary policy stance. In January the BoJ announced that it would provide additional monetary stimulus by pursuing a higher inflation target and commencing open-ended asset purchases in 2014 once the current round of asset purchases is complete.

Since the start of the Japanese election campaign in mid-November 2012, the yen has depreciated by around 14 per cent against the US dollar sparking complaints within the G20 of a 'currency war'. The lower yen should help export competitiveness but it remains to be seen whether the BoJ can achieve its higher inflation target, having consistently failed to rid Japan of deflation over the past two decades.

During the election campaign, the outcome of an Abe-led government was considered a near certainty, and so the December JIEFG forecasts had previously anticipated some degree of policy stimulus post-election. The eventual fiscal stimulus was somewhat larger than assumed, and as such the 2013 forecast for Japan has been revised up by a  $\frac{1}{4}$  of a percentage point to  $1\frac{1}{4}$  per cent. The 2014 forecast remains unchanged, with growth

constrained by the assumed introduction of a rise in the consumption tax rate in early 2014.

The forecast for **India's** economic growth in 2013 has been upgraded by 1 percentage point to 5¾ per cent. Partial indicators such as the service sector PMI and vehicle sales indicate activity has bottomed out.

However the pickup is assumed to be muted, with growth over the remainder of the forecast horizon unchanged. This is due to structural factors such as high inflation, widening fiscal and current account deficits, and various supply-side constraints, which are likely to impede higher rates of growth in the medium term.