ECONOMIC OUTLOOK FOR 2009-10 AND 2010-11

DECEMBER 2009

(THIS REPORT INCORPORATES DOMESTIC AND INTERNATIONAL DATA RELEASED UP TO 16 DECEMBER 2009)

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OVERVIEW

The outlook for the Australian economy has improved since the release of the Mid-Year Economic and Fiscal Outlook (MYEFO). This reflects continued improvements in underlying conditions and improved global conditions, which have strengthened the outlook for investment in particular.

Major trading partner (MTP) growth has been revised up by ½ of a percentage point in both 2009 and 2010, and by ¼ of a percentage point in 2011, driven by upgrades to the US, India and other East Asian economies.

The Australian economy is expected to grow by 1¾ per cent in 2009-10, compared to 1½ per cent at MYEFO, while the growth forecast for 2010-11 is stronger at 3¼ per cent. As a result of the improved outlook and strong performance of the labour market, the unemployment rate is now expected to peak at 6¼ per cent in June 2010, half a percentage point lower than expected in MYEFO. The outlook for inflation has been revised up slightly from MYEFO.

While the outlook for the real economy has improved, the forecast for the nominal economy has been revised down by ½ of a percentage point in 2009-10, but is stronger in 2010-11.

Table 1: Key Domestic Forecasts – December compared with MYEFO

	2008-09	2009-10		2010-11	
	Outcome (a)	MYEFO	December	MYEFO	December
Real GDP (b)	1.1	1 1/2	1 3/4	2 3/4	3 1/4
Nominal GDP (b)	6.6	1 1/4	3/4	5 1/2	6 1/2
Employment (b)	1.1	0	1/2	1	1 1/4
Unemployment rate (d)	5.7	6 3/4	6 1/4	6 1/2	6
CPI (c)	1.5	2 1/4	2 1/2	2 1/4	2 1/4
Underlying inflation (c)	3.9	2 1/4	2 1/2	2 1/4	2 1/4
WPI (b)	4.0	3 1/2	3 1/4	3 1/2	3 1/2
Terms of trade (b)	7.6	-9 3/4	-9 1/2	3 1/2	4

(a) Calculated using original data.
(b) Year average
(c) Through the year growth rate to the June quarter.
(d) June quarter

Since MYEFO, the flow of data has provided further confirmation of recovery in the global economy. Apart from the United Kingdom, all of Australia's major trading partners expanded in the September quarter, and confidence and activity continue to recover. Export-dependent economies have generally experienced the fastest rebound, as a recovery in world trade proceeds.

While outcomes have been generally better than expected since MYEFO, caution remains as to the strength of the global recovery. Growth in the September quarter slowed in most Asian economies and remained tentative amongst the US and European economies. With employment continuing to trend lower in advanced economies, a durable recovery in private demand has yet to be fully established. Continued slack in labour markets is expected to constrain consumption growth over the forecast horizon along with the ongoing process of financial deleveraging.

The improved outlook both globally and domestically has resulted in upgrades to growth forecasts in most sectors of the economy.

The improved outlook for the global economy will increase demand for Australian exports. This has resulted in a more positive outlook for domestic mining related investment. With a number of larger engineering construction projects now looking more likely to proceed, new engineering and construction investment is expected to grow by around 20 per cent in 2010-11. The rise in the number of large construction projects will increase the demand for capital goods imports. The stronger growth in imports will contribute to a larger current account deficit (CAD) in the coming years as the significant investment required for these projects outweighs domestic savings. However, an expected return to rising terms of trade will provide some offset to the widening CAD.

The outlook for household consumption has strengthened since MYEFO. Retail sales are holding up despite the unwinding of stimulus, and consumer confidence has held up better than expected given recent increases in interest rates. Forecasts for household consumption in 2009-10 have been revised up from a ¾ per cent increase at MYEFO to growth of 1½ per cent. Consumption growth in 2010-11 is also expected to be stronger at 3 per cent.

The near term outlook for the housing sector remains largely unchanged since MYEFO. Dwelling investment picked up in the September quarter (up 5.9 per cent) after three consecutive quarterly declines. Recent housing finance and building approvals data indicate that activity will continue to expand in coming months.

New business investment is expected to fall by 4 per cent in 2009-10 before recovering in 2010-11. Forecasts for 2009-10 have increased from MYEFO as a result of continuing improvement in business confidence and the effects of the Government's tax concessions. New engineering construction investment associated with large mining projects is expected to be strong in 2010-11 and beyond. With strong growth potential in the oil and gas sector and a number of other major resource projects in the pipeline, there is significant upside to the profile of engineering construction investment over coming years.

New public final demand is expected to grow by 7 per cent in 2009-10 and by 1½ per cent in 2010-11. These forecasts are broadly unchanged from the 2009-10 MYEFO. The Government's stimulus measures, which have boosted consumption in recent quarters, are now providing support to dwelling and non-residential investment.

Risks remain around public investment slippage. The quarterly profile has been revised since MYEFO to reflect updated information from jurisdictions on the expected profile of their stimulus spending, which shows further delays in spending.

Export volumes have remained remarkably resilient throughout the global downturn, driven in particular by demand for Australian commodities. Total export volumes are forecast to grow modestly in 2009-10 reflecting the anticipated recovery in the global economy, which will see export volumes strengthen in 2010-11, growing by 5½ per cent.

The forecast for the CAD has increased since MYEFO to 5¾ per cent of GDP in 2009-10 and 2010-11. The widening CAD reflects a widening trade deficit resulting from stronger imports as the economy recovers and the exchange rate remains high. The forecast for the terms of trade is stronger than at MYEFO, decreasing by 9½ per cent in 2009-10. It is expected that stronger than expected world demand will result in higher commodity prices going forward. The terms of trade are forecast to increase by 4 per cent in 2010-11.

The employment outlook has improved in line with the stronger outlook for GDP with the unemployment rate now expected to peak at 6¼ per cent. However, there are some risks to the labour market forecasts. The large fall in hours worked during the downturn may mean that as the economy recovers employers will respond to the extra demand through increasing hours worked rather than increasing employment, resulting in higher unemployment than currently forecast.

The outlook for earnings is broadly unchanged from MYEFO, with moderate wages growth forecast in line with excess capacity in the labour market expected over the forecast period. The WPI is expected to grow by 3¼ per cent and 3½ per cent through the year to the June quarters 2010 and 2011, unchanged from the MYEFO forecasts.

Headline and underlying inflation forecasts have been upgraded marginally since MYEFO, largely as a result of stronger than expected September quarter outcomes. Headline and underlying inflation are now expected to grow by 2½ per cent through the year to the June quarter 2010, up slightly from the 2¼ per cent forecast at MYEFO, and 2¼ per cent through the year to the June quarter 2011.

Overall, the December numbers reflect a slightly more positive outlook than at MYEFO. This mainly reflects stronger underlying conditions as well as an improved global outlook. The main risks going forward are a faltering of the global recovery, slippage in public spending and weak employment growth.

Table 2: Domestic economy forecasts[(a)]

	Outcomes (b)	Forecasts			
	Year average			Through the year	
	2008-09	2009-10	2010-11	June 2010	June 2011
Panel A - Demand and output(c)					
Household consumption	1.3	1 3/4	3	2	3 1/2
Private investment					
Dwellings	-1.9	3 1/2	11	17	8
Total business investment(d)	6.6	-4	5	-2 1/2	8 1/2
Non-dwelling construction(d)	8.5	-6	6 1/2	-5 1/2	12 1/2
Machinery and equipment(d)	4.8	-5	5 1/2	-1 1/2	8 1/2
Private final demand(d)	1.8	3/4	4	1 3/4	5
Public final demand(d)	4.3	7	1 1/2	10	-3
Total final demand	2.4	2	3 1/2	3 3/4	3
Change in inventories(e)					
Private non-farm	-0.7	1/2	1/2	1 1/4	1/2
Farm and public authorities(f)	-0.2	1/4	- 1/4	0	0
Gross national expenditure	1.5	2 3/4	3 3/4	4 1/2	3 1/2
Exports of goods and services	2.3	1	5 1/2	1 1/2	5 1/2
Imports of goods and services	-2.5	6	8	17 1/2	4 1/2
Net exports(e)	1.0	-1	- 1/2	-3	0
Gross domestic product	1.1	1 3/4	3 1/4	2 1/4	3 1/2
Non-farm product	0.8	1 3/4	3 1/4	1 1/2	4
Farm product	15.5	2	3	na	na
Nominal gross domestic product	6.6	3/4	6 1/2	5	6 1/4
Panel B - Other selected economic measures					
External accounts					
Terms of trade	7.6	-9 1/2	4	2 3/4	2 1/2
Current account balance					
$billion	-37.8	-73 1/2	-79	na	na
Percentage of GDP	-3.0	-5 3/4	-5 3/4	-6	-5 3/4
Labour market					
Employment (labour force survey basis)	1.1	1/2	1 1/4	1	1 1/2
Unemployment rate (per cent)(g)	5.0	6	6	6 1/4	6
Participation rate (per cent)(g)	65.4	65 1/4	65	65	65
Prices and wages					
Consumer Price Index (h)					
- headline	1.5	2	2 1/4	2 1/2	2 1/4
- underlying	3.9	3	2 1/4	2 1/2	2 1/4
Gross non-farm product deflator	5.7	- 3/4	3 1/4	3 1/4	2 3/4
Wage Price Index	4.0	3 1/4	3 1/2	3 1/4	3 1/2

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

(b) Calculated using original data.

(c) Chain volume measure.

(d) Excluding second-hand asset sales from the public sector to the private sector, and adjusted for the privatisation of Telstra.

(e) Percentage point contribution to growth in GDP.

(f) For presentation purposes, changes in inventories held by privatised marketing authorities are included with the inventories of the farm sector and public marketing authorities.

(g) The estimates in the final two columns are the forecast rates in the June quarter in 2010 & 2011 respectively.

(h) Through the year growth rate to the June quarter for 2008-09.

Source: ABS Cat. No. 5206.0, 5302.0, 6202.0, 6345.0, 6401.0, unpublished ABS data and Treasury.

Outlook for the domestic economy

The forecasts for the domestic economy are underpinned by several technical assumptions. The exchange rate is assumed to remain around levels at the time the forecasts were prepared (a trade-weighted index of around 70 and a $US exchange rate of around 92c). Interest rates are assumed to rise in line with market expectations over the forecast period. World oil prices (Tapis) are assumed to remain at around $US79 per barrel. The farm sector forecasts are based on an assumed return to average seasonal conditions over the remainder of the forecasting period.

Household consumption

The outlook for household consumption has strengthened since MYEFO. Retail sales are holding up despite the unwinding of stimulus, and consumer confidence is better than expected given recent increases to interest rates. Motor vehicle sales have also increased in the quarter.

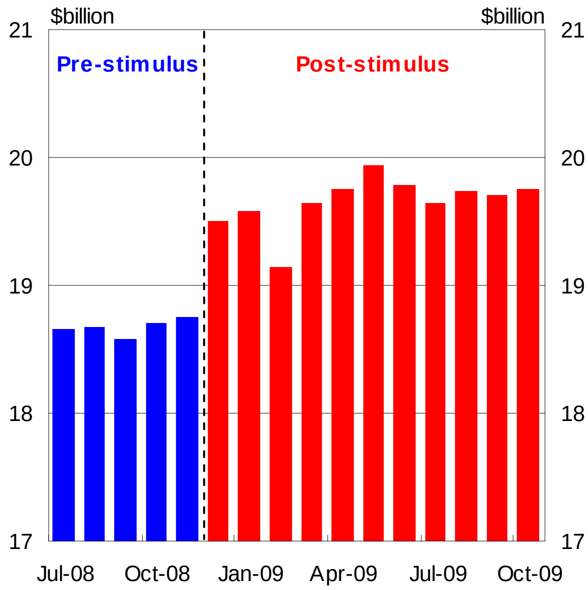
Share market values and house prices have continued to strengthen in the quarter. These gains have continued the upward movement in household wealth, and have also helped sustain consumer confidence.

Household consumption grew by a solid 0.7 per cent in the September quarter, while the March and June quarter outcomes were revised down slightly.

Consumption is expected to be subdued in the short term as the effect of temporary cash payments continues to subside before returning to trend growth rates in early 2010.

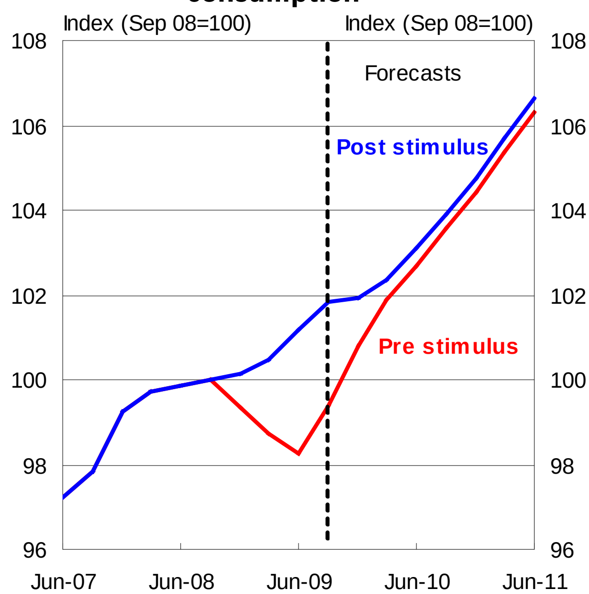
Forecasts for household consumption in 2009-10 have been revised up from a ¾ per cent increase at MYEFO to growth of 1¾ per cent. Consumption growth in 2010-11 is expected to be slightly higher than MYEFO, at 3 per cent.

Chart 1: Retail trade



Source: ABS Cat. No. 8501.0.

Chart 2: Effect of stimulus on consumption



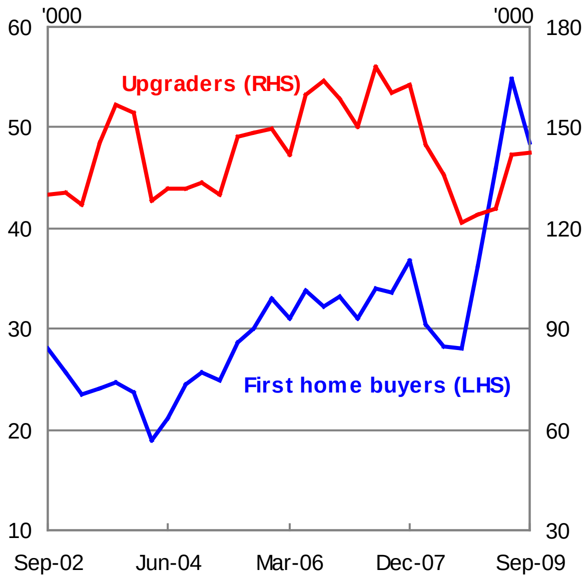
Source: ABS Cat. No. 5206.0 and Treasury.

Dwelling investment

The near term outlook for housing construction remains largely unchanged since MYEFO. Dwelling investment rebounded strongly in the September quarter (up 5.9 per cent), after three consecutive quarterly declines. Recent housing finance and building approvals data indicate that activity will gain further momentum in coming months. Residential approvals are now 11.7 per cent higher than a year ago and are back to around pre-crisis levels. Detached houses will lead the recovery with private house approvals rising for the past ten months.

While the First Home Owners Boost is approaching its end, there are early signs of upgraders coming back into the market. Low mortgage interest rates, improved household confidence and a more promising employment outlook will continue to attract investment in the sector (Chart 3).

Chart 3: Housing Finance

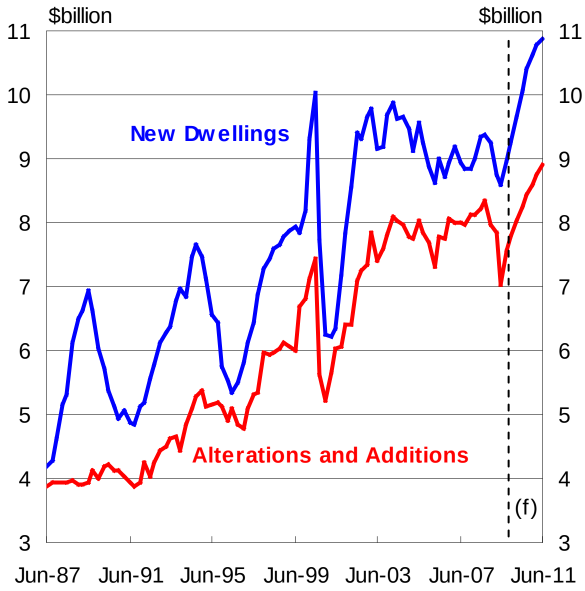


Source: ABS Cat. No. 5609.0

Strong population growth and a sluggish supply response in recent years appear to have led to substantial excess or pent-up demand. In the longer term, these factors are expected to support the housing sector. However, the prospect of higher interest rates is expected to slightly moderate growth in 2010-11. Dwelling investment is forecast to grow 11 per cent in 2010-11 compared to 12 per cent growth in MYEFO.

The risks identified at the time of the MYEFO are still present. On-going credit constraints, particularly in relation to medium and high density developments, continue to pose a downside risk to investment. In addition, higher interest rates could have a larger than expected impact on investment in 2010-11.

Chart 4: Private Dwelling investment (real)



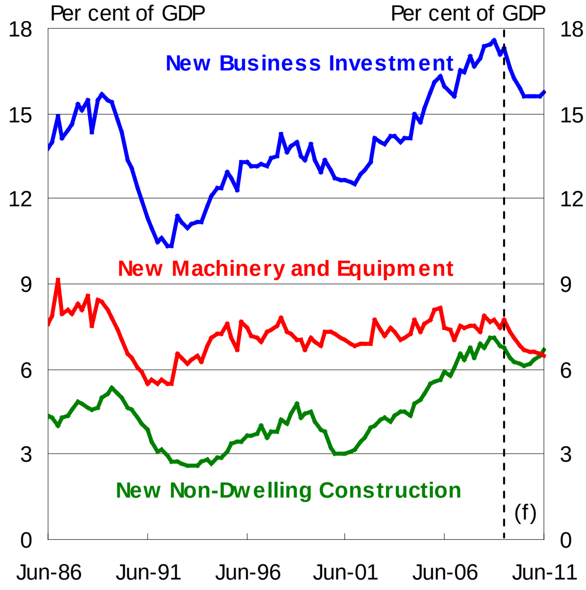
Source: ABS Cat. No. 5206.0 and Treasury.

Business investment

New business investment is expected to fall by 4 per cent in 2009-10 before recovering in 2010-11, growing by 5 per cent. Forecasts for 2009-10 have increased from the MYEFO as a result of continuing improvement in business confidence and the effects of the Government's Small Business and General Business Tax Break. (Chart 5)

Business conditions and sentiment have improved further over recent months with business confidence currently at a seven-year high. The significant rise in confidence is starting to be matched by improvements in measures of business conditions, which have returned to levels recorded in early 2008. Business surveys have also reported an improvement in investment intentions off the very low levels recorded earlier in the year. However, current survey results imply little, if any, real growth over the coming year. As business conditions recover further and current spare capacity is absorbed, investment is expected to bounce back in 2010-11.

Chart 5: Business investment to GDP ratio (nominal)



Source: ABS Cat. No. 5206.0 and Treasury.

Forecast investment in new machinery and equipment is stronger than the September round, reflecting higher CAPEX intentions in the September quarter release and the continued strong take up of the Government's investment incentives. While CAPEX intentions for 2009-10 have improved, they still imply negative investment growth for the year. Investment is now expected to fall by 5 per cent in 2009-10, before growing by 5½ per cent in 2010-11.

New engineering construction investment is expected to increase by 5 per cent in 2009-10, followed by a strong increase of 18 per cent in 2010-11. The updated forecasts reflect revised assumptions for the expected expenditure profiles of major projects in the forecast horizon. Estimates will continue to be refined as a clearer understanding of the timing of expected investment comes to hand. With strong growth potential in the oil and gas sector and a number of other major resource projects in the pipeline, engineering construction investment is expected to grow significantly as a share of total business investment over coming years.

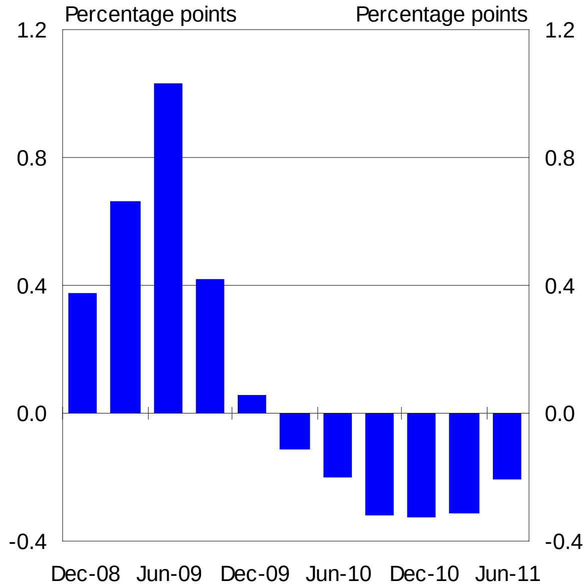
Non-residential building investment is expected to fall by 17½ per cent in 2009-10 and by 9 per cent in 2010-11. The overall fall in investment over the forecast horizon is broadly in line with the MYEFO forecast. However, investment in 2009-10 is now expected to decline at a slower rate as a result of revised assumptions about the impact on private sector activity under the Building the Education Revolution program. Outside of the education sector, investment will remain very weak reflecting the extremely low level of private non-residential building approvals, credit constraints, weak commercial property prices and higher vacancy rates.

Public final demand

Public final demand is expected to grow by 7 per cent in 2009-10 and by 1½ per cent in 2010-11. Compared to the forecast of the MYEFO, the forecast for 2009-10 is slightly lower, while the forecast for 2010-11 is 1 per cent higher.

The Government's stimulus packages continue to play a crucial role in supporting the overall level of activity in the economy. The contribution of stimulus to GDP growth peaked in the June quarter 2009 and will have a declining influence thereafter, subtracting from growth from the March quarter 2010 (Chart 6). The quarterly profile has been revised since MYEFO reflecting updated estimates from jurisdictions on the profile of stimulus spending.

Chart 6: Contribution of fiscal stimulus to GDP growth



Source: ABS Cat. No 5206.0 and Treasury.

Exports, imports and the current account deficit

Export volumes have remained remarkably resilient throughout the global downturn, driven in particular by demand for Australia's commodities.

Total export volumes are forecast to grow modestly in 2009-10. This reflects the anticipated recovery in the global economy, which will see export volumes strengthen further in 2010-11, growing by 5½ per cent.

The Chinese government's infrastructure focused stimulus package has continued to support demand for Australian coal and iron ore. Steel production and bulk commodity demand in the rest of the world are also beginning to show signs of recovery. However, exports of other ores and metals have declined over recent months and demand is expected to be subdued in the short run, reflecting lower Chinese demand for imports.

As such, non-rural commodities are expected to fall by ¼ of a per cent in 2009-10. Strong growth is forecast for 2010-11, reflecting a stronger outlook for world commodity demand and an expected increase in Australian iron ore production capacity.

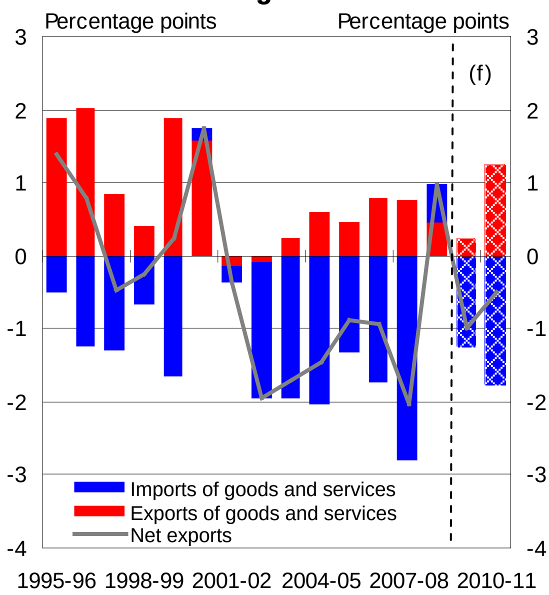
Farm production is expected to grow by 2 per cent in 2009-10, as better than expected rainfall patterns in some parts of the country have improved forecasts for rural output.

Stronger world growth has improved the outlook for elaborately transformed manufactures (ETM) and services exports. While ETM exports are expected to contract by 5½ per cent in 2009-10, this is an improvement on the MYEFO forecast. This improvement is influenced, in part, by information from business liaison which point to an enhanced export outlook, consistent with the improved outlook for global growth. ETM export volumes are forecast to recover in 2010-11, growing by 1½ per cent. Ongoing strength in education exports and a resilient inbound tourist market are expected to increase services exports by 3½ per cent in 2009-10. Services exports will continue to grow in 2010-11 as the outlook for the global economy improves.

Forecasts for goods and services imports in 2009-10 are significantly stronger than at MYEFO, growing by 6 per cent in 2009-10 as domestic demand continues to improve and in view of the stronger Australian dollar. Imports are expected to increase by a further 8 per cent in 2010-11.

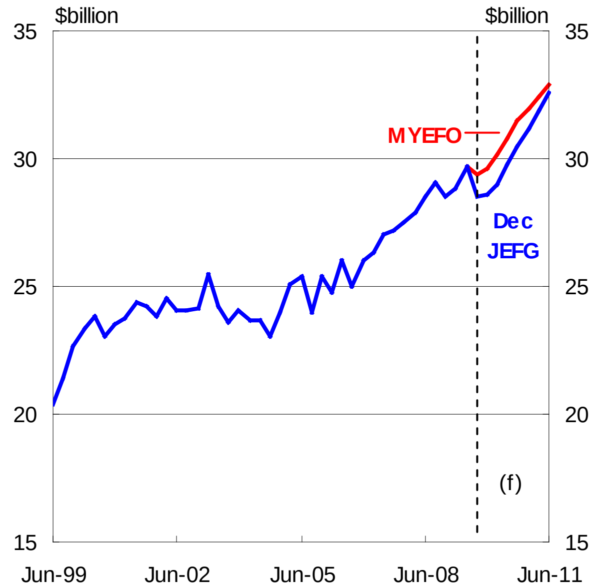
Net exports are expected to detract 1 percentage point from GDP growth in 2009-10, a more substantial subtraction than at MYEFO, as a result of stronger import volumes. Net exports are expected to detract ½ of a percentage point from growth in 2010-11 as import volumes continue to grow faster than export volumes.

Chart 7: Net exports – contribution to GDP growth



Source: ABS Cat. No. 5206.0 and Treasury.

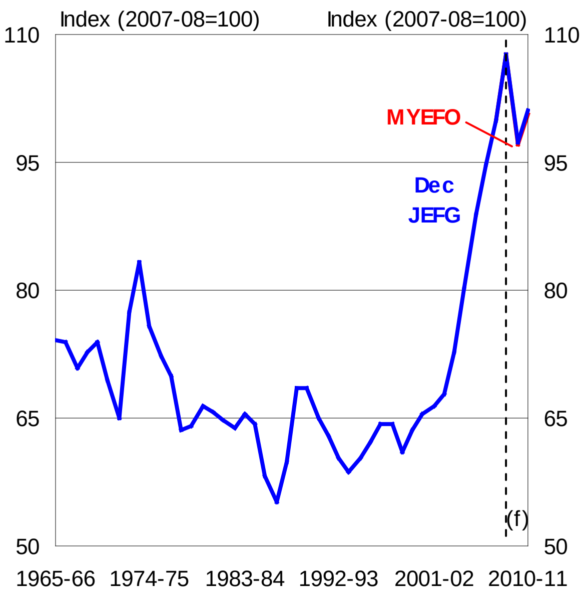
Chart 8: Non-rural commodities (CVM)



Source: ABS Cat. No. 5206.0 and Treasury.

The terms of trade are forecast to decline by 9½ per cent in 2009-10. While contract prices for Australia's bulk commodities have fallen as expected, they are forecast to rise in 2010 in line with growing world demand. Correspondingly, the terms of trade are forecast to increase by 4 per cent in 2010-11. Recent developments in commodity markets suggest that there is some upside risk to these forecasts.

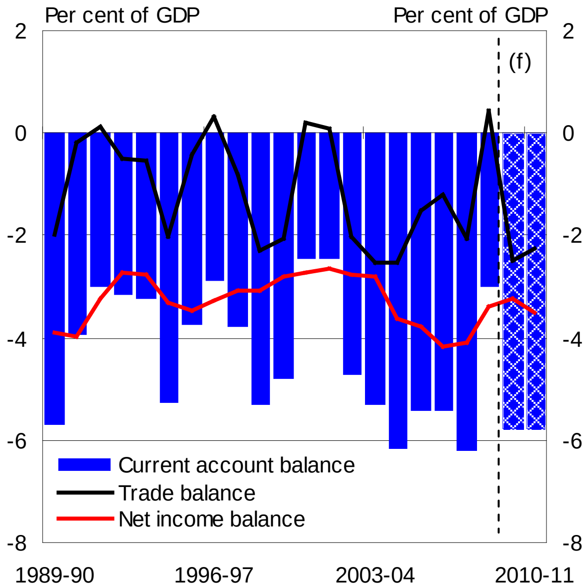
Chart 9: Terms of Trade



Source: ABS Cat. No. 5206.0 and Treasury.

The forecast for the current account deficit (CAD) has increased since MYEFO to 5¾ per cent of GDP in 2009-10 and 2010-11. This largely reflects a widening trade deficit resulting from stronger imports growth as the domestic economy recovers. The net income deficit (NID) is expected to widen in 2010-11, to 3½ per cent of GDP, as the improved outlook for Australia's export earnings and stronger commodity prices result in equity income outflows.

Chart 10: Current Account Deficit



Source: ABS Cat. No's. 5206.0, 5302.0 and Treasury.

Employment, wages and inflation

The employment outlook has improved in line with the stronger outlook for the economy.

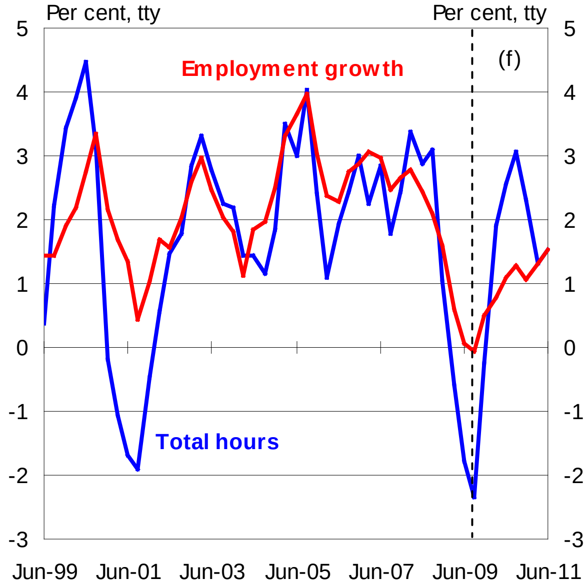
Since MYEFO, the outlook for the labour market has improved. This reflects stronger than expected employment growth, with almost 100,000 jobs created in the past three months. This has been driven by an increase in full-time employment, which accounted for around 70 per cent of the increase in employment. Employment is expected to grow by 1 per cent through the year to the June quarter 2010, stronger than the growth of ¼ per cent forecast in MYEFO.

Hours worked have also been increasing, with trend aggregate hours rising for five consecutive months. A recovery in average hours of employees is expected as labour market conditions begin to improve.

A more positive outlook for employment is expected to result in a lower peak unemployment rate than forecast at MYEFO. The unemployment rate is expected to peak in the June quarter 2010 at 6¼ per cent. This is a more subdued rise than the peak of 6¾ per cent in the June quarter 2010 forecast at MYEFO.

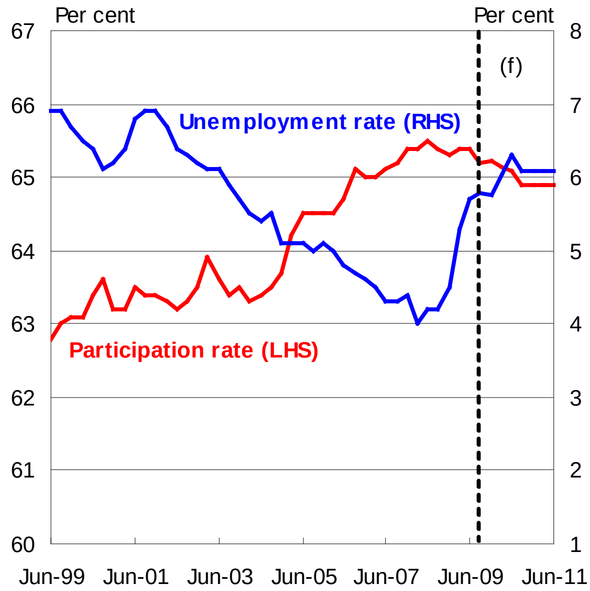
In contrast with previous downturns, the participation rate has held up during the current downturn. The increased employment opportunities offered by a stronger than expected labour market are anticipated to result in a more moderate fall in the participation rate than forecast at MYEFO with fewer discouraged workers expected to leave the labour force.

Chart 11: Employment growth and total hours (sa)



Source: ABS Cat. No 6202.0 and Treasury.

Chart 12: Unemployment and Participation Rates (sa)



Source: ABS Cat. No. 6202.0 and Treasury.

The outlook for earnings is broadly unchanged from MYEFO, with moderate wages growth forecast in line with excess capacity in the labour market expected over the forecast period.

The National Accounts measure of Average Weekly Earnings fell in both the March and June quarters, driven by declining average hours worked and cuts in bonuses. As the recovery takes hold, a resurgence in average hours worked is expected to support earnings growth over the near term.

A weak September quarter result, accompanied by downward pressure from the Australian Fair Pay Commission's zero increase in minimum wages suggest that growth in the WPI will continue to slow in through-the-year terms for the remainder of 2009, before levelling off in 2010. The WPI is expected to grow by 3¼ per cent and 3½ per cent through the year to the June quarters 2010 and 2011, unchanged from the MYEFO forecasts.

Headline and underlying inflation forecasts have been upgraded marginally since MYEFO, largely as a result of stronger than expected September quarter outcomes. Headline and underlying inflation are now expected to grow by 2½ per cent through the year to the June quarter 2010, up slightly from the 2¼ per cent forecast at MYEFO, and 2¼ per cent through the year to the June quarter 2011.

The headline CPI increased by 1.0 per cent in the September quarter 2009 to be 1.3 per cent higher through the year. The result was largely driven by increases in the prices of utilities, automotive fuel, house purchases and deposit and loan facilities. Over the next few quarters headline inflation is expected to move into the target band of 2 to 3 per cent and remain there for the rest of the forecast period.

Underlying inflation, which responds with a lag to economic activity, is expected to continue to moderate over the forecast period in line with ongoing spare capacity in the economy. This is consistent with growth in labour costs and import prices - key drivers of underlying inflation - which are expected to continue to moderate over the next few quarters.

DECEMBER 2009 ROUND: OUTLOOK FOR THE INTERNATIONAL ECONOMY

Table 1: International GDP growth forecasts(a)

	2008	2009		2010		2011	
	Actual	MYEFO	Dec JEFG	MYEFO	Dec JEFG	MYEFO	Dec JEFG
United States	0.4	-2 1/2	-2 1/2	1 1/2	2	1 3/4	2
Euro Area	0.5	-4 1/4	-4	1/2	1	1 1/4	1 1/4
Japan	-1.2	-5 3/4	-5 1/4	1 1/2	1 1/4	1	1 3/4
China	9.0	8 1/4	8 1/4	9 1/4	9 1/4	9 1/2	9 1/2
India	7.5	5 1/2	6 3/4	6	7 1/4	6 1/4	7
Other East Asia (b)	2.7	-1 3/4	- 3/4	4	5	4 1/4	4 1/2
Major Trading Partners	2.5	-1	- 1/2	3 1/2	4	3 3/4	4
World	3.0	-1	-1	3 1/4	3 1/2	3 1/2	3 3/4

(a) Calculations for World and euro area growth rates use GDP weights based on purchasing power parity (PPP). Calculations for Major Trading Partners and Other East Asia use export trade weights.
(b) Other East Asia is: Korea, Taiwan, Hong Kong, Singapore, Indonesia, Malaysia, Thailand, Vietnam and the Philippines.
Source: National statistical publications, IMF and Treasury.

World outlook

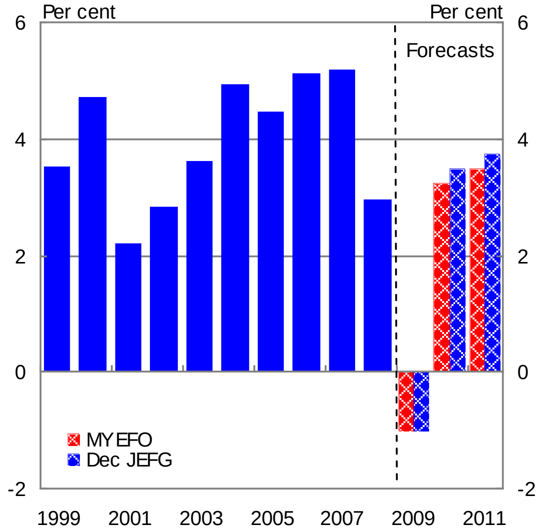
Since MYEFO, the flow of data has provided further confirmation of recovery in the global economy. Apart from the United Kingdom, all of Australia's major trading partners expanded in the September quarter, and confidence and activity continue to recover toward pre-crisis levels. Export-dependent economies have generally experienced the fastest rebound, as the recovery in world trade proceeds.

Consistent with the more positive outlook, financial market conditions have continued to improve. Short-term inter-bank funding spreads have moderated significantly and are approaching pre-crisis levels, and many financial institutions are no longer reliant on government support to obtain funding.

However, conditions remain difficult in some parts of the financial system. Long-term securitisation markets remain stressed and continue to be heavily supported by central banks. Lower-rated long-term bond spreads remain well above pre-crisis levels and some lower-rated financials are still finding it difficult to raise funding without government support. Some pressures remain on financial intermediaries' funding costs, with these higher costs being reflected in lending spreads.

While data have generally been better than expected since MYEFO, uncertainty remains over the strength of the recovery. Growth in the September quarter slowed in most Asian economies and remained tentative amongst Atlantic economies. With hours worked and employment continuing to trend lower in advanced economies, a durable recovery in private demand has yet to be fully established. Continued slack in labour markets is expected to constrain consumption growth over the forecast horizon.

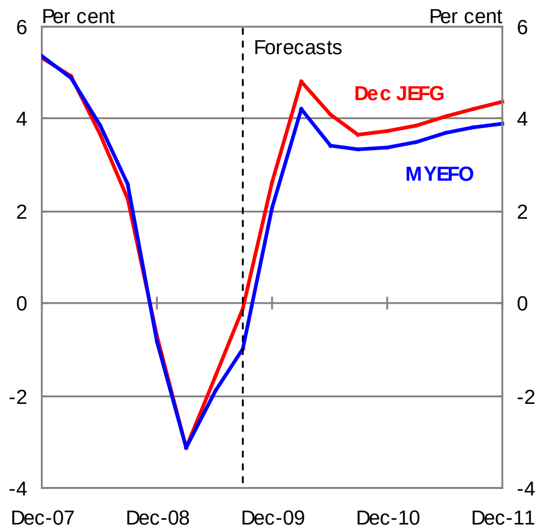
Chart 1: World GDP growth



Source: IMF and Treasury.

On balance, the outlook for world growth has improved. As a result, world GDP growth forecasts have been upgraded by ¼ of a percentage point in both 2010 and 2011 (Chart 1). Collective major trading partner (MTP) growth has been revised up by ½ of a percentage point in both 2009 and 2010 and by ¼ of a percentage point in 2011 (Chart 2).

Chart 2: Through-the-year MTP growth



Source: National agencies and Treasury.

Most individual trading partner forecasts have been revised higher, particularly in Asia (Table 1). Stronger-than-expected data have seen growth forecasts upgraded in emerging Asia, led by India, while advanced Asia has also been revised higher as recovery takes hold amongst the hard-hit and trade-exposed Newly Industrialised Economies. Forecasts for China, where events have unfolded as expected, are unchanged. Forecasts for the US, UK and euro area have been upgraded, particularly in 2010, although growth in these economies is expected to remain below trend across the forecast horizon.

Risks

A high level risk confronting the global economy is an outbreak of protectionism, which the world has largely avoided thus far. In particular, below-trend growth and persistently high unemployment in the US, combined with concerns that China is relying excessively on an undervalued exchange rate and the external sector for its growth, could fuel protectionist pressures.

While financial market conditions are normalising, risks have not disappeared. The recent debt moratorium in Dubai and heightened concerns about the sustainability of Greece's fiscal position have highlighted risks around the ability of some countries to manage high levels of debt.

In addition, concerns about the potential for new asset price bubbles in emerging markets are increasing. Driven by their solid growth prospects, and low borrowing costs in key advanced economies, many emerging economies have seen increasing capital inflows which have placed upward pressure on their currencies.

Country summaries

The outlook for the **United States** has continued to improve, with widespread signs of a policy-supported recovery in the September quarter raising near-term expectations. Stronger household consumption and further improvements in housing market conditions should support growth in coming quarters, augmenting the large boost provided by a turn in the inventory cycle and the fiscal stimulus package. Accordingly, 2 per cent growth is forecast for 2010 and 2011, a ½ and ¼ of a percentage point upgrade respectively.

Nevertheless, the recovery is still expected to be tepid compared to past recessions, with growth forecast to remain below trend in both 2010 and 2011. Recent increases in activity have been heavily influenced by policy, with scant signs of the broad-based improvement in private final demand which will be necessary to support a return to strong growth once the impacts of stimulus and inventory adjustment fade.

Our baseline expectation is for US consumption growth to be highly restrained over the forecast horizon. However, it is possible that spending could rebound more strongly should US households engage in more modest deleveraging than envisaged, particularly if asset values continue to rebound and the labour market recovery is less protracted than anticipated.

The outlook for **China** is unchanged since MYEFO. Since the implementation of the fiscal stimulus package a year ago, the Chinese economy has recovered strongly from record low growth through the year to the March quarter 2009. With support from stimulus expected to continue into 2010, China is forecast to grow by 8¼ per cent in 2009, accelerating to 9¼ per cent in 2010, before stabilising at 9½ per cent, around trend, in 2011.

Domestic demand continues to benefit considerably from Government policies, with stimulus-affected consumption and production sectors experiencing particularly strong growth. While investment is expected to be the main driver of growth in 2010, consumption is expected to remain solid, buttressed by continued policy and subsidy support. The external sector is also expected to benefit in the short run from stimulatory policies and the recent effective depreciation of the Renmimbi.

The sustainability of growth once stimulus winds down in late 2010 will hinge upon a recovery in private and global demand. The re-emergence of inflationary pressures, potential asset price bubbles, an increase in non-performing loans, and overcapacity in the steel sector, present additional downside risks. However, recent statements suggest that the Government recognises these risks and is prepared to act if necessary.

The **Japanese** economy is facing a fragile recovery. On the one hand, growth is expected to be boosted by a continued rebound in exports and industrial production, particularly driven by demand from emerging markets. In addition, sizeable fiscal stimulus, which is anticipated to be carried through into 2013, will provide support to consumption. On the other hand, the waning effect of inventory restocking will weigh on production, while continued yen strength will act as a drag on export growth. Business investment is likely to remain relatively subdued, given the sizeable output gap, tight financial conditions and prolonged deflationary pressures. In addition, a full-fledged recovery in consumption is unlikely as long as employment and incomes remain weak.

Japan is forecast to contract by 5¼ per cent in 2009, before returning to above-trend growth of 1¼ per cent in 2010 and 1¾ per cent in 2011. A sustained recovery in the corporate sector and its flow-on effect on households will be key determinants of the outlook for Japan.

The **Newly Industrialised Economies** continue to recover at a solid pace. GDP in the NIEs is forecast to contract by 1¼ per cent in 2009, before recovering to grow by 5 per cent in 2010 and 4¼ in 2011. Growth momentum is expected to pick up mainly due to improvements in domestic demand. Stronger growth prospects have seen large capital inflows into the NIEs from mid-2009. However, this has raised concerns about asset bubbles, which may induce policymakers to raise interest rates and adopt measures to maintain export competitiveness and limit financial instability.

The outlook for the **Indian** economy has improved considerably since MYEFO. The recovery, which began in the early part of 2009, is expected to continue on the back of improved business and urban consumer confidence, and an improved outlook for key export economies. Renewed foreign capital inflows — a driver of investment growth prior to the financial crisis — are also expected to support growth. Accordingly, forecasts for 2009, 2010 and 2011 have been revised up to 6¾ per cent, 7¼ per cent and 7 per cent.

Direct impacts from India's worst drought since 1972 are expected to be modest, as agriculture accounts for a relatively small share of GDP. Nevertheless, consequent food scarcity will keep inflationary pressures elevated, and together with the strengthening recovery, will likely prompt a tightening in monetary policy in early 2010.

Economic activity in the **ASEAN-5** region has continued to show encouraging signs of consolidation, as improved consumption led to positive September quarter GDP outturns across the region. The region is forecast to grow by ¼ per cent in 2009, before rebounding to 4¾ per cent in 2010 and 2011.

Downside risks to the ASEAN-5 outlook remain, including potential bottlenecks in fiscal stimulus spending across the region and a weak external position in Vietnam. On the upside, stronger US household consumption and better growth prospects in the major economies may help to lift growth. Improved capital flows into the region will also help boost liquidity and investment. However, the rise in capital inflows may also slow exports as currencies appreciate, and stoke inflation and asset price bubbles.

The improved **euro area** economic outlook reflects strengthening sentiment in most sectors, an increase in new export orders, and the continuation of fiscal support measures. Inventory restocking is also expected to provide temporary support to growth in the short term. However, the recovery is expected to remain sluggish as labour market deterioration continues and the appreciation of the euro weighs on export growth. As such, GDP is forecast to contract by 4 per cent in 2009, a ¼ of a percentage point upgrade, with growth of 1 per cent and 1¼ per cent forecast for 2010 and 2011.

Recent indicators suggest the **United Kingdom** economy is improving, with the recession expected to end in the December quarter 2009. Nonetheless, the recovery is expected to remain weak and prolonged, as growth is held back by constrained access to credit. High levels of public and private debt, along with the need to unwind large policy stimulus will also weigh on the recovery. GDP is forecast to contract by 4¾ per cent in 2009, before recording modest growth of 1 per cent in 2010 and 2 per cent in 2011.

New Zealand's recovery from prolonged recession has been quicker than expected, with the outlook improving markedly, aided by strong external demand from China. Forecasts for growth have been upgraded in all years, particularly in 2010, with GDP projected to grow by 2¼ per cent in 2010 and 2¾ per cent in 2011. While the outlook has improved, there is a risk that further appreciation of the dollar may weigh on growth.