ECONOMIC OUTLOOK FOR 2009-10, 2010-11 AND 2011-12

MARCH 2010

(THIS REPORT INCORPORATES DOMESTIC AND INTERNATIONAL DATA RELEASED UP TO 19 MARCH 2010)

Overview

Since December JEFG, the labour market has continued to surprise on the upside, suggesting greater strength in the economy than implied by outcomes for real GDP. The unemployment rate has fallen to 5.3 per cent and average hours have recovered somewhat, suggesting that spare capacity in the economy is diminishing.

It is puzzling that this labour market performance has been achieved in an economy growing at a rate we consider to be below trend, which is giving mixed messages about the strength of the underlying recovery and degree of excess capacity. The economy has also been supported by fiscal and monetary stimulus, suggesting some need for caution in assessing the strength of the economy in the forecast period. However, on balance the evidence suggests that a solid recovery is underway and that the economy is moving back to capacity more quickly than previously expected.

The global recovery is gathering pace putting upward pressure on prices for Australia's key commodity exports. This is expected to cause a substantial rise in Australia's terms of trade, which will boost incomes in the economy. Investment intentions in the mining industry are strong as companies seek to take advantage of the more positive outlook for commodity prices and improved credit conditions. The significant pipeline of work developing in the mining industry could see capacity constraints begin to bite, even with public sector stimulus being withdrawn over this period.

World GDP is expected to grow by 4 per cent in 2010 and 4¼ per cent in 2011. The US economic outlook continues to improve, albeit from a low base, reflecting stronger-than-expected household consumption and recent signs of a faster recovery in business investment. The outlook for emerging economies is strong, particularly in Asia. China is forecast to grow at a double-digit pace this year.

There are on-going risks to the global recovery. The process of financial deleveraging will continue to slow recovery in private demand in the major advanced economies, and the need to consolidate fiscal positions will place a drag on public demand. Global financial conditions are returning to normal, but risks around sovereign debt in Greece and other countries may continue to test confidence.

Australian real GDP is expected to grow by 2 per cent in 2009-10, compared with 1¾ per cent growth in the December JEFG, while the growth forecast for 2010-11 is unchanged at 3¼ per cent. An additional forecast year has been prepared for the March JEFG with real GDP in 2011-12 forecast to grow by 4 per cent. The economy is expected to be operating around capacity in 2011-12, much earlier than previously envisaged.

Table 1: Key Domestic Forecasts — March JEFG compared with December JEFG

	2008-09	2009-10		2010-11		2011-12
	Outcome (a)	December	March	December	March	March
Real GDP (b)	1.3	1 3/4	2	3 1/4	3 1/4	4
Nominal GDP (b)	6.5	1	2 1/2	6 1/2	7 3/4	6 3/4
Employment (b)	1.1	3/4	1 1/4	1 1/4	2 1/2	2
Unemployment rate (d)	5.7	6 1/4	5 1/4	6	5	5
CPI (c)	1.5	2 1/2	3	2 1/4	2 1/2	3
Underlying inflation (c)	3.9	2 1/2	2 3/4	2 1/4	2 1/2	2 1/2
WPI (b)	4.0	3 1/4	3	3 1/2	3 1/4	4
Terms of trade (b)	9.6	-9 1/2	-5	4	10 1/2	0

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

Recent strong labour market outcomes suggest an economy approaching capacity. Stronger population growth and a higher participation rate are expected to slow down the decline in unemployment rate from here onwards. The unemployment rate is expected to fall to 5 per cent by the June quarter of 2010-11, consistent with the expectation that the labour market will reach capacity around that time. However, there is a risk that the unemployment rate could fall below 5 per cent over the forecast horizon. Strong labour demand will be required in the short term to keep pace with strong population growth and a rising participation rate. The participation rate is expected to increase to 65½ per cent over the forecast horizon, with the forecast taking into account underlying demographic trends.

A stronger labour market is expected to support a more positive outlook for household consumption. Consumer confidence has been bolstered by improved employment conditions and the rebound in household wealth from rising house prices and share values. While rising interest rates are expected to temper growth in dwelling investment, recent commencements and approvals data indicate continued strength in the pipeline which will support activity over most of 2010.

Strength in the global economy is expected to support a higher terms of trade. The terms of trade are forecast to increase by 10½ per cent in 2010-11 following a forecast fall of 5 per cent in 2009-10. This largely reflects expectations of substantial contract price rises for coal and iron ore in 2010. The terms of trade are assumed to be flat in 2011-12, with commodity prices remaining at high levels. Movements in commodity prices can be expected to add some volatility to the forecasts in the period ahead.

Strength in the resources sector is expected to spearhead a recovery in business investment in 2010-11 and 2011-12. The recovery will also be supported by a pick-up in underlying investment in other industries. Investment in new machinery and equipment was boosted in December quarter 2009 by the Small Business and General Business Tax Break — as this effect unwinds there is likely to be weakness in business investment in the near term.

While the private sector recovers, the effects of the Government’s stimulus measure on infrastructure investment will unwind over the forecast period. New public final demand is forecast to grow by 7¼ per cent in 2009-10, 1 per cent in 2010-11 and to fall by ½ of a per cent in 2011-12. The forecast for 2011-12 takes into account the Commonwealth’s fiscal targets. The withdrawal of the Government’s fiscal stimulus has already begun. Through the year to the December quarter 2010, the withdrawal of stimulus is expected to detract around 1 percentage point from GDP growth.

The current account deficit (CAD) is forecast to widen to 5 per cent of GDP in 2009-10, less of a widening than at December JEFG, reflecting the stronger forecast for non-rural commodity export values. The CAD is expected to narrow to 4¼ per cent of GDP in 2010-11 due to higher export earnings, before widening to 5 per cent of GDP in 2011-12, driven by stronger import volumes and increased income outflows due to rising mining profits. Strong investment is likely to put pressure on the CAD further out.

A stronger economy is expected to see a pick up in inflation pressures compared with December JEFG, but with underlying CPI inflation in the middle of the RBA's target band. Prices and wages growth have eased in recent times, and the higher exchange rate has had a moderating effect on inflation. Underlying inflation is expected to be 2¾ per cent through the year to the June quarter 2010 and 2½ per cent through the year to the June quarters 2011 and 2012. The planned commencement of the Carbon Pollution Reduction Scheme from July 2011 is expected to add 0.4 percentage points to headline inflation through the year to June quarter 2012.

Table 2: Domestic economy forecasts[a]

	Outcomes (b)	Forecasts					
		Year average			Through the year		
	2008-09	2009-10	2010-11	2011-12	June 2010	June 2011	June 2012
Panel A - Demand and output(c)							
Household consumption	1.9	3	3 1/2	4	3 1/4	3 3/4	4 1/4
Private investment							
Dwellings	-1.9	3 1/2	8 1/2	4	13	8 1/2	3
Total business investment(d)	6.6	-2 1/2	6	12	-2	11 1/2	12
Non-dwelling construction(d)	8.5	-7	8	14	-7	16	12 1/2
Machinery and equipment(d)	4.8	- 1/2	6	13	1	12	13 1/2
Private final demand(d)	2.3	1 3/4	4 1/2	5 3/4	2 3/4	5 3/4	6
Public final demand(d)	4.3	7 1/4	1	- 1/2	8 1/2	-1 1/4	0
Total final demand	2.7	3	3 3/4	4 1/2	4	4	4 1/2
Change in inventories(e)							
Private non-farm	-0.7	1/2	1/2	0	1 1/2	1/4	0
Farm and public authorities(f)	-0.2	1/4	0	0	0	0	0
Gross national expenditure	1.8	3 3/4	4	4 1/2	5	4 1/2	4 1/2
Exports of goods and services	0.1	1 1/2	5	5 1/2	2 1/2	4 1/2	6 1/2
Imports of goods and services	-2.8	6	9	8	16 1/2	7	8 1/2
Net exports(e)	0.6	-1	-1	- 3/4	-2 3/4	- 3/4	- 3/4
Gross domestic product	1.3	2	3 1/4	4	2 1/4	3 3/4	4 1/4
Non-farm product	1.0	2	3 1/2	4	2 1/4	3 3/4	4 1/2
Farm product	17.6	6	1	2	na	na	na
Nominal gross domestic product	6.5	2 1/2	7 3/4	6 3/4	7 1/4	7	7
Panel B - Other selected economic measures							
External accounts							
Terms of trade	9.6	-5	10 1/2	0	12	4 1/4	- 1/4
Current account balance							
$billion	-38.2	-64 3/4	-60 3/4	-73 3/4	na	na	na
Percentage of GDP	-3.0	-5	-4 1/4	-5	-4 1/2	-4 1/2	-5
Labour market							
Employment (labour force survey basis)	1.1	1 1/4	2 1/2	2	2 1/2	2 1/4	1 3/4
Unemployment rate (per cent)(g)	5.0	5 1/2	5 1/4	5	5 1/4	5	5
Participation rate (per cent)(g)	65.4	65 1/4	65 1/4	65 1/2	65 1/4	65 1/2	65 1/2
Prices and wages							
Consumer Price Index (h)							
- headline	1.5	2 1/4	2 1/2	3	3	2 1/2	3
- underlying	3.9	3	2 1/2	2 1/2	2 3/4	2 1/2	2 1/2
Gross non-farm product deflator	5.5	3/4	4 1/4	2 1/2	5	3	2 1/2
Wage Price Index	4.0	3	3 1/4	4	2 3/4	3 3/4	4

(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.
(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 three columns are the forecast rates in the June quarter in 2010, 2011 & 2012 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 71 and a $US exchange rate of around 92c). Interest rates are assumed to rise in line with market expectations over the forecast period, that is, a rise in the cash rate to about 5 per cent by early 2011. World oil prices (Tapis) are assumed to remain at around $US84 per barrel. The farm sector forecasts are based on average seasonal conditions over the remainder of the forecasting period.

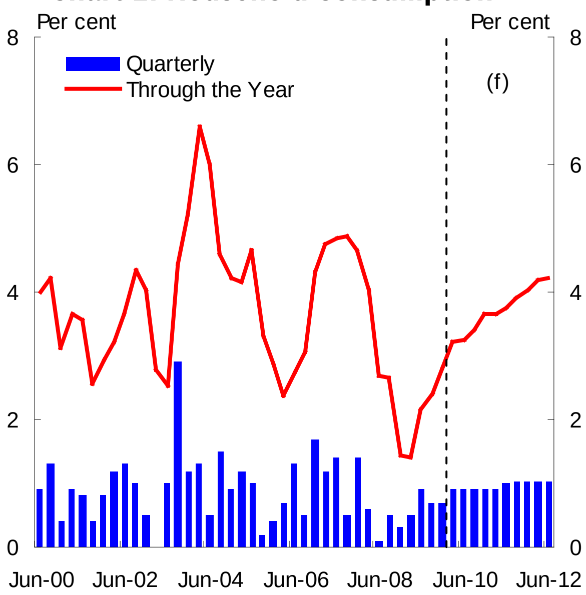
Household consumption

The outlook for household consumption has strengthened since December JEFG. Consumer confidence has been bolstered by improved employment outcomes and the rebound in household wealth from rising house prices and share values. In the second half of 2009, retail trade continued to grow solidly.

Household consumption grew by a solid 0.7 per cent in both the September and December quarters. The unwinding of the stimulus and rising interest rates do not appear to have substantially weakened household consumption.

The forecast for household consumption growth in 2009-10 has been revised up from 1¾ per cent at December JEFG to 3 per cent. Household consumption is expected to grow by 3½ per cent in 2010-11 and 4 per cent in 2011-12, supported by a pick-up in wages growth (Chart 1).

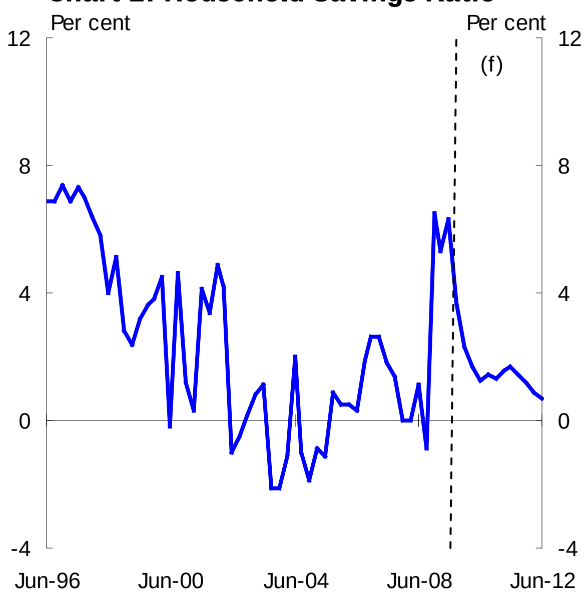
Chart 1: Household Consumption



Source: ABS Catalogue Number 5206.0 and Treasury.

The household saving ratio is expected to decline over the forecast period but remain positive (Chart 2). A recovery in asset values is expected to see some reduction in the rate of saving out of current income

Chart 2: Household Savings Ratio



Source: ABS Catalogue Number 5206.0 and Treasury.

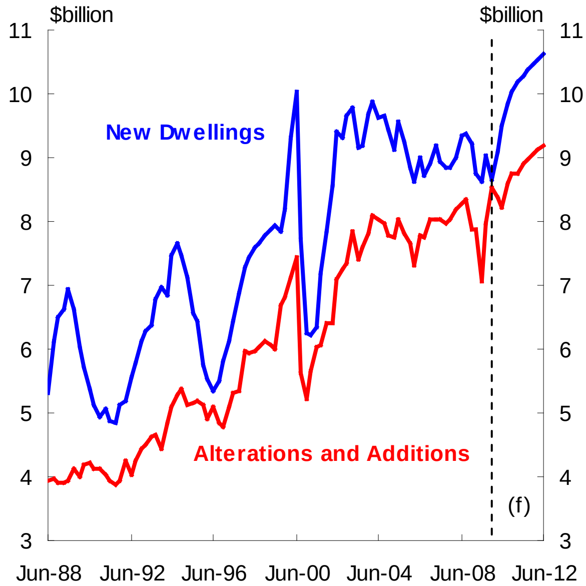
Dwelling investment

A recovery in dwelling investment is expected over the forecast horizon. Recent commencements and approvals data indicate continued strength in the pipeline that will support activity over most of 2010. Dwelling unit commencements grew strongly during the second half of 2009 while approvals are currently running at levels last seen in late 2007. Detached houses will continue to lead the recovery with private house approvals rising in 12 out of the last 13 months.

While the First Home Owners Boost was phased out at the end of 2009, house price growth, improved household confidence, strong population growth and a more promising employment outlook are expected to attract upgraders and investors back into the market.

Business liaison suggests that credit conditions for medium and high-density developments have improved somewhat. However, continuing difficulties in accessing finance, particularly for small developers, along with interest rates rising to more normal levels are expected to temper the momentum in dwelling investment. Dwelling investment is forecast to grow by 8½ per cent in 2010-11, down from 11 per cent at December JEFG, and increase by 4 per cent in 2011-12.

Chart 3: Private Dwelling investment (real)



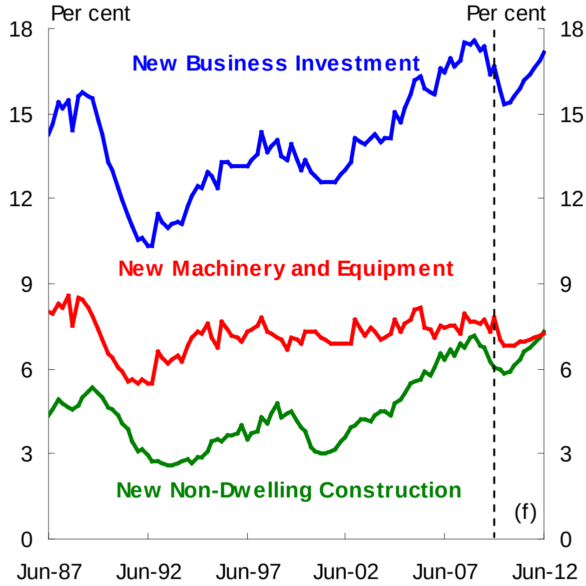
Source: ABS Catalogue Number. 5206.0 and Treasury.

Business investment

New business investment is now expected to fall only modestly in 2009-10 by 2½ per cent, before recovering strongly, growing by 6 per cent in 2010-11 and 12 per cent in 2011-12. The recovery is expected to be driven by a pick-up in underlying investment and a renewed surge in mining investment.

Forecasts for 2009-10 have increased from December JEFG due to the significant boost to investment in new machinery and equipment from the Small Business and General Business Tax Break in late 2009 and a modest improvement in underlying conditions. The improvement in underlying conditions is expected to gather momentum through 2010-11 and 2011-12. Non-residential building investment is expected to remain subdued until late in the forecast period (Chart 4).

Chart 4: Business Investment to GDP ratio (nominal)



Source: ABS Catalogue Number 5206.0 and Treasury.

Survey measures of business conditions and business confidence have generally been tracking above long-run average levels since late 2009, with confidence currently at its highest level since 2002.

Forecast investment in **new machinery and equipment** is stronger than at December JEFG, reflecting higher CAPEX intentions in the December quarter release and a stronger economy. Investment is now expected to fall slightly by ½ of a per cent in 2009-10. While stimulus-related investment incentives have now been withdrawn, investment in machinery and equipment is forecast to rise over the forecast horizon as firms resume necessary maintenance and asset replacement programs that were previously delayed. This is expected to drive growth of 6 per cent in 2010-11 and 13 per cent in 2011-12.

New engineering construction investment is expected to grow strongly over the forecast horizon as a number of major resource projects commence and begin to ramp up. Recent CAPEX data indicate particular strength in investment intentions for 2010-11 in the mining sector which appears likely to be repeated in 2011-12. Engineering investment is expected to increase by 4 per cent in 2009-10, followed by growth of 19 per cent in 2010-11 and 20½ per cent in 2011-12. A major driver of the forecasts is the significant number of large scale LNG projects currently under construction or approaching final investment decisions.

New non-residential building investment is expected to fall by 7 per cent in 2009-10, before a modest recovery commences in 2010-11 with growth of 8 per cent followed by growth of 14 per cent in 2011-12. The short-term outlook for the sector remains subdued with continuing weak levels of building approvals, rising vacancy rates and credit constraints. However, as commercial property vacancy rates stabilise and previously built floor space is absorbed through the broader recovery of the economy, building approvals are expected to recover during 2011, leading to renewed activity in the sector.

Public final demand

New public final demand is forecast to grow by 7¼ per cent in 2009-10, 1 per cent in 2010-11 and to fall by ½ of a per cent in 2011-12. These growth profiles are driven by Government stimulus measures and their subsequent withdrawal. The forecast for 2011-12 also takes into account the Commonwealth's fiscal targets.

The withdrawal of the Government's fiscal stimulus has already begun. The peak impact of the stimulus on GDP growth is estimated to have occurred in the June quarter 2009 and has since been phasing down. Through the year to the December quarter 2010, the withdrawal of stimulus is expected to detract around 1 percentage point from GDP growth. The bulk of the stimulus that remains is in building infrastructure.

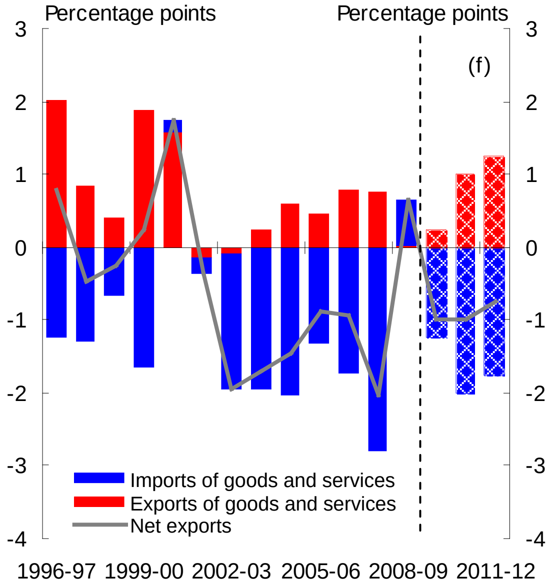
Exports, imports and the current account deficit

While export volumes are expected to grow strongly over the forecast period in line with a forecast rebound in global growth, import volumes are forecast to increase at a more rapid pace — reflecting strengthening domestic activity and a high exchange rate.

As such, net exports are expected to detract 1 percentage point from GDP growth in both 2009-10 and 2010-11, and ¾ of a percentage point in 2011-12.

Export volumes are forecast to grow modestly in 2009-10, followed by stronger growth of 5 per cent in 2010-11 and 5½ per cent in 2011-12.

Chart 5: Net Exports — contribution to GDP growth



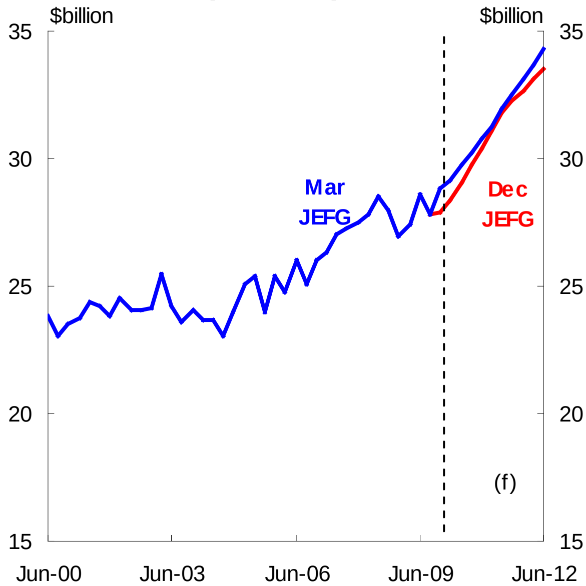
Source: ABS Catalogue Number. 5206.0 and Treasury.

Non-rural commodity exports are expected to increase significantly over the forecast period, reflecting strengthening global demand and additional supply capacity. Demand for Australia's bulk commodity exports is expected to increase, driven by ongoing strong demand from China and a rebound in steel production in the rest of the world. Australian iron ore mine capacity is expected to increase over the forecast period, and coal exports will be boosted by further port expansions on the east coast.

As such, exports of non-rural commodities are expected to grow by 4 per cent in 2009-10 — a sizeable increase compared with December JEFG — followed by growth of 7½ per cent for both 2010-11 and 2011-12.

Farm production is expected to grow by 6 per cent in 2009-10. This represents a significant improvement on the December JEFG forecasts, as better-than-expected rainfall in key growing areas is expected to improve yields. Farm production is expected to remain at a high level over the remainder of the forecast period.

Chart 6: Non-rural Commodities (Volumes)



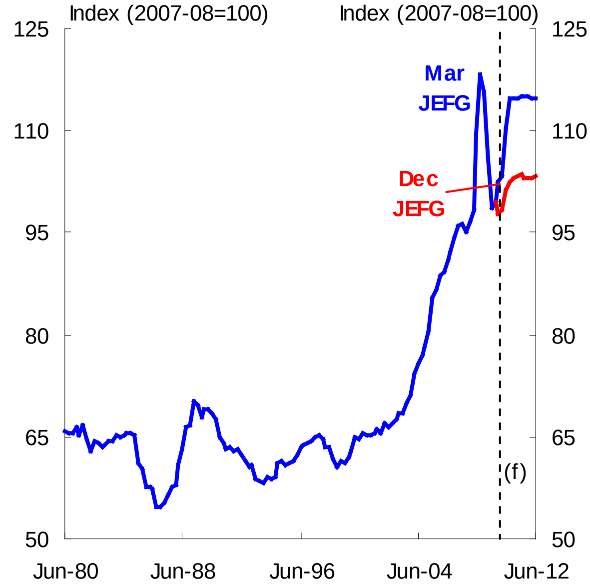
Source: ABS Catalogue Number 5206.0 and Treasury.

The stronger outlook for world growth has improved the prospects for exports of elaborately transformed manufactures (ETM) and services. ETM exports are expected to grow by 4 per cent in 2010-11 and 4½ per cent in 2011-12, stronger than expected at December JEFG. This reflects a more positive outlook for exports of transport equipment, in line with the forecast recovery in key export markets. Services exports are expected to fall by 2 per cent in 2009-10 following a sustained decline in foreign student commencements in Australia's education sector, particularly from South Asia. Services exports are expected to grow by 1½ per cent in 2010-11 and 6 per cent in 2011-12, as the world economy recovers.

The outlook for imports growth is slightly stronger than at December JEFG, in line with stronger domestic demand. Import volumes are forecast to increase by 6 per cent in 2009-10, 9 per cent in 2010-11 and 8 per cent in 2011-12. Strong growth in the latter part of the forecast period reflects an expected pickup in imported capital equipment for use in the construction of large LNG projects.

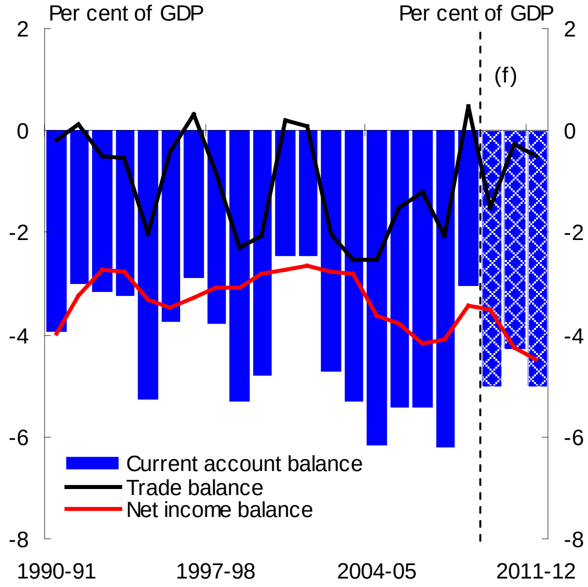
Following a forecast fall of 5 per cent in 2009-10, the terms of trade are forecast to increase by 10½ per cent in 2010-11. This largely reflects expectations of significant contract price rises for coal and iron ore in 2010, due to increasing world demand. New metallurgical coal contract prices have recently been settled by BHP Billiton, with reports suggesting a US$ price of around 55 per cent above the JFY2009-10 level. For 2011-12, the terms of trade are forecast to be flat — with commodity prices expected to remain at a high level. Import prices are forecast to remain at a low level over the forecast period, following the significant appreciation of the Australian dollar and global excess capacity.

Chart 7: Terms of Trade



Source: ABS Catalogue Number 5206.0 and Treasury.

Chart 8: Current Account Deficit



Source: ABS Catalogue Numbers 5206.0, 5302.0 and Treasury.

The trade deficit is expected to narrow significantly in 2010-11 to be ¼ of a per cent of GDP. This largely reflects higher non-rural commodity export prices. The trade deficit is forecast to widen slightly to ½ of a per cent of GDP in 2011-12 due to higher import volumes.

The net income deficit is expected to widen significantly in 2010-11, to 4¼ per cent of GDP — wider than at December JEFG. This largely reflects the expectation of increased income outflows, in line with the stronger forecast for non-rural commodity export income.

The current account deficit (CAD) is forecast to widen to 5 per cent of GDP in 2009-10 — less of a widening than at December JEFG, reflecting the stronger terms of trade. The CAD is expected to narrow to 4¼ per cent of GDP in 2010-11 due to higher export earnings, before widening to 5 per cent of GDP in 2011-12.

Employment, wages and inflation

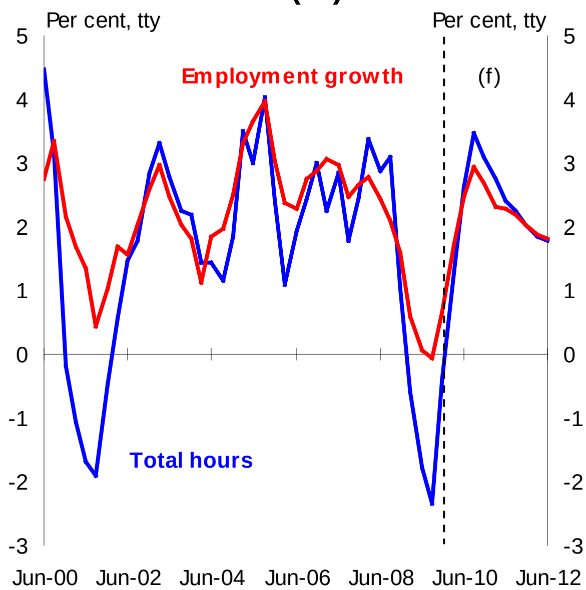
The employment outlook has improved since December JEFG, reflecting continued momentum in recent labour market outcomes and a stronger outlook for the economy. Spare capacity in the labour market appears to be diminishing.

The labour market has performed better than expected in recent months, with almost 200,000 jobs created in the past six months and the unemployment rate declining in three of the past four months. Employment is expected to grow by 2½ per cent through the year to the June quarter 2010, much stronger than the 1 per cent expected at December JEFG.

Hours worked have also been increasing, with trend aggregate hours rising for eight consecutive months. Average hours are now at their highest level in 12 months. Average hours are expected to improve further over the forecast period.

A more positive outlook for employment is expected to result in a lower unemployment rate over the forecast period than expected at December JEFG. The unemployment rate is expected to fall to 5 per cent by June quarter 2011, in line with an expectation that the labour market will reach full capacity in that period.

Chart 9: Employment Growth and Total Hours (sa)



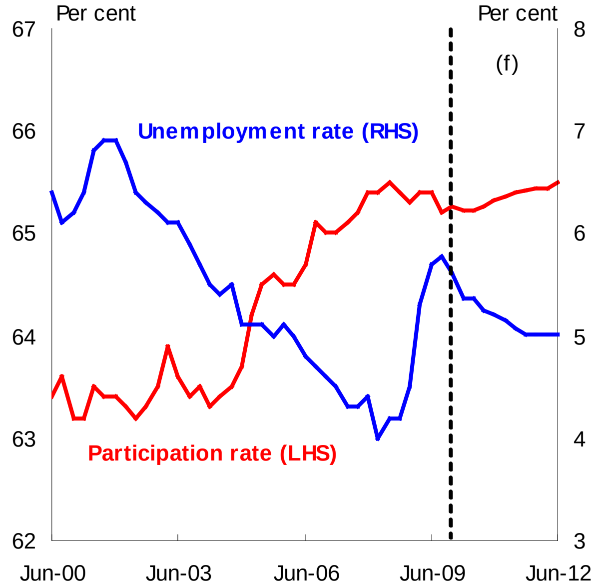
Source: ABS Catalogue Number 6202.0 and Treasury.

The participation rate has declined only modestly during the downturn, and is expected to trend up slowly over the forecast period, to reach 65½ per cent in the June quarter 2011. The increasing participation rate over the forecast period also takes account of underlying demographic trends, with the forecasts assuming a continuation of the increases in age- and gender-specific participation rates that have been experienced in recent years.

The overall outlook for wages has been revised up since December JEFG, consistent with a tightening labour market and a recovering economy. However, historically low wage growth in the December quarter means that annual wages growth is likely to be weak in the near term.

The National Accounts measure of Average Weekly Earnings recorded its slowest through-the-year growth on record in the December quarter. The recovery in average hours worked and full-time employment over the next few quarters is likely to contribute to earnings growth over the next year.

Chart 10: Unemployment and Participation Rates (sa)



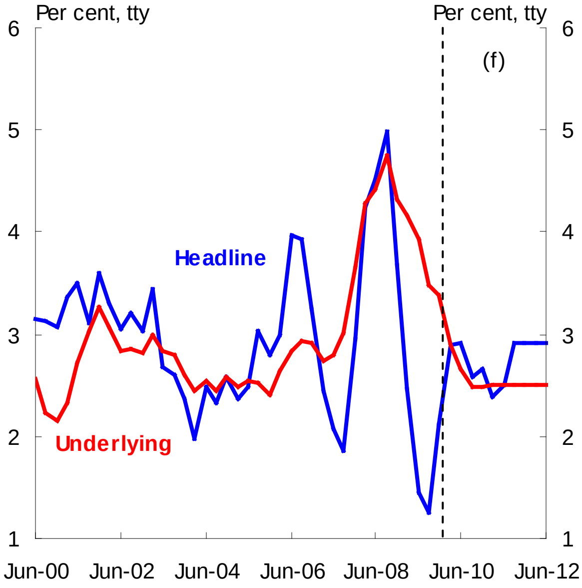
Source: ABS Catalogue Number 6202.0 and Treasury.

A weak December quarter result, continued downward pressure from the 2009 Australian Fair Pay Commission's minimum wage decision and ongoing weakness in outcomes for wage agreements suggest that annual growth in the Wage Price Index (WPI) will continue to be weak for most of 2010. The current strength of the labour market is expected to result in faster wages growth towards the end of 2010 and in early 2011. Beyond this, with the labour market rapidly approaching capacity and with ongoing impetus from the recovery in the terms-of-trade, wages are expected to grow above trend going into 2012. The WPI is expected to grow by 2¾ per cent through the year to the June quarter 2010 rising to 4 per cent through the year to the June quarter 2012.

The forecasts for headline and underlying inflation have been upgraded since December JEFG. Underlying inflation is expected to continue to ease over the coming quarters, reflecting recent falls in import prices, moderate wages growth and a considerable easing in the demand pressures that prevailed in 2008. Underlying inflation is expected to be 2¾ per cent through the year to the June quarter 2010 and 2½ per cent through the year to the June quarters of both 2011 and 2012.

Headline inflation is expected to pick up in the near term as automotive fuel and financial services prices rebound after exhibiting large falls in 2009. Headline inflation is expected to be 3 per cent through the year to the June quarter 2010 before moderating to 2½ per cent through the year to the June quarter 2011 and picking up to 3 per cent through the year to the June quarter 2012.

Chart 11: Headline and Underlying Inflation



Note: Excludes the effects of the new tax system.
Source: ABS Cataloge Number 6401.0, RBA and Treasury.

The forecasts for headline inflation incorporate the proposed commencement of the Carbon Pollution Reduction Scheme (CPRS) on 1 July 2011. The CPRS is expected to increase headline inflation over 2011-12 by 0.4 per cent, with most of the impact occurring in the September quarter 2011. It has been assumed that the CPRS will have no impact on underlying inflation.

MARCH 2010 ROUND: OUTLOOK FOR THE INTERNATIONAL ECONOMY

Table 1: International GDP growth forecasts(a)

	2009	2010		2011	
	Actual	December	March	December	March
United States	-2.4	2	2 3/4	2	2 1/2
Euro Area	-4.1	1	3/4	1 1/4	1 1/4
Japan	-5.2	1 1/4	1 3/4	1 3/4	2
China	8.7	9 1/4	10	9 1/2	9 1/2
India	6.4	7 1/4	7	7	8 1/4
Other East Asia (b)	-0.4	5	5 1/2	4 1/2	4 3/4
Major Trading Partners	0.0	4	4 3/4	4	4 3/4
World	-0.6	3 1/2	4	3 3/4	4 1/4

(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

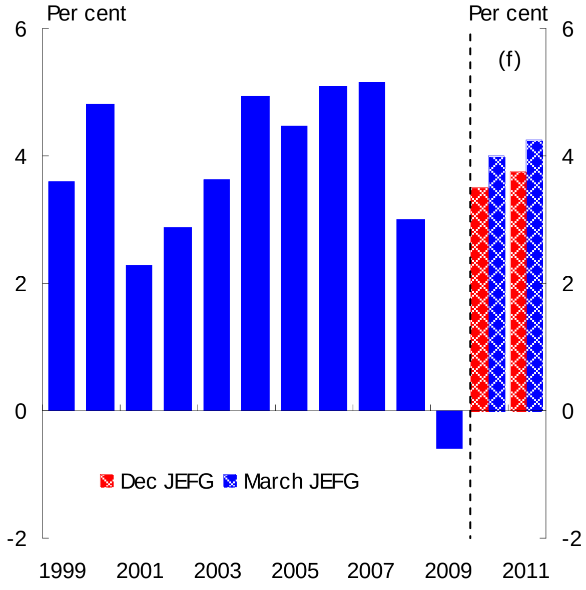
The outlook for the global economy continues to improve. While concerns over sovereign debt are likely to remain a source of risk and volatility for the next several years, the recent data points to a global economy that is performing better than envisaged at the time of the December JEFG forecasting round.

Part of the improved optimism is directly attributable to the stronger-than-expected performance at the end of 2009 among our major trading partner (MTP) economies. GDP outcomes in the December quarter were generally strong, and in some cases, surprisingly so, particularly in East Asia. While the accelerating growth phase in the global economy looks to have passed, a more moderate growth path is the most likely scenario from here, although a double-dip in some of the European periphery economies remains likely.

Despite stresses in some sovereign debt markets, financial market conditions more broadly continue to improve. Short-term inter-bank funding spreads remain at near pre-crisis levels, long-term bond spreads continue to normalise, activity in securitisation markets has picked up while market volatility has fallen to near its long-run average.

Against the backdrop of stronger growth, continued healing in overall financial conditions, and emerging signs that the economic recovery has broadened beyond the global industrial cycle, global growth forecasts have been marked up by ½ of a percentage point for both 2010 and 2011 (Chart 1).

Chart 1: World GDP growth



Source: IMF and Treasury.

The outlook looks especially encouraging for emerging markets, and in particular, our Asian neighbours. China is forecast to grow at a double-digit pace this year. Reflecting the relative outperformance of our major emerging Asian trading partner economies and their larger share of our export market, MTP economies are forecast to grow more rapidly than global GDP, with growth of 4¾ per cent in both years.

The divergence in growth performance will see a disparity in the pace of monetary policy normalisation. Among our major developing trading partner economies, monetary policy normalisation has either already commenced or is imminent, while in our major developed trading partner economies, this process is not expected to occur until towards the end of 2010 at the earliest.

While the outlook has improved noticeably compared to where we stood just three months ago, there are still important risks in both directions.

The most obvious downside risk relates to the sustainability of sovereign debt as the situation in Greece acutely demonstrates. At a time where large parts of the global economy are transitioning from policy-induced growth to self-sustaining expansion, there is a real risk that this transition is disrupted by the need to bring forward fiscal consolidation measures. Although this is a low probability risk, should such a scenario unfold, it would have serious negative consequences. In addition, there may be subsequent negative ramifications for business and consumer confidence, which would lead to private sector retrenchment, and cause further strains on already fragile economies.

Fiscal consolidation plans will eventually need to be enacted across many economies, which will lead to a more subdued outlook for advanced economies in the period ahead. In contrast, emerging economies are coming out of this crisis with lesser concerns over sovereign debt.

On the upside, however, there is the possibility that we may be underestimating both the short term momentum of the global economy and the positive feedback of improving confidence on economic conditions.

Country summaries

The outlook for the **United States** continued to improve in late 2009. A turn in the inventory cycle and expanded business investment and consumption supported strong growth in the December quarter. Despite ongoing strains from a weak labour market, constricted credit flows and past asset price shocks, US households have been more resilient than expected, boosting the outlook for consumption growth.

Accordingly, forecasts for 2010 and 2011 have increased to 2¾ per cent and 2½ per cent, respectively. Nevertheless, the recovery in the US economy is still expected to be sluggish and protracted compared with past recessions. While the outlook for consumption has improved, spending is expected to be subdued as cautious households grapple with damaged balance sheets and a tepid labour market recovery. With final domestic demand still subdued and considerable policy support set to expire over the forecast horizon, there is considerable uncertainty about the sustainability of the recovery. A faster-than-expected rebound in employment and a resumption in house price growth could prompt a stronger recovery in household spending. However, fading support from policy measures — particularly those targeting the housing market and disposable income — suggests some downside risk to the outlook.

The outlook for **China** has been upgraded since December JEFG, with government stimulus providing a stronger-than-expected boost to growth. GDP grew by 8.7 per cent in 2009, higher than forecast, driven by an acceleration in domestic demand. Expansionary monetary and fiscal policies have driven China's recovery, with investment contributing a strong 8 percentage points to growth in 2009.

With support from stimulus expected to continue into 2010, China's economy is forecast to grow by 10 per cent in 2010, before easing to 9½ per cent in 2011. Consumption has remained solid and export growth has rebounded. However, strong domestic demand has heightened concerns over asset price bubbles, inflationary pressures and overheating.

The Government has implemented measures to reduce liquidity, raising reserve requirement ratios for large banks by 100 basis points and cautioning banks against excessive lending. Fiscal stimulus is expected to be redirected from investment towards consumption. However, monetary and fiscal policies remain clearly expansionary. Risks centre on the Government's ability to manage domestic overheating, while countering the effects of a potentially subdued global recovery.

The recovery in the **Japanese** economy is delicately poised. The strong recovery in exports and production evident during the past year is likely to continue to drive growth. Much of this growth is expected to come from emerging markets, as highlighted by China's replacement of the US as Japan's largest export destination last year. In addition, fiscal stimulus will continue to provide support to consumption. In March this year, Japan's lower house passed a record ¥92.3 trillion ($A1.15 trillion) budget for FY2010 which includes a range of measures to support consumption, including direct payments to households.

However, substantial downside risks to Japan's growth remain. The rapid rate of increase in Japanese exports is expected to slow as the global export rebound settles. Domestically, the signs are improving, but the pace of recovery in some areas has been painfully slow. While unemployment has peaked, falling below 5 per cent in January, low wages are holding back the recovery in private consumption. Business investment appears to have bottomed out, but the sizeable output gap and prolonged deflation suggest it is likely to remain subdued during 2010.

The economy is expected to grow by 1¾ per cent in 2010 and 2 per cent in 2011. These above-trend rates of growth largely reflect a rebound from last year's record annual fall in GDP rather than inherent strength in the Japanese economy. Enduring recovery will hinge on the extent to which deflation becomes entrenched and whether the recovery in the corporate sector spreads to households, thereby allowing domestic consumption to develop its own momentum.

The outlook for the **Indian** economy remains strong, notwithstanding a weaker-than-expected December quarter result, a consequence of India's worst drought since 1972. Despite this setback, the recovery in the Indian economy is expected to be sustained on the back of improved business and urban consumer confidence, improved weather conditions, a better outlook for key export economies, and renewed foreign capital inflows. The Indian economy is forecast to grow by 7 per cent in 2010 before accelerating to 8¼ per cent in 2011.

As a result of the drought, food prices have risen markedly, propelling inflation into double-digits, although inflation is expected to ease once the winter crop is brought into the market around March and April. Monetary policy remains highly accommodative, which should continue to support activity, while the authorities' commitment to fiscal deficit targets is expected to improve investor sentiment.

The recovery of the **Newly Industrialised Economies (NIEs)** has proved to be more solid than expected amid continued improvements in the global economy. The NIEs are expected to grow by 5½ per cent this year and 4¾ per cent in 2011. The outlook for exports and industrial production is generally positive, with restocking of inventories in the advanced economies providing a significant boost. However, inflation is rising, as already seen in some property markets.

Economic activity in the **ASEAN-5** has continued to gather momentum, supported by improved exports and expansionary monetary and fiscal policy, which saw the region stage a V shaped recovery over 2009. The year ahead is again expected to be characterised by the strong export led recovery that is currently underway, with economic growth in the region's relatively small, open economies likely to benefit from strong intra-regional trade — particularly to China — and the normalisation in world trade.

The region is forecast to grow by 5¾ per cent in 2010 and 5¼ per cent in 2011. The outlook for the year ahead is however tempered somewhat by the risk of overheating in Vietnam, while political frailties in the region, particularly in Thailand, also pose downside risks.

The recovery in the **euro area** has slowed recently as weak domestic demand continues to detract from growth. While net exports are expected to provide some support as world trade strengthens, rising unemployment and ongoing deleveraging by households should continue to dampen private consumption. Uncertainty over sovereign debt levels in some countries is also weighing on sentiment across the euro area. As a result, the recovery is expected to remain drawn out and sluggish, with GDP forecast to grow by ¾ per cent in 2010 before strengthening slightly to 1¼ per cent in 2011.

The **United Kingdom** economy ended six consecutive quarters of negative growth in the December quarter 2009. However, the recovery is expected to be feeble and prolonged, as growth is held back by tight credit conditions. High levels of public and private debt, the need to unwind the large policy stimulus and the uncertainty surrounding this year's election will also weigh on the recovery. After contracting by 5 per cent in 2009, GDP is forecast to record modest growth of 1 per cent in 2010 and 2 per cent in 2011.

Forecasts for **New Zealand** GDP growth have been upgraded, with growth expected to pick up from 2¾ per cent in 2010 to 3¼ per cent in 2011. The New Zealand recovery reflects improved global growth, housing strength and government spending. Despite expected interest rate increases, household consumption is forecast to rise and business investment is expected to strengthen. Export commodity prices have risen recently, boosting the terms of trade, although export gains are likely to be partially offset by the recent appreciation of the New Zealand dollar.