



Australian Government

The Treasury

JOINT ECONOMIC FORECASTING GROUP

ECONOMIC OUTLOOK FOR 2011-12, 2012-13 AND 2013-14

MARCH 2012

This report incorporates Domestic and International data released up to 12 April 2012.

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OVERVIEW

The outlook for the Australian economy is broadly unchanged from December JIEFG. The Australian economy is expected to grow at around trend over the next two years, underpinned by a record pipeline of resources investment and strong growth in non-rural commodity exports associated with ongoing demand from emerging Asia. Real GDP is forecast to grow 3¼ per cent in 2012-13 and 3 per cent in 2013-14 (Table 1). While households are expected to remain cautious in their spending decisions, consumption growth is also expected to support around-trend economic growth. However, conditions are expected to remain uneven: global softness and the high Australian dollar will weigh heavily on the non-resources-related sectors of the economy where the majority of workers are employed. Reflecting the uneven economic outlook, and a weaker-than-expected March quarter outcome, forecast employment growth has been downgraded slightly in 2011-12 and 2012-13. Weaker growth in employment is expected to lead to a slight upward drift in the unemployment rate to 5½ per cent in the June quarter of 2013.

Although the outlook for the Australian economy is positive, downside risks remain substantial. The key international risk is the potential for a re-escalation of the European sovereign debt crisis. With large fiscal consolidations in train and monetary policy settings near zero, the capacity of many advanced economies to respond would be limited and any further weakness would likely flow through to the emerging economies of Asia and to Australia. Domestically, the transition taking place in the economy poses a particular risk for the labour market with the risk that employment growth in the rapidly expanding, but less labour-intensive resources and resources-related sector, may not be enough to offset the weakness in employment in other parts of the economy.

Table 1: Key Domestic Forecasts^(a) – March compared with December

	2010-11	2011-12		2012-13		2013-14	
	Outcome	Dec	Mar	Dec	Mar	Dec	Mar
Real GDP	2.0	3 1/4	3	3 1/4	3 1/4	3	3
Nominal GDP	8.3	6	5 1/2	5 1/4	5	5 1/4	5 1/4
Unemployment rate	4.9	5 1/2	5 1/4	5 1/2	5 1/2	5 1/2	5 1/2
Employment	2.2	1	1/2	1 1/2	1 1/4	1 1/2	1 1/2
CPI	3.6	2 1/4	2	3 1/4	3 1/4	2 1/2	2 1/2
Underlying inflation	2.7	2 1/4	2 1/4	2 3/4	2 3/4	2 1/2	2 1/2
WPI	3.8	3 3/4	3 1/2	3 3/4	3 3/4	3 3/4	3 3/4
Terms of trade	20.6	1 3/4	3 1/4	-5 1/4	-5 3/4	-2 3/4	-3 1/4

(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 for the June quarter.

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

Global economic conditions are weak and uneven and financial markets remain fragile. As expected, the euro area appears to have entered recession and growth in the export-dependent emerging economies has slowed in line with weaker advanced economy demand. Despite this, China appears to be on track for a 'soft landing', while the United States has continued to recover and there have been some better-than-expected signs in the US labour market, albeit from a position of considerable weakness. Employment growth in the US is rising and the unemployment rate has declined in recent months. In line with December JIEFG, the world is expected to slowly return to trend growth over the forecast horizon. World growth is forecast to increase from 3½ per cent in 2012, to 4 per cent in 2013 and 4¼ per cent in 2014.

While the central forecast for world growth is largely unchanged, there has been some improvement in the growth outlook for Australia's major trading partners (weighted by export share) reflecting an

upward revision to the Japan and Other East Asian growth outlook. Major trading partner growth is forecast to be 4¼ per cent in 2012, rising to 5 per cent in both 2013 and 2014, considerably faster than the world as a whole.

The relative strength of Australia's major trading partners continues to provide impetus to export growth. Notwithstanding this, the outlook for export growth has been downgraded since December JIEFG, largely reflecting resource industry capacity issues. Total exports are expected to grow 4 per cent in 2011-12 and 4½ per cent in both 2012-13 and 2013-14.

The main downward revision to export growth has been to non-rural export volumes due to revised assessments of system operating rates and new capacity coming online, particularly for coal exports. Coal exports have underperformed relative to expectations throughout 2011, as the industry struggled to recover from the 2011 Queensland floods. The floods were responsible for the majority of the 9.7 per cent fall in coal, coke and briquettes export volumes in 2011.

Although the Queensland coal industry is no longer constrained by the 2011 floods, exports from Queensland are still down around 15 per cent from their pre-flood peak in mid-2010. A combination of industrial relations disputes and wet weather in the first quarter of 2012 continues to weigh on output from the broader coal industry. Recent rainfall briefly closed a number of rail lines in Queensland, while earlier wet weather in New South Wales hindered operations and likely led to several days of lost production. In addition, escalating industrial disputes, particularly in Queensland, are expected to have a more significant impact on export volumes than in 2011. These factors, combined with delays to new capacity coming online due to the slower-than-expected recovery from the 2011 floods, are expected to lower coal exports growth, particularly metallurgical coal, across the forecast horizon. Partly offsetting this, the outlook for iron ore exports has been upgraded, reflecting the strong growth and demonstrated capability of the sector to produce to capacity targets in recent quarters. Overall, non-rural exports are still expected to grow solidly over the next two years as high investment in the sector continues to translate into export output.

The outlook for dwelling investment has also weakened significantly since December JIEFG, with forecast growth downgraded 2 percentage points in 2011-12 and 1½ percentage points in 2012-13. This reflects a much weaker-than-expected December quarter outcome and continued weakness in forward indicators, suggesting that the Victorian housing market will moderate faster than previously anticipated, after the boom in recent years. Reflecting this slowdown and the ongoing caution of households to spending and borrowing since the global financial crisis, dwelling investment is forecast to contract in 2011-12, remain flat in 2012-13 and grow modestly in 2013-14.

Mining investment is expected to be a key driver of growth over the forecast horizon along with solid non-rural commodity exports growth, despite the downgrade to coal export volumes. Led by liquefied natural gas investment in Western Australia and Queensland, December quarter CAPEX and project-by-project analysis suggest that mining investment remains on track to reach record highs as a percentage of GDP in 2012-13. However, the CAPEX survey suggests that, outside the resources and resources-related sectors, firms remain cautious in their investment plans.

Recent business survey results also highlight this divergence across the economy. The December NAB Quarterly Business Survey suggests that conditions in the mining industry are significantly stronger than their long-run average, while conditions in the manufacturing, construction and retail industries are significantly weaker. Similarly, the latest ACCI-Westpac Survey of Industrial Trends reported weak actual and expected conditions in the manufacturing sector in the December quarter. Meanwhile, the AIG-Commonwealth Bank Performance of Services Index reported that activity in the services sector contracted in March, as it did in 8 of the past 12 months. Likewise, the AIG-HIA Performance of Construction Index remained in contractionary territory for the twenty-second consecutive month in March.

Overall economic growth has been downgraded by $\frac{1}{4}$ of a percentage point in 2011-12 and there are downside risks to the 2012-13 forecasts. Nevertheless, economic growth is forecast to strengthen to $3\frac{3}{4}$ per cent in 2012-13 and then ease slightly to 3 per cent in 2013-14 largely reflecting slowing, albeit still strong, business investment growth. Forecast growth in nominal GDP is also lower in 2011-12 in line with the downgrade to real GDP growth and lower domestic price growth, partly offset by a higher forecast rise in the terms of trade. The higher terms of trade forecast is largely the result of lower-than-expected import prices.

The terms of trade are forecast to increase $3\frac{3}{4}$ per cent in 2011-12, followed by declines of $5\frac{3}{4}$ per cent in 2012-13 and $3\frac{3}{4}$ per cent in 2013-14, as growing global supply of iron ore and coal, particularly out of Australia, weighs on commodity prices. The anticipated falls in 2012-13 and 2013-14 are expected to be marginally larger than December JIEFG, resulting in the level of the terms of trade at the end of the period remaining broadly unchanged.

With the economy growing around trend and some weakness in the labour market, inflation and wages growth are expected to remain contained, notwithstanding a temporary spike associated with the introduction of the Government's carbon price in 2012-13. Nominal GDP is expected to grow $5\frac{1}{2}$ per cent in 2011-12, 5 per cent in 2012-13 and $5\frac{1}{4}$ per cent in 2013-14.

Employment growth is expected to slowly recover over the next two years and the unemployment rate is expected to rise to $5\frac{1}{2}$ per cent. Employment is expected to grow $1\frac{1}{4}$ per cent through the year to the June quarter of 2013 and $1\frac{1}{2}$ per cent through the year to the June quarter of 2014. A key source of weakness and risk to the labour market outlook is the divergent performance of the economy, with the vast majority of workers employed outside the resources and related sectors.

Table 2 – Domestic economy forecasts^(a)

	Outcomes (b)	Forecasts		
	2010-11	2011-12	2012-13	2013-14
Panel A - Demand and output(c)				
Household consumption	3.1	3 1/4	3	3
Private investment				
Dwellings	3.0	-1	0	2 1/2
Total business investment(d)	5.6	18	12 1/2	8
Non-dwelling construction(d)	8.8	25	14	7 1/2
Machinery and equipment(d)	3.0	16 1/2	12 1/2	8 1/2
Private final demand(d)	3.3	6	5	4 1/4
Public final demand(d)	3.4	1 1/2	- 1/2	0
Total final demand	3.3	5	3 3/4	3 1/4
Change in inventories(e)	0.5	0	0	0
Gross national expenditure	3.8	5	4	3 1/2
Exports of goods and services	0.2	4	4 1/2	4 1/2
Imports of goods and services	10.4	12 1/2	7 1/2	5 1/2
Net exports(e)	-2.0	-2	- 3/4	- 1/2
Real gross domestic product	2.0	3	3 1/4	3
Non-farm product	1.9	3 1/4	3 1/4	3
Farm product	7.1	-6	2	1
Nominal gross domestic product	8.3	5 1/2	5	5 1/4
Panel B - Other selected economic measures				
External accounts				
Terms of trade	20.6	3 1/4	-5 3/4	-3 1/4
Current account balance				
\$billion	-33.0	-42 1/2	-75 1/4	-97 1/2
Percentage of GDP	-2.4	-3	-4 3/4	-6
Labour market				
Employment (labour force survey basis)(f)	2.2	1/2	1 1/4	1 1/2
Unemployment rate (per cent)(g)	4.9	5 1/4	5 1/2	5 1/2
Participation rate (per cent)(g)	65.5	65 1/4	65 1/4	65 1/4
Prices and wages				
Consumer Price Index (h)				
- headline	3.6	2	3 1/4	2 1/2
- underlying	2.7	2 1/4	2 3/4	2 1/2
Gross non-farm product deflator	6.0	2 1/2	1 3/4	2 1/4
Wage Price Index(f)	3.8	3 1/2	3 3/4	3 3/4

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

(b) Calculated using original data unless otherwise indicated.

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

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

(e) Percentage point contribution to growth in GDP.

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

(g) Seasonally adjusted rate in 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 76 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\$130 per barrel. The farm sector forecasts are based on average seasonal conditions in 2012-13 and 2013-14.

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

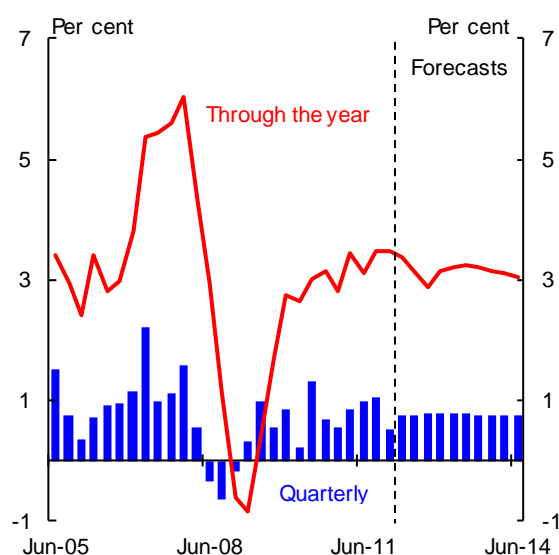
OUTLOOK FOR THE DOMESTIC ECONOMY

Australia's economic growth is forecast to be 3 per cent in 2011-12, 3¼ per cent in 2012-13 and 3 per cent in 2013-14. Compared with December, real GDP growth forecasts have been downgraded by a ¼ of a percentage point in 2011-12. Growth in resources investment, non-rural commodity exports and consumption continues to underpin real GDP growth in both 2012-13 and 2013-14. All forecasts in this report are inclusive of the estimated impact of the Government's carbon price policy.

Household consumption

The outlook for **household consumption** is broadly unchanged since the December JIEG. While household wealth has begun to grow, it remains well below the levels of early 2011 and the outlook for employment and wages growth remains modest. With household consumption expected to grow broadly in line with disposable incomes, the saving rate is expected to remain elevated. Consumption is forecast to grow 3¼ per cent in 2011-12 and 3 per cent in 2012-13 and 2013-14 (Chart 1).

Chart 1: Household consumption



Source: ABS cat. no. 5206.0 and Treasury.

Near-term indicators suggest ongoing weakness in the household goods sector, with

motor vehicles sales remaining broadly flat, and retail sales rising only moderately in January and February following a series of weak outcomes in late 2011. However, these partial indicators do not capture the anticipated growth in the consumption of services, which represent around two-thirds of the consumption basket and contributed around two-thirds of the 3.5 per cent growth in overall household consumption in 2011. Some of this strength is expected to continue over the forecast horizon.

Also not captured by partial indicators is the consumption by Australian tourists overseas, taking advantage of the high Australian dollar. This category also made a significant contribution to consumption during 2011 and is also expected to remain strong in the near-term. (While this type of spending boosts household consumption it is netted off through imports and therefore has no direct impact on Australian GDP.)

Nevertheless, with consumer sentiment having remained below its long-run average for the past five months, overall consumption growth is still expected to be modest in the March and June quarters.

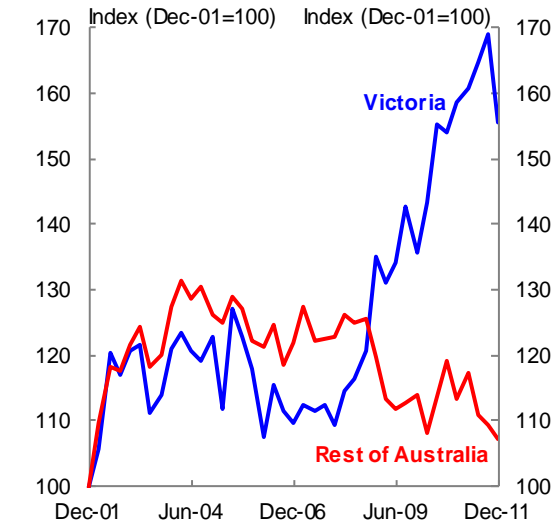
Over the entire forecast period, consumption growth is expected to be supported by growing incomes and wealth. Household net worth remains considerably lower than a year ago, but is showing early signs of recovery following share market gains in recent months and tentative signs that house prices might be stabilising. Consumption growth is expected to grow modestly in 2012-13 and 2013-14, in line with the outlook for employment and wages growth.

Dwelling investment

The outlook for **dwelling investment** has weakened significantly since December JIEG, with growth forecasts downgraded 2 percentage points in 2011-12 and 1½ percentage points in 2012-13. This downgrade reflects a much weaker-than-expected December quarter outcome and continued weakness in forward indicators, suggesting that the Victorian housing market will moderate faster than previously anticipated. Dwelling investment is forecast to contract 1 per cent in 2011-12 and remain flat in 2012-13 before growing 2½ per cent in 2013-14.

New dwelling investment grew 5.3 per cent in 2010-11, the strongest growth in eight years. This was underpinned by strong growth in construction activity in Victoria, where new dwelling investment grew at a double-digit rate for the third year in a row (Chart 2). December JIEG forecasts had factored in a mild easing in the Victorian market over the forecast period. However, National Accounts data for the December quarter suggest that the moderation is occurring faster than expected. New dwelling investment contracted 3.9 per cent in the December quarter, led by a 7.9 per cent fall in the Victorian market, while national housing commencements fell 10.9 per cent over 2011.

Outside Victoria, ongoing supply constraints associated with onerous planning and approval processes, as well as high costs of development and land release restrictions, particularly in the Sydney market, are also expected to continue to weigh on dwelling investment growth.

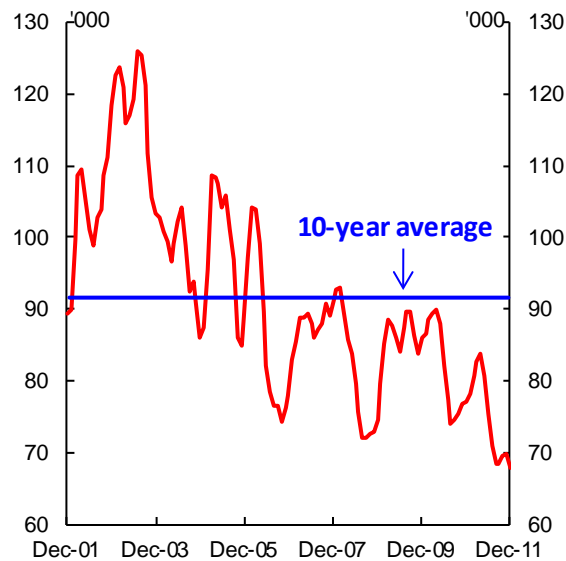


Source: ABS cat. no. 5206.0 and Treasury.

This moderation in activity has occurred despite a sizable stock of work in the pipeline. This suggests that property developers are reluctant to proceed with projects in the context of insufficient demand for new housing, with new home sales at their lowest level in more than a decade (Chart 3). The weak outlook for dwelling investment also reflects the more cautious approach of households to spending and borrowing since the global financial crisis, which has seen a greater tendency for households to pay down existing housing debt and a reluctance to take on new borrowing.

Chart 3: New home sales (annualised)

Chart 2: New dwelling investment



Source: HIA.

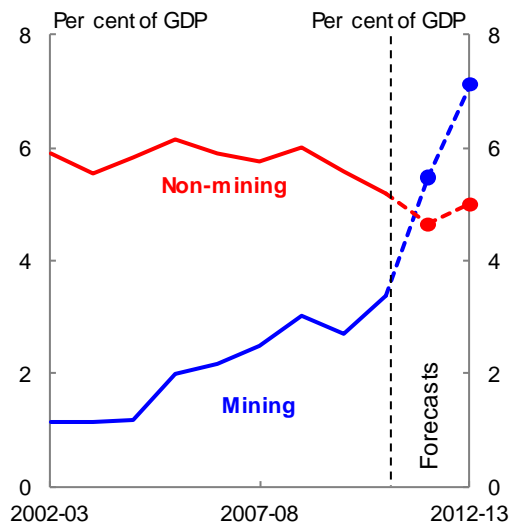
Business investment

The outlook for **new business investment** remains strong and, with the exception of some re-profiling, is broadly unchanged since December JIEFG. Despite the uncertainty and volatility in commodity markets in the later part of 2011, the latest CAPEX survey data imply increased investment intentions in the resources sector. Offsetting this rise is a decrease in non-mining investment intentions.

New business investment growth forecasts have been upgraded 1½ percentage points in 2011-12, but downgraded 1 percentage point in 2012-13 and 1½ percentage points in 2013-14. New business investment is forecast to grow 18 per cent in 2011-12, 12½ per cent in 2012-13 and 8 per cent in 2013-14.

The resilience of investment intentions in the resources sector has also been confirmed in updated company announcements. The latest CAPEX survey reported new highs for mining investment intentions in both 2011-12 and 2012-13. Based on these survey results, Treasury estimates that mining investment will account for around 60 per cent of total CAPEX in 2012-13 (Chart 4). Treasury analysis of individual major resource projects indicates that most mining investment planned to be undertaken over the forecast horizon is already committed to or under construction.

Chart 4: Mining and non-mining investment



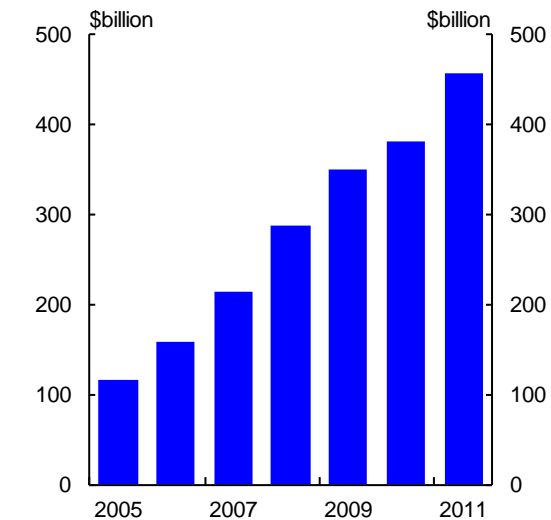
Note: Estimates for 2011-12 and 2012-13 are from the ABS CAPEX survey, and based on Treasury estimated realisation ratios.

Source: ABS cat. no. 5206.0, 5625.0 and Treasury.

Engineering construction investment forecasts have been upgraded in 2011-12 following stronger-than-expected investment over the first half of 2011-12. Progress at a number of major projects has been quicker than expected, but growth rates are expected to moderate somewhat over coming quarters. Growth in 2012-13 and 2013-14 is expected to be slightly weaker than at December JIEFG, based on discussions with major project participants and recent company announcements of revised expenditure profiles. Despite this, the resources investment pipeline remains extremely high (Chart 5).

With investment intentions at record highs, there is expected to be significant competition between major resource projects for specialised resources and therefore not all projects are expected to meet planned levels of capital expenditure within announced timeframes. For this reason, a conservative approach has been used when translating CAPEX investment intentions into investment outcomes. New engineering construction is forecast to grow 36 per cent in 2011-12, 20½ per cent in 2012-13 and 9 per cent in 2013-14.

Chart 5: Estimates of the resources investment pipeline



Source: ABARES and BREE.

Forecasts for investment in new **machinery and equipment** remain broadly unchanged since December JIEFG. While the forecast for 2011-12 of 16½ per cent growth is slightly weaker, reflecting the December quarter outcome, expected investment growth in both 2012-13 and 2013-14 remains unchanged, growing 12½ per cent and 8½ per cent respectively.

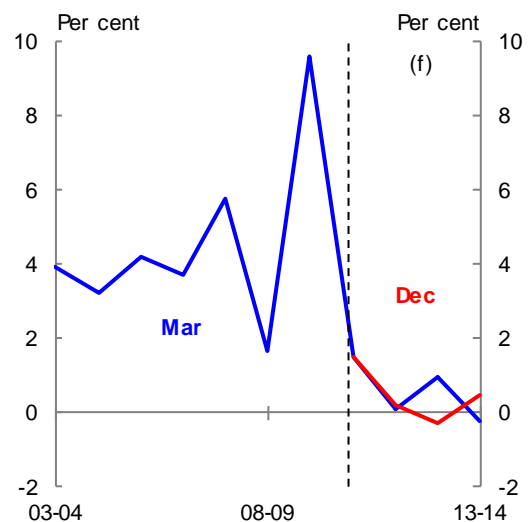
Machinery and equipment investment in the non-mining related parts of the economy is expected to be weak over the forecast horizon as these sectors struggle with the high exchange rate, cautious consumer spending and changing spending habits. However, booming mining-related investment in machinery and equipment is expected to more than offset this weakness and drive solid growth over the forecast period.

The outlook for **non-residential building** remains weak despite recent strength in mining-related accommodation (which is expected to fade) and hospital construction. More generally, underlying demand in the non-residential building sector remains weak with a modest employment outlook and modest consumer spending weighing on new construction of commercial offices and retail space. With limited new investment currently in the pipeline, non-residential building is forecast to grow 4 per cent in 2011-12, fall ½ of a per cent in 2012-13 and rise 3½ per cent in 2013-14.

Public final demand

Public final demand is forecast to grow at below-average rates in 2011-12 and 2012-13 as governments at all levels undertake fiscal consolidation. Public final demand is forecast to grow 1½ per cent in 2011-12, before falling ½ of a per cent in 2012-13. Public final demand is forecast to remain flat in 2013-14. Recent state budget updates suggest higher expenditure over the forecast period, particularly with respect to investment expenditure in 2012-13, offsetting a slightly larger fall in commonwealth spending in 2012-13 (Chart 6). The forecast for growth in 2013-14 has been downgraded reflecting higher expenditure in 2012-13.

Chart 6: Growth in real State and Local Government Expenditure



Note: Excluding second-hand asset sales from the public sector to the private sector.

Source: ABS cat. no. 5206.0 and Treasury.

Exports, imports and the current account deficit

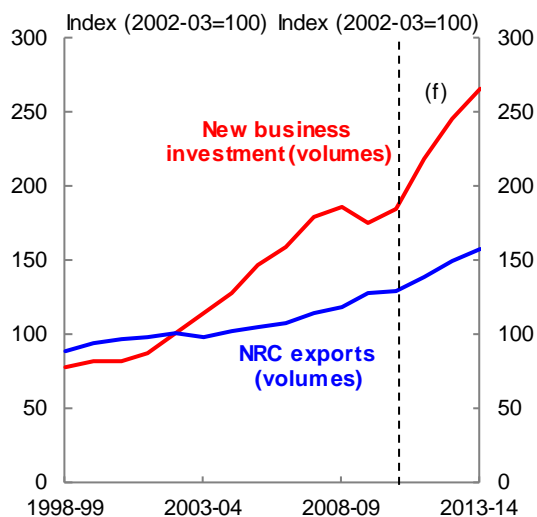
The outlook for export growth has been downgraded since December JIEFG, largely reflecting resource industry capacity issues, weak global demand and a high Australian dollar. **Net exports** are expected to detract 2 percentage points from real GDP growth in 2011-12, ¾ of a percentage point in 2012-13 and ½ of a percentage point in 2013-14. This is a

slightly larger detraction in 2011-12 than forecast in December JIEFG, reflecting weaker export growth in that year.

Total exports forecasts in 2011-12 and 2012-13 have been downgraded from December JIEFG. This largely reflects a downgrade to non-rural commodities, with services and rural exports also weaker. Export growth in 2013-14 has been upgraded from December JIEFG reflecting an upgrade to MTP growth. Total exports are expected to grow 4 per cent in 2011-12 and 4½ per cent in both 2012-13 and 2013-14.

Non-rural export volume forecasts have been downgraded since December JIEFG due to revised assessments of new capacity coming online, particularly with respect to coal exports. Despite this downgrade, non-rural exports volumes are still expected to grow solidly over the next two years as current strong investment translates into enhanced production and export capacity (Chart 7).

Chart 7: Non-rural commodity exports and business investment



Source: ABS cat. no. 5206.0 and Treasury.

Coal exports have underperformed relative to expectations throughout 2011, as the industry has struggled to recover from the 2011 Queensland floods. While Queensland coal exports had largely recovered from the 2011 floods in the month of December, recent data indicate that wet weather and industrial relations disputes will reduce growth in the March quarter. In addition, the

slower-than-expected recovery in 2011 is expected to have a flow-on impact on industry expansion plans and output over the forecast horizon.

Partly offsetting this, forecasts of iron ore exports have been upgraded over the next two years, reflecting the strong growth and demonstrated capability of the sector to produce to capacity targets in recent quarters. Overall, non-rural exports are expected to grow solidly over the next two years as high investment in the sector continues to translate into increased export output. Non-rural volume growth is expected to be strong at 8 per cent in 2011-12, 7½ per cent in 2012-13 and 5½ per cent in 2013-14.

Rural export volumes forecasts for 2011-12 have been downgraded, reflecting reduced yield expectations for some summer crops. Nevertheless, volumes are expected to grow a strong 8 per cent to a record \$29.7 billion. Forecasts for 2012-13 and 2013-14 have been upgraded, reflecting near-full soil moisture profiles and water storages across most growing regions. Nevertheless, 2011-12 levels are so high that, in terms of growth, rural export volumes are expected to be flat in 2012-13 and grow just 2 per cent in 2013-14, based on an assumption of a return to more normal seasonal conditions.

Farm GDP growth forecasts have been downgraded by 7 percentage points in 2011-12 reflecting lower than previously expected yields for some summer crops and upgraded in 2012-13 and 2013-14 reflecting near-full soil moisture profiles. Farm GDP is now expected to decline 6 per cent in 2011-12, before rising 2 per cent in 2012-13 and 1 per cent in 2013-14.

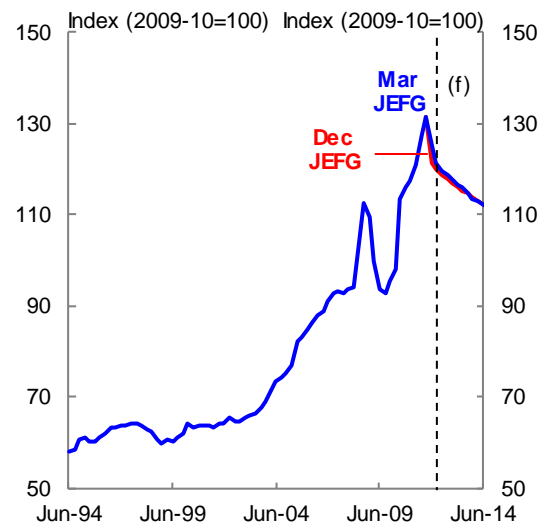
The outlook for **elaborately transformed manufactures** (ETM) export volumes is broadly unchanged from December JIEFG. While growth in 2011-12 is forecast to be weaker due to the weaker-than-expected December quarter outcome, growth in 2012-13 is likely to be stronger reflecting stronger forecast MTP growth. ETM export volumes are expected to grow 2½ per cent in 2011-12 and 2012-13, and 3 per cent 2013-14.

Services export volume forecasts have been downgraded since the December JIEFG. The outlook remains subdued, as the high exchange rate and weak advanced economy growth is leading to continuing weakness in tourist arrivals. While changes to the student visa regime announced as part of the Knight Review in November are expected to have some positive impact over the medium term, international student numbers are expected to remain weak in the near term. Services exports are expected to fall 5½ per cent in 2011-12 before rising 1½ per cent in 2012-13, and 3 per cent in 2013-14.

Total imports volume forecasts are slightly weaker over the forecast period than at December JIEFG reflecting a much weaker-than-expected December quarter outcome and a slight downgrade in forecast capital goods imports due to expected delays in liquefied natural gas projects. Nevertheless, the mining investment boom will continue to fuel significant demand for imports, particularly capital goods imports, over the forecast horizon. Total imports are expected to grow 12½ per cent in 2011-12, 7½ per cent in 2012-13 and 5½ per cent in 2013-14.

The forecast increase in the **terms of trade** in 2011-12 is marginally stronger than forecast in December JIEFG. However, the anticipated falls in 2012-13 and 2013-14 are expected to be marginally larger resulting in the level of the terms of trade at the end of the period remaining broadly unchanged from December JIEFG. The upgrade in 2011-12 largely reflects a weak outcome for import prices in the December quarter (Chart 8).

Chart 8: The terms of trade



Source: ABS cat. no. 5206.0 and Treasury.

While the outlook for iron ore prices is broadly unchanged from December JIEFG, metallurgical and thermal coal contract prices are forecast to be lower than previously anticipated. The terms of trade are forecast to increase 3¼ per cent in 2011-12, followed by declines of 5¾ per cent in 2012-13 and 3¼ per cent in 2013-14, as growing global supply of iron ore and coal, particularly out of Australia, weighs on commodity prices.

The **current account deficit** is forecast to widen to a lesser extent than at December JIEFG as a result of a narrower net income deficit. The **trade balance** forecasts are largely unchanged since the December JIEFG. However, the **net income deficit** is expected to widen by less than previously expected, largely reflecting an expected reduction in the return on foreign owned mining assets compared with December JIEFG due to lower commodity prices than forecast in December JIEFG. Nevertheless, the current account deficit as a per cent of GDP is expected to double over the next two years, largely as a result of the surge in imports, particularly of capital goods associated with the mining investment boom. Liquefied natural gas investment alone will exceed \$100 billion over the next three years and two thirds of this will be met through imports. The **current account deficit** is forecast to widen from 3 per cent of GDP in

2011-12, to 4¾ per cent of GDP in 2012-13 and 6 per cent of GDP in 2013-14.

Employment, wages and inflation

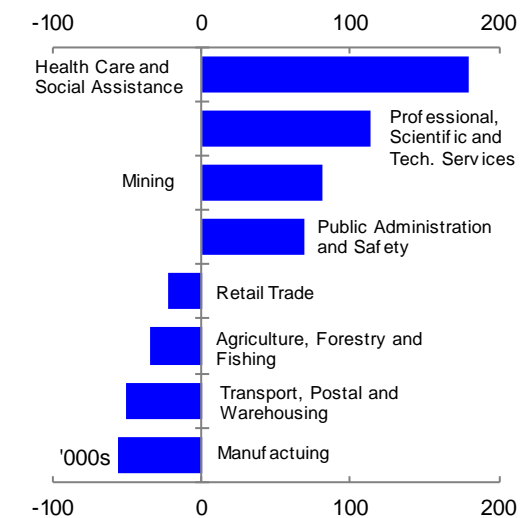
Labour market

The labour market outlook has weakened further since December JIEFG, consistent with the weaker-than-expected March quarter outcome and the downgrade to the outlook for economic growth in 2011-12.

Growth in employment over 2011 was subdued, reflecting an unwind of the strong growth over 2010 where employment growth greatly outpaced economic activity. However, the extent of the slowdown has been much greater than anticipated at the time of the December JIEFG. Over the forecast period, a moderate recovery in employment growth is expected, albeit from a low base. However, with softness in labour demand outside the mining and related sectors expected to continue, employment growth is nevertheless expected to be modest in 2012-13 and 2013-14, with the unemployment rate expected to rise to 5½ per cent.

The pace of structural adjustment in the economy is a key risk to the employment outlook. Over the past few years, strong employment growth in the mining and government sectors has largely offset below-trend growth (or falls) in retail, manufacturing and non-mining construction (Chart 9). However, employment growth in those previously-strong sectors may slow and they may not be able to fully compensate for any acceleration in the decline of retail and manufacturing. If an acceleration in job losses were to occur, that orderly but fast-paced shift of employment between the sectors could very quickly turn into a difficult period of higher unemployment.

Chart 9: Change in employment for selected industries (Feb-09 to Feb-12)



Source: ABS cat. no. 6291.0.55.003.

Employment growth is forecast to be ½ of a per cent through the year to the June quarter of 2012, 1¼ per cent through the year to the June quarter of 2013 and 1½ per cent through the year to the June quarters of 2014. This represents a downgrade of ½ of a percentage point for the year to June 2012 and ¼ of a percentage point for the year to June 2013 compared with December JIEFG.

The **participation rate** has also been downgraded since December JIEFG, reflecting weakness in recent outcomes. After peaking at 66.0 per cent in November 2010, the participation rate has since declined to 65.4 per cent in March 2012. The participation rate is forecast to remain broadly stable at 65¼ per cent over the forecast horizon.

As a consequence of the anticipated weaker short-term employment growth, the **unemployment rate** is forecast to increase to 5½ per cent in June 2013 and remain at this level through to June 2014. Over the past 12 months, the unemployment rate has increased only slightly, with weakness in employment growth largely offset by a decline in the participation rate.

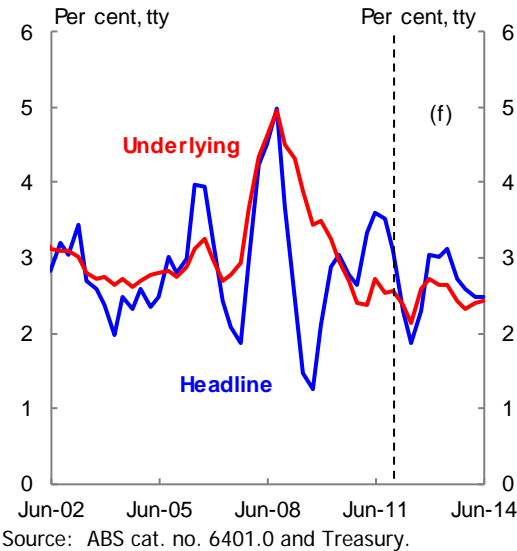
Inflation

The outlook for inflation is broadly unchanged since December JIEFG. Underlying price

pressures are expected to remain subdued, consistent with an economy that is growing around trend over the next two years. The introduction of the carbon price will lead to a temporary spike in inflation in through-the-year terms to June 2013.

Headline inflation is forecast to be 2 per cent through the year to the June quarter of 2012, and 3¼ per cent through the year to the June quarter of 2013 with the introduction of the carbon price adding ¾ of a percentage point, before easing to 2½ per cent through the year to the June quarter of 2014. **Underlying inflation** is forecast to be 2¼ per cent through the year to the June quarter of 2012, and 2¾ per cent through the year to the June quarter of 2013 with the introduction of the carbon price adding a ¼ of a percentage point, before easing to 2½ per cent through the year to the June quarter of 2014 (Chart 10).

Chart 10: Inflation



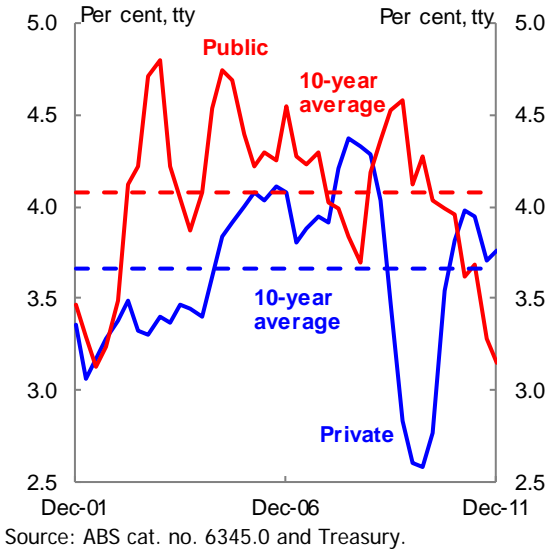
Wages

The outlook for wages growth has been downgraded slightly since December JIEFG.

This largely reflects the weaker labour market outlook. However, it also takes account of the faster-than-anticipated slowdown in public sector wages growth associated with the fiscal consolidations taking place at all levels of government. Wage Price Index growth forecasts have been downgraded by ¼ of a percentage point in 2011-12.

Wages growth slowed in the second half of 2011, largely reflecting the decline in public sector wage growth (Chart 11). Public sector wages grew at their slowest rate in almost a decade in the year to the December quarter 2011. In aggregate, the Wage Price Index (WPI) increased 3.6 per cent through the year to December 2011, a little below its 10-year average of 3.8 per cent.

Chart 11: Wage Price Index growth



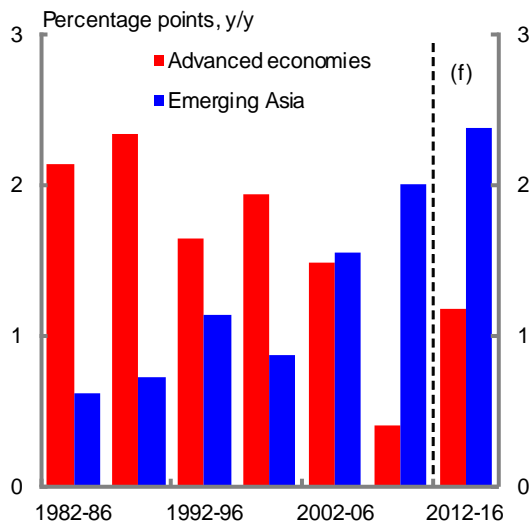
The Wage Price Index is expected to grow 3½ per cent through the year to the June quarter of 2012, and 3¾ per cent through the year to the June quarters of 2013 and 2014.

Box 1: The impact of the rise of emerging Asia on Australian exporters

Australia's natural resource base and location in the Asian region has meant that that our exporters have been able to take advantage of the expanding markets of emerging Asia at a time of relative weakness in the world's advanced economies.

In the past decade, emerging economies, primarily those in Asia, have become the engine room of growth in the global economy (Chart 1).

Chart 1: Contributions to global growth (5-yr-average)



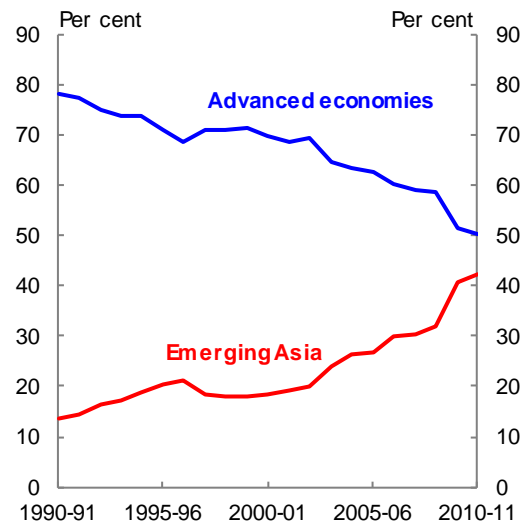
Note: IMF forecasts 2012-16.

Source: IMF and Treasury.

While China has been a significant contributor, due to its size and strong growth, all the key emerging economies of Asia, India, Indonesia, Malaysia, Vietnam, have grown more rapidly than their European and North American counterparts.

Australian exporters have been steadily re-orientating their exports toward emerging Asia for many years and this shift has been even more marked since the global financial crisis (Chart 2).

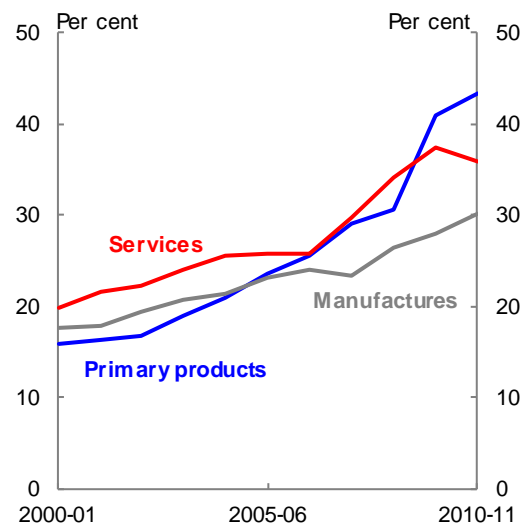
Chart 2: Merchandise export shares



Source: ABS cat. no. 5368.0 and Treasury

The re-alignment is most stark for commodities but is evident in all major export classes (Chart 3).

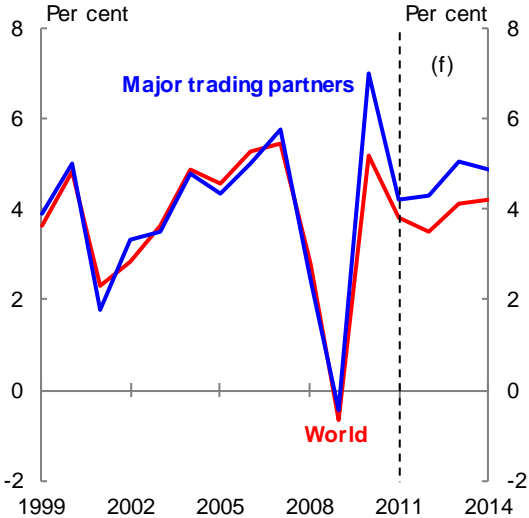
Chart 3: Emerging Asia share of exports



Source: Department of Foreign Affairs and Trade and ABS cat. no. 5368.0.55.003.

This shift towards strongly growing emerging Asia away from weakly growing advanced economies has meant that since 2009, growth in Australia’s major trading partners (by export weight) has exceeded world growth by around 1 percentage point per year, on average (Chart 4).

Chart 4: Major trading partners and World GDP growth



Source: IMF and Treasury.

The gap should narrow marginally over the next three years as emerging economy growth moderates slightly and the recovery in the large advanced economies slowly gathers momentum. However, major trading partner growth will nevertheless remain strong, helping to support our exporters at a time of a high exchange rate and weak global activity.

OUTLOOK FOR THE INTERNATIONAL ECONOMY

Table 3: International GDP growth forecasts^(a)

	2010	2011		2012		2013		2014	
	Actual	Dec JIEFG	Mar JIEFG	Dec JIEFG	Mar JIEFG	Dec JIEFG	Mar JIEFG	Dec JIEFG	Mar JIEFG
United States	3.0	1 3/4	1.7	2	2	2 1/4	2 1/4	2 1/2	2 1/2
Euro area	1.9	1 1/2	1.5	- 1/4	- 1/2	1	3/4	1 1/4	1 1/4
Japan	4.4	- 3/4	-0.7	2 1/4	2 1/4	1 1/4	1 3/4	1	1 1/4
China ^(b)	10.4	9 1/4	9.2	8 1/4	8 1/4	8 1/2	8 1/2	8 1/4	8 1/4
India ^(b)	10.2	7 1/4	7.3	6 1/2	6 1/4	8	7 3/4	7 1/2	7 1/2
Other East Asia ^(c)	7.8	4 1/2	4.2	3 3/4	3 3/4	4 3/4	5	5	5
Major Trading Partners	6.8	4	4.2	4 1/4	4 1/4	4 1/2	5	4 1/4	5
World	5.2	3 3/4	3 3/4	3 1/2	3 1/2	4	4	4 1/4	4 1/4

(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.

Source: National statistical publications, IMF *World Economic Outlook* September 2011, Thomson Reuters and Treasury.

World outlook and risks

Although global conditions have stabilised somewhat since December JIEFG, markets continue to be volatile and remain alert to any signs of deterioration in the outlook for the euro area, especially surrounding the debt sustainability of Spain, Italy, and Portugal. On the upside, economic activity in the United States has continued to gain traction.

As forecast in December, the euro area appears to have re-entered recession. In the absence of a major shock, the recession is expected to be relatively mild, but with the subsequent recovery modest at best. Growth in export-dependent emerging economies has been impacted by the weakness in Europe and the subdued recovery in the US. However, growth in the emerging economies as a whole remains relatively robust, with China appearing to be on track for a 'soft landing', as expected at December JIEFG.

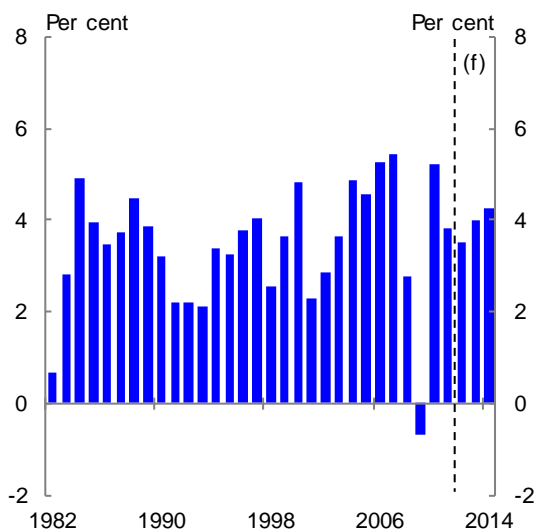
A re-escalation in the euro area sovereign debt crisis remains the key risk to the global recovery. The European Central Bank's (ECB) injection of around €1 trillion of liquidity into the euro area's financial system calmed markets at the beginning of 2012. However, in recent weeks data show that Spanish, Italian, and Portuguese banks have used the additional liquidity from the ECB to purchase the debt of their governments in record amounts. This has increased the exposures of these banks to their countries' sovereign debt, triggering renewed market anxiety about the

adverse impact a likely decline in the value of these sovereign bonds will have on the financial sector of these countries and the rest of the region. The sustainability of Spain's sovereign debt arising from slippages in Spain's 2011 fiscal targets has also contributed to the renewed market uncertainty. In addition, markets are not convinced that the increase in the size of the euro area's bailout funds, as announced on 30 March, will comprehensively deal with the crisis. Questions also remain over the political will to implement agreed austerity measures in a number of euro area countries. Accordingly, the threat of contagion from the euro area sovereign debt crisis persists.

Aside from a re-intensification of the European sovereign debt crisis, another risk that has emerged since December JIEFG is the rising tensions between Iran and the West which, if they were to escalate, would result in an oil price shock which would negatively impact global growth.

The international growth forecasts continue to be predicated on the euro area avoiding a disorderly resolution to its sovereign debt crisis. In conjunction with the broad stabilisation in global conditions in recent months, the forecasts for 2012 and 2013 global growth remain unchanged at 3½ per cent and 4 per cent (Chart 12).

Chart 12: World GDP growth



Source: IMF and Treasury.

With much of Australia’s MTP basket consisting of robustly growing Asian economies, growth rates for Australia’s major trading partners (MTPs) as a whole are expected to remain relatively healthy. The upward revision to the forecasts for MTP growth also reflects the ongoing and rapid increase in the share of Australia’s merchandise exports that are consumed by China.

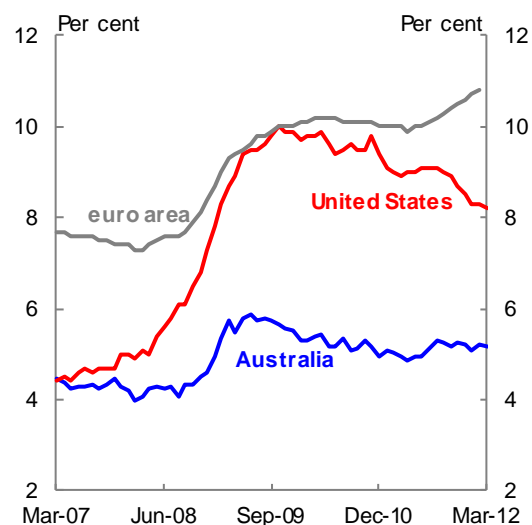
The March JIEG MTP forecasts include the latest annual update to MTP weights, incorporating Australia’s 2011 calendar year merchandise export outcomes. However, the forecast for 2012 remains unchanged at 4¼ per cent. This reflects China’s increased contribution being partly offset by the cumulative effects of downward revisions to growth in India and New Zealand, and a slight downward revision to other East Asia’s aggregate growth. MTP growth in 2013 has been revised up by a ½ of a percentage point to 5 per cent, reflecting an upward revision to Japanese and other East Asia’s GDP growth rates and China’s increased share of the MTP basket.

The recovery in the **United States** is evolving in line with expectations and the forecasts for US growth are unchanged from the December JIEG round at 2 per cent in 2012 and 2¼ per cent in 2013. The temporary factors that impinged on growth in the first half of

2011, for example the impact on supply chains from the Japanese earthquake and tsunami, have now fully abated. However, the US recovery nevertheless remains vulnerable due to the deep underlying weaknesses in the labour and housing markets mitigating the potential for a faster paced recovery.

There have been some encouraging signs that the long-awaited recovery in the labour market may finally be getting underway, with employment growth strengthening and the unemployment rate falling in recent months. However, unemployment in the US is still historically high, and is composed of a large number of long-term unemployed (Chart 13). Further, a contributing factor to recent falls in the unemployment rate has been a labour force participation rate which remains around a 30-year low. The historically low participation rate suggests that the labour market still has a long way to go before it returns to reasonable health.

Chart 13: Unemployment rates



Source: ABS cat. no. 6202.0, national statistical agencies and Thomson Reuters.

The depressed housing market also remains a constraint on growth, with a recovery still some way off as the US’ large housing inventory is slowly absorbed.

The US also faces risks from fiscal policy uncertainty. This risk has been removed for 2012 with the extension to the end of the year of the payroll tax cut and unemployment

benefits which were originally legislated to expire at the end of 2011. However, in late 2012 a 'lame duck' session of Congress will face some difficult fiscal policy decisions that could have a large bearing on 2013 and beyond.

Firstly, Congress will have to decide on the future of the 'Bush era' tax cuts, which are currently legislated to expire on 1 January 2013. Secondly, Congress will need to decide whether to amend or abolish the discretionary spending cuts that are scheduled to commence in fiscal year 2013 (which starts on 1 October 2012), that result from the November 2011 failure of the 'Super Committee' to agree to a medium-term deficit reduction plan. Accordingly, there is a risk of a substantial fiscal tightening in 2013, which would undermine what will still be only a moderate recovery. On current projections, it is also possible that a further increase in the US' legislated public debt ceiling may be necessary later in 2012, risking another protracted and damaging debate on this issue.

A further complication for the US outlook beyond 2012 is ensuring an appropriate balance between the need for short-term fiscal support and medium-term fiscal consolidation. For example, if the 'Bush era' tax cuts are extended and the discretionary spending cuts are watered down or removed entirely, this would help support short-term growth but could prove detrimental to market confidence in the longer term if a medium-term fiscal consolidation plan is not forthcoming. For the time being markets remain sanguine about the ability of the US to pay its sovereign debt obligations, with the yield on 10-year US Treasuries around a 60-year low. However, as long as there is an absence of a credible and substantive medium-term fiscal consolidation plan, the US will remain exposed to a shift in market sentiment.

The forecasts for Chinese growth also remain unchanged from December JIEFG, with economic conditions in **China** remaining solid, despite weakening domestic activity and the deterioration in external demand, especially from the European Union (EU), China's largest single export market. Activity is generally moderating in line with expectations, with inflation having eased noticeably since

mid-2011. With inflationary pressure likely to continue easing, particularly in the first half of 2012, policy makers are turning their attention to supporting growth with an eye to economic reforms.

In recent years, domestic demand, particularly investment, has accounted for the bulk of Chinese growth. With China recognising the need to shift towards a more sustainable economic model, the announcement of a lower growth target of 7.5 per cent for this year (from 8 per cent previously) and in the current Five-Year plan (7 per cent, from 7.5 per cent previously) provides room for China to support its rebalancing efforts.

In particular, in future, the economy is likely to be characterised by a gradual shift towards greater household consumption, with investment contributing less to growth. This shift is expected to be supported by strong wage and jobs growth and increased spending on social services. However, rebalancing efforts are likely to remain modest without more substantive reforms, particularly within the financial sector. Furthermore, in a transition year for China's political leaders, stability is again likely to take precedence.

The major headwinds to growth in 2012 are likely to stem from the weak external environment and a fragile domestic property sector. Trade outcomes so far this year confirm that it will be a challenging year on the trade front, with growth in exports to the EU especially muted. The property sector has also been weakening under the weight of administrative restrictions on purchases as well as tight credit conditions for developers, posing risks to the overall investment outlook.

Should external or domestic conditions deteriorate, China retains ample capacity to use macroeconomic policy to stimulate growth, although the Chinese Government would be more cautious now in funding stimulus through the banking system. Any further fiscal stimulus, if necessary, would likely be different to the stimulus package of 2009, with a lower weighting on investment and a greater focus on boosting consumption. Monetary policy has already tentatively shifted towards supporting growth. Selective

monetary easing and an increase in credit to relieve stress amongst small and medium-sized enterprises (SMEs) is already underway while the extension of new yuan loans is likely to be somewhat higher than last year, supported by reserve requirement ratio cuts.

While global growth forecasts are for the most part unchanged, risks to the outlook nonetheless remain firmly to the downside. Renewed instability in Europe remains a risk to global financial markets. The debt swap between Greece and its private creditors was finalised without causing any significant negative financial shocks, and the European Commission/IMF/ECB troika signed off on the second Greek bailout package in the first half of March. As welcome as such developments are, further measures need to be taken towards resolving the euro area sovereign debt crisis as fresh fears surrounding the sustainability of Spanish, Italian and Portuguese sovereign debt threaten to derail the progress achieved to date.

The forthcoming Greek elections, scheduled for 6 May, may be another potential flashpoint that could undermine confidence if the newly-elected Greek authorities back away from the agreed reforms that were required to receive funding under the conditions of the second bailout. Further, the recent announcement of an increase in the combined capacity of the European Financial Stability Facility (EFSF) and its successor, the European Stability Mechanism (ESM) to €700 billion is regarded as inadequate to prevent the

contagion that would stem from a re-escalation of the crisis.

A further, nascent risk to the global recovery is the potential for another spike in global oil prices. Tensions have been growing between Iran and the US and EU over embargoes on Iranian oil, with Iran threatening to block the Strait of Hormuz, the key oil shipping channel in the Persian Gulf.

Global oil prices have been drifting upwards recently, although it is difficult to disentangle how much of this reflects political tensions between Iran and the West, and how much reflects other relevant factors. For example, the rise in oil prices seen in 2012 to date may also reflect improving sentiment over US and global economic prospects, and oil supply disruptions in Syria, Yemen and Sudan. Nonetheless, Iran accounts for around 5 per cent of global oil production and exports approximately 2.6 million barrels of oil per day. Accordingly, if tensions escalate, a substantive rise in oil prices is entirely plausible.

Amongst all the downside risks, there is the occasional upside. If activity in the US were to exceed expectations, particularly growth in employment, the large amount of cash currently stockpiled by US banks and corporates could finally find its way into a boost in investment and a virtuous circle of self-sustaining recovery may finally get underway.