ECONOMIC OUTLOOK FOR 2009-10 AND 2010-11

SEPTEMBER 2009

(THIS REPORT INCORPORATES DOMESTIC AND INTERNATIONAL DATA RELEASED UP TO 10 SEPTEMBER 2009)

OVERVIEW

The Australian economy has performed better than expected in recent months. This reflects more robust underlying conditions and a stronger than expected response to the fiscal stimulus and lower interest rates, which have bolstered confidence to a surprising degree. Stronger demand from China has supported Australia's commodity exports, causing our exports to grow despite a global contraction in trade volumes. This has improved the outlook for the mining sector and is expected to flow through to stronger investment outcomes, with a number of larger engineering construction projects now looking more likely to proceed.

World output is now expected to decline by 1¼ per cent in 2009 (previously 1½ per cent), reflecting the contraction that has already taken place during the first half of the year. Growth in 2010 has been revised upwards from 2¼ to 3¼ per cent, with slightly stronger growth expected amongst Australia's major trading partners.

Accordingly, the September round forecasts for the Australian economy have been revised upwards since the June update. Real GDP is now expected to grow by 1¼ per cent in 2009-10, compared to a ¼ per cent contraction forecast in June, while the growth forecast for 2010-11 is a little stronger at 2½ per cent. As a result of the improved outlook, the unemployment rate is now expected to peak at 7 per cent, one percentage point lower than expected in June.

Table 1: Key Domestic Forecasts – September compared with June

	2008-09	2009-10		2010-11	
	Outcome (a)	June	September	June	September
Real GDP (b)	1.0	- 1/4	1 1/4	2 1/4	2 1/2
Nominal GDP (b)	6.1	-1 1/4	3/4	4	5
Employment (b)	1.1	-1	- 1/4	- 1/4	1/2
Unemployment rate (d)	5.7	7 3/4	6 3/4	8	7
CPI (c)	1.5	1 3/4	2 1/4	1 1/2	2
Underlying inflation (c)	3.9	1 3/4	2	1 1/2	2
WPI (b)	4.0	3 1/2	3 1/2	3 1/4	3 1/2
Terms of trade (b)	7.6	-12 1/2	-9 3/4	0	3 1/2

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

Australia has continued to grow despite the global recession and is the only advanced economy to have recorded positive growth through the year to June 2009. After the severe contraction recorded during the December and March quarters, the world economy appears to have stabilised. A recovery is underway in our Asian trading partners, with key regional economies rebounding strongly over the past six months. In particular, China has continued to perform better than expected, with domestic demand supported by aggressive monetary and fiscal policy stimulus. There also appear to be tentative signs of a bottoming in GDP in advanced economies, most notably the United States.

While news on the global economy has improved, conditions are expected to remain weak over the next year (and beyond) as the major advanced economies deal with the legacy of weak financial systems and deleveraging. Challenges therefore remain for the Australian economy. Timely support from macroeconomic stimulus will remain important to maintaining activity until a more sustained recovery in private sector activity takes hold.

The continued strength in Chinese demand has helped support Australia's export volumes, which are now expected to grow by 1½ per cent in 2009-10, compared to a contraction of 2½ per cent forecast in the June update. In particular, demand for non-rural commodities has remained robust, supported by Chinese demand associated with that country's stimulus measures.

The terms of trade are expected to fall by 9¾ per cent in 2009-10, principally reflecting declines in contract prices for bulk commodity exports that are already largely locked in. The fall has been tempered somewhat since the June round by increases in spot commodity prices and the short term effects of a higher Australian dollar. The terms of trade are expected to recover somewhat in 2010-11 as the recovery in world growth bolsters commodity export prices.

The outlook for business investment has improved since June, with recent business surveys suggesting that businesses are becoming increasingly optimistic about their future prospects. However, overall business investment is still expected to contract by 9 per cent in 2009-10 and the outlook is markedly different amongst the different components of investment. Engineering construction is expected to grow strongly in 2010-11 as a number of major resource projects ramp up, most notably the Gorgon Liquefied Natural Gas project. In fact, the potential scale of these projects represents a key upside risk to the broader growth outlook. However, non-residential construction is expected to decline by 23½ per cent in 2009-10 as on-going credit constraints and higher vacancy rates continue to weigh on the sector. Plant and equipment investment is expected to contract as the effects of tax concessions unwind before staging a gradual recovery in line with the recent rebound in business confidence.

The Government's cash payments to households and historically low interest rates have continued to support household consumption. Some near term weakness in household consumption is expected as the impact of the cash payments unwinds. However, robust consumer confidence, a smaller rise in unemployment and the sustained recovery in asset prices should support household consumption through calendar 2010.

The public sector will be an important source of activity in the near term as a range of infrastructure projects associated with the Government's stimulus packages come on line. The forecasts for public sector activity are driven by expected profiles for spending under the stimulus packages, which have been updated on the basis of progress reports from the states and territories and the Office of the Coordinator General. This exercise has suggested some slippage in the expected timing of activity, with more activity from the infrastructure packages now expected to be in the first half of 2010.

The possibility of further slippage in public infrastructure activity is a key risk to the forecasts. The data available to assess the progress of the States and Territories spending in these areas are incomplete. While it is a relatively straightforward task to monitor funds being transferred to the States and Territories, so far it has proven more difficult to translate this to activity 'on the ground'.

The decline in dwelling investment is expected to have bottomed during the June quarter, after which it will contribute to growth. Recent increases in housing finance and building approvals suggest a recovery in this sector is imminent. Increased consumer confidence, low mortgage interest rates and strong population growth all support recovery in this sector. However, downside risks remain, notably the prospect of monetary policy tightening and the withdrawal of the First Home Owners Boost.

Given the stronger outlook, the contraction in employment is expected to bottom in late 2009, with the peak unemployment rate of 7 per cent in the December quarter of 2010. In the current downturn, employers have reacted to lower domestic demand more by reducing hours than shedding jobs. An unwinding in the drop in average hours worked is expected as labour market conditions improve.

Underlying inflation is forecast to be stronger than forecast in the June update in line with a stronger economy, only partially offset by the effect of a higher exchange rate on import prices. Underlying inflation is expected to be 2 per cent through the year to June in both 2009-10 and 2010-11.

Overall, the September round forecasts reflect a more positive outlook than in June. This is in large part due to the continued resilience of the household sector and export volumes, reflecting the success of policy stimulus measures to date - both in Australia and amongst our trading partners. A significant amount of uncertainty remains concerning the sustainability of the global recovery and the degree of strength in underlying demand as policy stimulus is withdrawn.

Moreover, there is a need for caution in interpreting recent outcomes given the conflicting messages evident in the ABS data. The production and income based measures of GDP in the National Accounts suggest the economy contracted over the year to June 2009. The expenditure-based measure suggested the economy grew by nearly 3 per cent. There is therefore the possibility of the starting point for these forecasts looking very different after the ABS has the opportunity to revise the data. The ABS will seek to resolve differences in the various measures of GDP in future National Accounts releases.

Table 2: Domestic economy forecasts[(a)]

	Outcomes (b)	Forecasts			
		Year average		Through the year	
	2008-09	2009-10	2010-11	June 2010	June 2011
Panel A - Demand and output(c)					
Household consumption	1.4	1/2	2 1/4	1/4	2 3/4
Private investment					
Dwellings	-1.9	1 1/2	12	14 1/2	10 1/2
Total business investment(d)	6.7	-9	5 1/2	-8	10
Non-dwelling construction(d)	7.5	-9 1/2	4	-9	13
Machinery and equipment(d)	5.2	-11	7 1/2	-9	10
Private final demand(d)	2.0	-1 1/4	3 1/2	- 3/4	4 3/4
Public final demand(d)	4.6	7 3/4	1/2	8	- 1/4
Total final demand	2.5	3/4	2 3/4	1 1/4	3 3/4
Change in inventories(e)					
Private non-farm	-1.2	1/4	3/4	3/4	1
Farm and public authorities(f)	-0.1	1/4	- 1/4	- 1/4	- 1/4
Gross national expenditure	1.3	1 1/4	3 1/2	2	4 1/2
Exports of goods and services	1.8	1 1/2	4	1 1/2	4
Imports of goods and services	-2.5	1	8 1/2	8 1/2	9
Net exports(e)	1.0	1/4	-1	-1 1/2	-1 1/4
Gross domestic product	1.0	1 1/4	2 1/2	1 1/4	3 1/4
Non-farm product	0.7	1 1/4	2 1/2	3/4	3 1/2
Farm product	13.6	4	0	na	na
Nominal gross domestic product	6.1	3/4	5	3 3/4	5 1/4
Panel B - Other selected economic measures					
External accounts					
Terms of trade	7.6	-9 3/4	3 1/2	3	1 1/2
Current account balance					
$billion	-38.4	-61 1/2	-67 1/4	na	na
Percentage of GDP	-3.2	-5	-5 1/4	-4 1/2	-5 3/4
Labour market					
Employment (labour force survey basis)	1.1	- 1/4	1/2	0	1
Unemployment rate (per cent)(g)	5.0	6 1/4	7	6 3/4	7
Participation rate (per cent)(g)	65.4	65	64 3/4	65	64 3/4
Prices and wages					
Consumer Price Index (h)					
- headline	1.5	1 3/4	2	2 1/4	2
- underlying	3.9	2 3/4	2	2	2
Gross non-farm product deflator	5.4	- 1/2	2 1/2	3	2
Wage Price Index	4.0	3 1/2	3 1/2	3 1/4	3 1/2

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

(b) Calculated using original data.

(c) Chain volume measure.

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

(e) Percentage point contribution to growth in GDP.

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

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

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

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

Outlook for the domestic economy

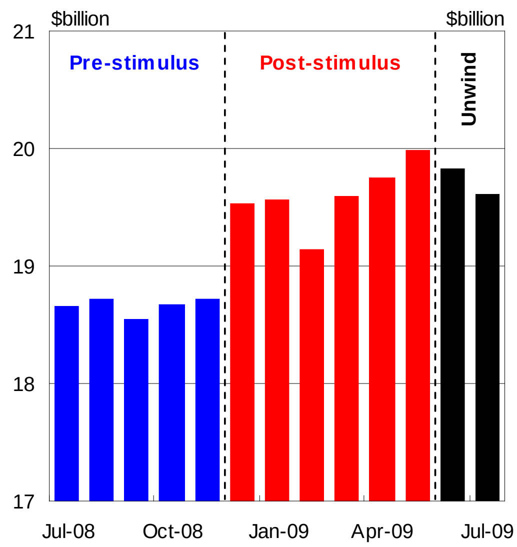
The forecasts for the domestic economy are underpinned by several technical assumptions. The exchange rate is assumed to remain around levels observed at the time the forecasts were prepared (a trade-weighted index of around 66 and a $US exchange rate of around 83c). Interest rates are assumed to rise in line with market expectations over the forecast period. World oil prices (Tapis) are assumed to remain at around $US 78 per barrel. The farm sector forecasts are based on an assumed return to average seasonal conditions over the remainder of forecasting period.

Household consumption

The household sector has remained resilient, despite significant wealth and confidence effects associated with the global downturn. Consumer confidence has improved markedly, supported by the Government's cash payments and sustained low interest rates. The improved outlook for the unemployment rate has also bolstered consumer confidence.

Household consumption grew by a solid 0.8 per cent in the June quarter. However, consumption growth is forecast to be negative in the September quarter, as the effects of the cash payments begin to wane. This is supported by a decline in retail sales figures in June and July.

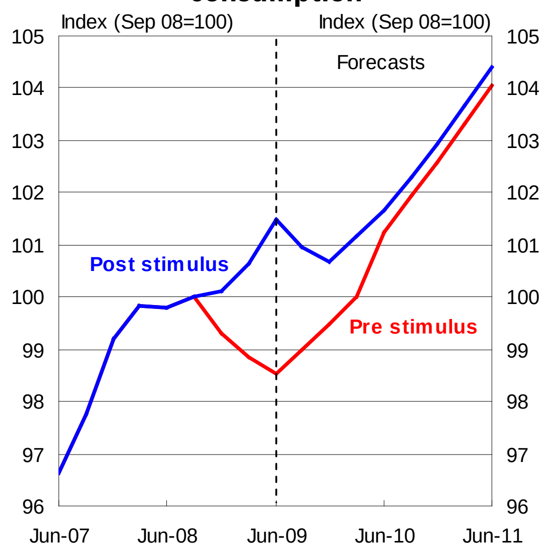
Chart 1: Retail trade



Source: ABS Cat. No. 8501.0.

The outlook for household consumption in 2009-10 is broadly unchanged, with growth forecast to be a subdued ½ a per cent. Household consumption is expected to grow by 2¼ per cent in 2010-11, supported by a more benign outlook for the labour market.

Chart 2: Effect of stimulus on consumption



Source: ABS Cat. No. 5206.0 and Treasury.

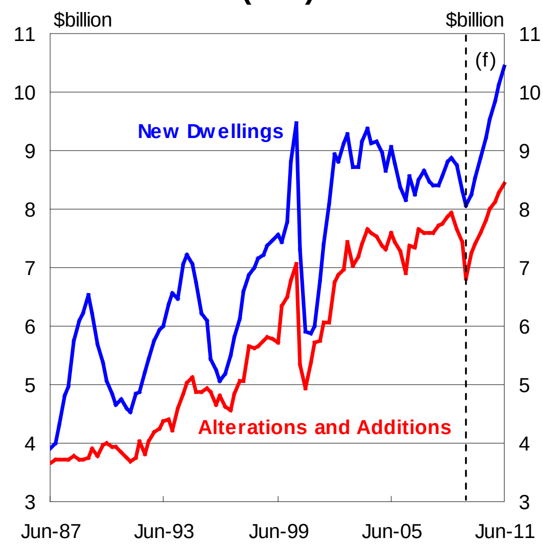
Dwelling investment

The recovery in the dwellings sector appears to be emerging as expected. **House prices** grew by a buoyant 4.2 per cent in the June quarter, the strongest growth since 2007, although this outcome was likely influenced by the temporary effects of the First Home Owners Boost. Recent housing finance and building approvals data imply a recovery in the sector strengthening from the September quarter 2009, with **dwellings investment** forecast to grow 12 per cent in 2010-11.

The imminent recovery in the sector will be supported by improved household confidence, low mortgage interest rates and the more benign unemployment outlook. In addition, longer term fundamentals, such as strong **population growth** and high rental yields are also expected to support growth.

Despite the upbeat outlook for the sector, pockets of weakness remain. On-going credit constraints, particularly for medium and high density developments, continue to weigh on the sector. In addition, the prospect of higher interest rates could also moderate the recovery in dwelling investment in 2010-11.

Chart 3: Private Dwelling investment (real)



Source: ABS Cat. No. 5206.0 and Treasury.

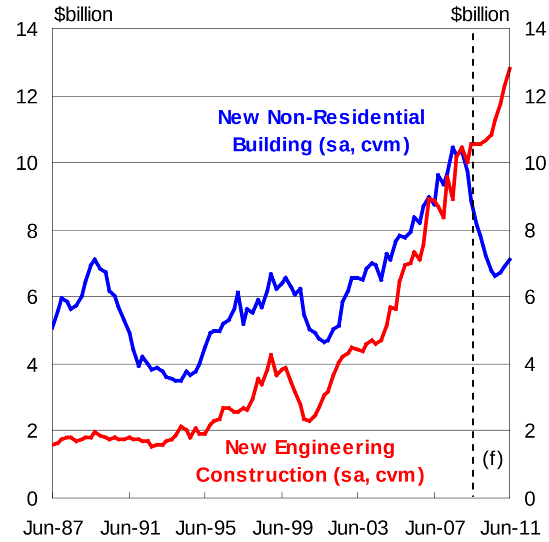
Business investment

On balance, the outlook for business investment has improved, in line with better than expected domestic conditions and the improved outlook for the mining sector. However, the outlook is markedly different for each component of investment.

Business conditions and sentiment have rebounded strongly from their lows over recent months. Business surveys have indicated some improvements in investment intentions although it takes time for improvements in sentiment to translate into activity. Continued weakness is expected for the remainder of calendar 2009.

Total new business investment is expected to post a smaller than expected decline of 9 per cent in 2009-10 before recovering in 2010-11 to grow by 5½ per cent.

Chart 4: New non-residential building and engineering construction



Source: ABS Cat. No. 5206.0 and Treasury.

The outlook for **engineering construction** investment has improved significantly on the back of a stronger outlook for commodities. This stronger outlook is underpinned by the increasing number of large resources projects that are now more likely to proceed.

New engineering construction is expected to increase by 3½ per cent in 2009-10, followed by a strong increase of 13 per cent in 2010-11, supported by a handful of high value projects in the oil and gas sectors beginning to ramp up construction, including the Gorgon LNG project.

There are clear risks to these forecasts as there remains uncertainty surrounding the precise timing of these major projects over the next few years.

Forecast investment in **new machinery and equipment** is marginally stronger than the June update. Investment is expected to decrease by 11 per cent in 2009-10, reflecting subdued domestic demand and the staged withdrawal of the Small Business and General Business Tax Break. Investment is expected to rebound strongly in 2010-11 by 7½ per cent, supported by the improved outlook for corporate profits and the domestic and international economies.

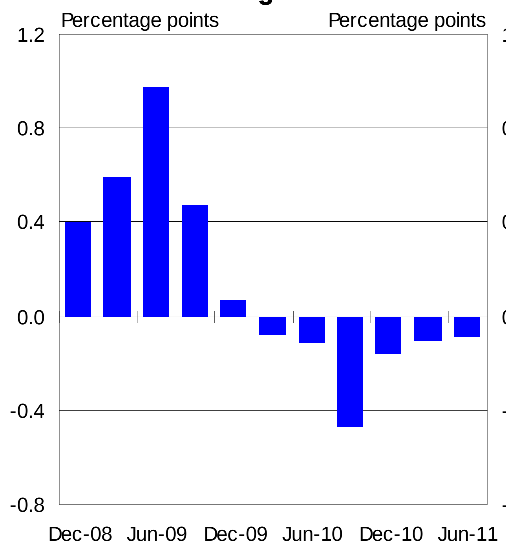
The outlook for **non-residential building** investment remains depressed. A combination of weak private sector building approvals and on-going credit constraints continues to weigh on activity. In addition, new supply being completed over the next two years is expected to push up vacancy rates, further depressing investment. As a result, non-residential building activity is expected to plunge by 23½ per cent in 2009-10 and by a further 9 per cent in 2010-11.

Public final demand

Public final demand is expected to grow strongly in 2009-10, as the direct spending under the Government's stimulus packages ramps up. New public final demand is expected to grow by 7¾ per cent in 2009-10 and by ½ of a per cent in 2010-11, slightly higher than in the June update.

As illustrated by Chart 5, the withdrawal of the packages is expected to *detract* from growth from the March quarter of 2010 onwards, as private sector activity begins to contribute to growth. However, the packages will remain important to supporting the overall *level* of activity in the economy.

Chart 5: Contribution of fiscal stimulus to GDP growth



Source: ABS Cat. No 5206.0 and Treasury.

The expected stimulus profile is based on updated information received from the states and territories and the Office of the Coordinator-General about activity under the major infrastructure programs. This exercise has suggested some slippage in the expected timing of activity, with more activity from the infrastructure packages now expected to be in the first half of 2010. There remains a risk of further slippage in infrastructure activity, which could result in some of this investment occurring when private activity has already begun to recover, putting upwards pressure on labour and capital costs.

Exports, imports and the current account deficit

Export volumes are continuing to perform better than anticipated, driven by stronger demand for Australia's bulk commodities such as iron ore and coal.

Total export volumes are now expected to grow modestly, rather than contract, in 2009-10, before strengthening in 2010-11 to grow by 4 per cent, reflecting the anticipated recovery in the global economy.

Non-rural commodities are expected to grow by 3 per cent in 2009-10, a reversal from the contraction expected in the June update, reflecting a stronger outlook for world commodity demand and an expected increase in Australian iron ore production capacity. Strong growth is also forecast for 2010-11.

Commodity demand has continued to hold up, driven by infrastructure investment under the Chinese government's stimulus package. Further, lower prices for iron ore and coal as well as concerns about mine safety, have led to closures of some Chinese mines, driving a number of Chinese steel producers to switch to lower-cost Australian coal and iron ore. Steel production in the rest of the world is also beginning to show signs of recovery.

Farm production is forecast to grow by 4 per cent in 2009-10, with rural exports growing strongly due to better than expected rainfall patterns in some areas.

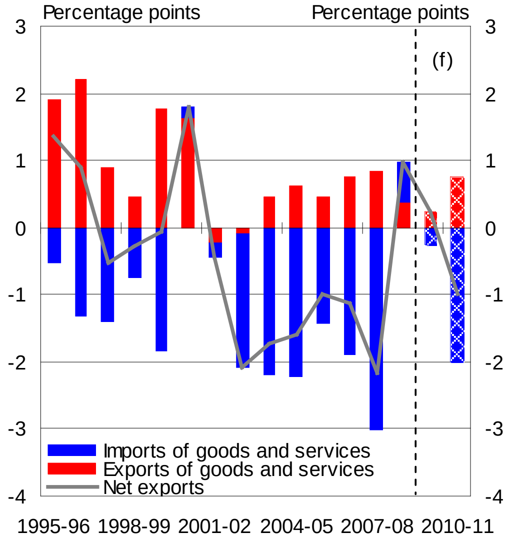
Stronger world growth, coupled with a higher Australian dollar, provides a mixed outlook for **elaborately transformed manufactures** (ETM) and **services** exports. ETM exports are expected to contract by 11½ per cent in 2009-10. Services exports are expected to decline by 1 per cent in 2009-10. Services exports have held up better than expected, in part due to on-going strength in education exports to China and India. However, weakness in the inbound tourist market is expected to lead to a fall in services exports.

Strengthening global growth is expected to lead to a gradual recovery in ETM and services exports in 2010-11.

Imports of goods and services are expected to rise by 1 per cent in 2009-10 and 8½ per cent in 2010-11, reflecting a higher Australian dollar, inventory rebuilding and broad strength in private sector demand going forward. These factors are expected to drive growth in both capital and consumption goods imports.

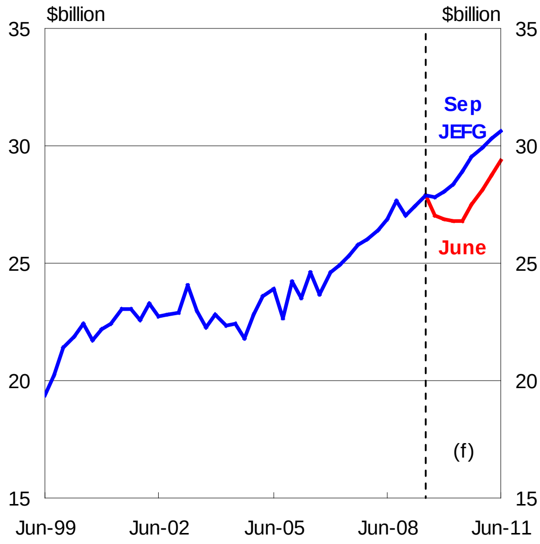
Net exports are expected to contribute ¼ of a percentage point to GDP growth in 2009-10, lower than at June, in line with stronger import volumes. Net exports are expected to detract 1 percentage point from growth in 2010-11 as import volumes recover faster than export volumes.

Chart 6: Net exports – contribution to GDP growth



Source: ABS Cat. No. 5206.0 and Treasury.

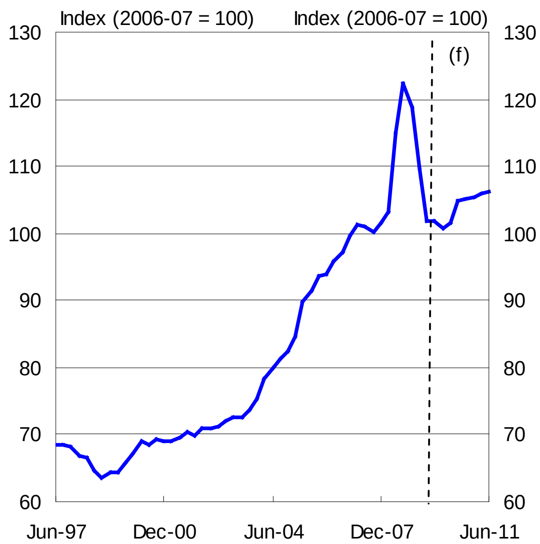
Chart 7: Non-rural commodities (CVM)



Source: ABS Cat. No. 5206.0 and Treasury.

The **terms of trade** are forecast to decrease by 9¾ per cent in 2009-10, a smaller fall than expected at June – largely due to the appreciation of the Australian dollar and higher spot commodity prices. Contract prices for Australia's bulk commodities such as iron ore and coal have fallen in line with our expectations. The terms of trade are forecast to increase by 3½ in 2010-11 as coal and iron ore contract prices increase in line with growing world demand.

Chart 8: Terms of Trade

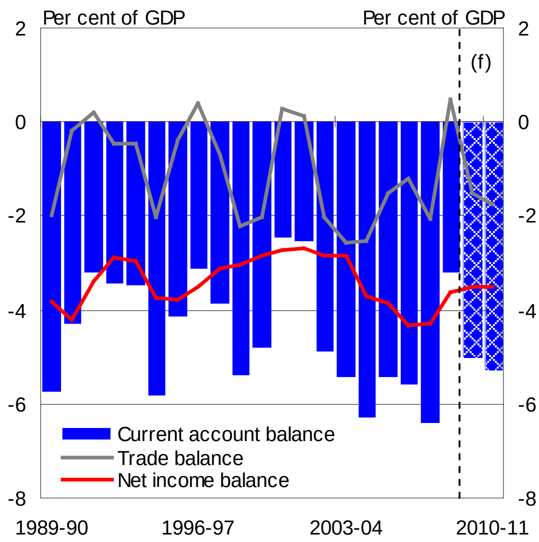


Source: ABS Cat. No. 5206.0 and Treasury.

The forecast for the **current account deficit** (CAD) has increased since June to 5 per cent of GDP in 2009-10, before widening to

5¼ per cent in 2010-11. The 2009-10 trade balance forecast is marginally narrower than in the June update, with a slight widening in the trade deficit expected in 2010-11, in line with stronger imports. The **net income deficit** (NID) is expected to be 3½ per cent of GDP in 2009-10, larger than forecast at June, driven by an increase in both the net equity and net debt income deficits since the June update. This reflects a smaller than previously expected fall in equity income paid to foreigners and a larger than previously expected debt liability stock.

Chart 9: Current Account Deficit



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

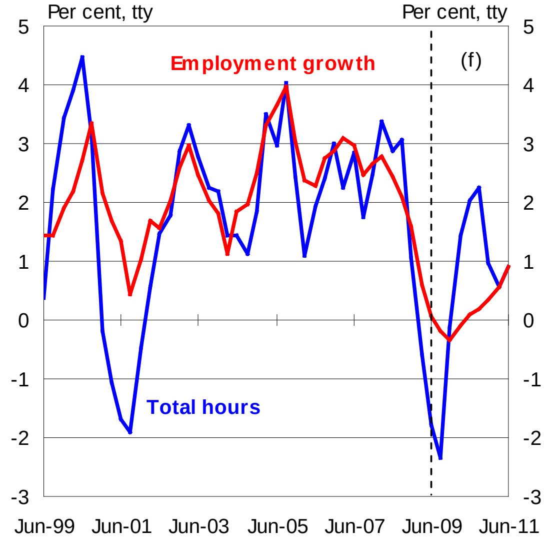
Employment, wages and inflation

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

Employment growth is expected to remain flat through the year to the June quarter 2010, which is considerably stronger than the 1½ per cent contraction forecast at the June update. In through-the-year terms, the contraction in employment is now expected to bottom in late 2009. This would amount to a considerably smaller fall in employment than in previous downturns.

In the current downturn, many employers appear to have reduced staff working hours in many cases in preference to job shedding. Indeed, the recent fall in total hours has been significant, and is greater than implied by recent GDP outcomes. The fall in average hours is expected to be reversed over the forecast period.

Chart 10: Employment growth and total hours (sa)



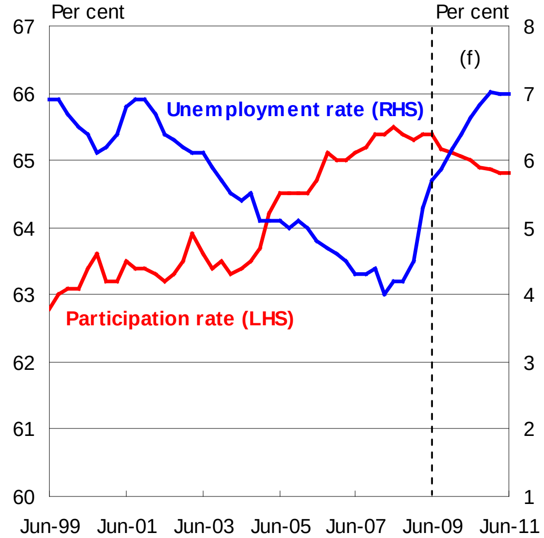
Source: ABS Cat. No 6202.0 and Treasury.

A more moderate deterioration in employment is expected to result in a lower peak unemployment rate than forecast in the June update. The **unemployment rate** is expected to rise to 6¾ per cent by the June quarter 2010 before peaking at 7 per cent in December quarter 2010. This is a more subdued rise than the peak of 8 per cent in March 2011 forecast in the June update.

After reaching all-time highs in 2008, the **participation rate is** beginning to moderate, although somewhat less sharply than envisaged in the June update. In line with the better outlook for the labour market, fewer discouraged workers are likely to leave the labour force and demand for overseas workers may not fall as sharply as expected in June.

The participation rate is forecast to reach 65 per cent in the June quarter 2010 before falling to 64¾ per cent in the June quarter 2011, slightly higher than forecast in the June update.

Chart 11: Unemployment and Participation Rates (sa)



Source: ABS Cat. No. 6202.0 and Treasury.

The outlook for wages growth is stronger than was expected at June, in line with the resilience of the Australian labour market and wider economy.

The National Accounts measure of **Average Weekly Earnings** fell in both the March and June quarters. These unexpectedly strong declines were likely driven by declining average hours worked and cuts in bonuses.

The near term outlook for average weekly earnings is lower than forecast in the June update. However, as the recovery takes hold and average hours recover, average weekly earnings are expected to grow faster than envisaged in the June update from mid 2010.

The **Wage Price Index** is expected to grow by 3¼ per cent and 3½ per cent through the year to the June quarters of 2010 and 2011, reflecting a slight revision from June update forecasts of 3¼ per cent for both years.

Underlying inflation is forecast to be stronger than forecast in the June update in line with a stronger economy, only partially offset by the effect of a higher exchange rate on import prices. Underlying inflation is expected to be 2 per cent through the year to June in both 2009-10 and 2010-11. Headline inflation is expected to be a little stronger than underlying inflation in 2009-10, reflecting higher oil prices, rising to 2¼ per cent through the year to June 2010.

SEPTEMBER 2009 ROUND: OUTLOOK FOR THE INTERNATIONAL ECONOMY

Table 1: International GDP growth forecasts[a]

	2008	2009		2010		2011	
	Actual	June	Sept	June	Sept	June	Sept
United States	0.4	-3	-2 3/4	1/4	1 1/4	1 3/4	1 3/4
Euro Area	0.7	-4 3/4	-4	0	1/2	1 1/4	1 1/4
Japan	-0.7	-6 3/4	-5 3/4	1 1/2	1 1/2	3/4	1
China	9.0	6 3/4	8	8 1/4	9 1/4	8 1/2	9 1/2
India	7.3	4 3/4	5 1/2	5 1/4	6	6 1/4	6 1/4
Other East Asia [b]	2.6	-4 1/4	-2 1/4	2	3 1/2	3 1/4	4 1/4
Major Trading Partners	2.6	-2 1/4	-1 1/4	2 3/4	3 1/2	3 1/4	3 3/4
World	3.0	-1 1/2	-1 1/4	2 1/4	3 1/4	3 1/2	3 1/2

(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

A stabilisation in financial markets, and better than expected economic data, suggest that the worst of the global recession may have passed. A number of economies returned to growth in the June quarter. In addition, partial indicators, including industrial production, trade and confidence have rebounded from their lows.

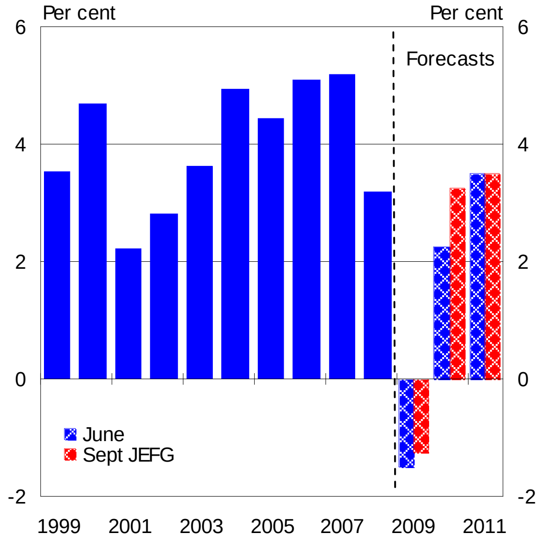
The upturn in activity in the June quarter varied across regions with the rebound in the emerging economies of Asia stronger than in the advanced economies. The outlook, however, remains uncertain and reliant on the ongoing implementation of extensive macroeconomic stimulus. An expected upturn in the inventory cycle is expected to support activity in 2010. Recovery in the longer term is contingent upon a sustained recovery in private demand supporting growth as the contribution from the public sector stimulus fades.

There has been a marked improvement in financial market conditions since early March 2009. Global equity markets have rebounded strongly, albeit from very depressed levels and credit spreads have narrowed significantly, reflecting both a perceived decline in system-wide risks and expectations of a global recovery.

Improved investor sentiment has seen wholesale funding markets reopen, allowing systemically-important financial institutions to raise significant amounts of new capital. Overall, the degree of stress in the world's key financial systems has fallen to the lowest levels since mid-2007.

Against this backdrop, world GDP is now estimated to contract by 1¼ per cent in 2009, a slight upward revision from the June forecast, but still the first annual contraction in six decades (Chart 1). Growth forecasts for 2009 have been upgraded across all economies (Table 1).

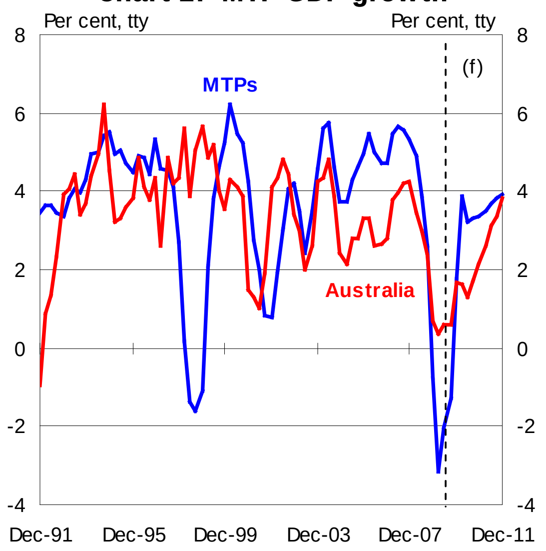
Chart 1: World GDP growth



Source: IMF and Treasury.

As a group, Australia's major trading partners are expected to contract by 1¼ per cent in 2009, a one percentage point upgrade from June largely reflecting the stronger outlook for key East Asian trading partners (Chart 2).

Chart 2: MTP GDP growth



Source: IMF and Treasury.

Deep contractions are forecast this year in the US, Euro area and Japan. Trade dependent economies of East Asia recorded the steepest declines in GDP as trade flows collapsed. Equally these same economies have bounced back the most rapidly. While China and India's growth has been revised up, they will still be at below-trend pace. In some other emerging economies, growth will be impeded by a combination of still weak external demand and the need for structural reforms to increase the contribution of domestic activity and decrease their reliance on external demand.

The massive macroeconomic stimulus, both monetary and fiscal, as well as measures to shore up bank balance sheets and restore credit flows should help the global economy continue to gradually recover in 2010.

However, any self-sustaining recovery is conditional on the continued stability of financial conditions, a restoration of global trade flows and improved confidence. Deleveraging by both firms and households will continue, which together with rising unemployment will act as a continued drag on economic growth.

Risks

A number of the upside risks identified in June — improved stability in financial markets and rapid response to fiscal stimulus, especially in Asia — have materialised, underpinning the near-term rebound. Over the medium to longer term a number of large risks remain around getting the global economy onto a sustainable growth path.

Much of the rebound in the first half of 2009 can be attributed to the large amount of stimulus around the world. However, over the longer term, fiscal constraints, especially in advanced economies, and the potential for a build up of inflationary pressures as output gaps narrow mean that fiscal stimulus needs to be withdrawn. The timing of fiscal consolidation will be a crucial factor affecting the outlook. If stimulus is withdrawn too early, before private sector demand becomes self-sustaining, this would provide a setback to the recovery. If it occurred too late, it would risk an even bigger public debt burden, the crowding out of private sector spending and inflation pressures.

An associated risk is that the high level of stimulus goes into speculative activity that leads to asset price bubbles, especially in Asia. Also as global growth recovers there is the risk of further sharp rises in commodity prices impacting on costs of production and public finances.

As deleveraging results in increased savings rates in advanced economies, the strength and sustainability of the global recovery depends on a successful rebalancing of demand between emerging and advanced economies. This is a key long term challenge facing the world economy and one on which the G20 has an important role to play by helping coordinate policy actions across the world's major economies.

Significant risks to financial stability remain over both the short and medium term. Most immediately, rising default rates amongst household and corporate borrowers combined with the ongoing likelihood of write-downs will continue to place pressure on bank balance sheets in the US and Europe.

There is still the downside risk of a possible re-intensification of the negative feedback loop between the real economy and the financial system that could undermine the recovery.

Looking further ahead, the means and speed with which the public interventions in financial markets are withdrawn entails significant risks to financial stability over the medium term. Financial systems remain susceptible to sharp reversals in sentiment, and a premature — or poorly coordinated — withdrawal of public support risks sparking a secondary crisis. Conversely, leaving support mechanisms in place for too long risks creating fertile conditions for future crises.

Evidence of drought in India and Southeast Asia has the potential to undermine the important agricultural sectors in these economies, and to impact negatively on consumption, detracting from growth in 2009 and 2010.

Country summaries

The improved outlook for the **United States** reflects the faster than expected stabilisation in financial and housing market conditions and a more moderate rate of decline in investment. Additionally, a turn in the inventory cycle is likely to provide support to growth in the near term, augmenting the boost provided by the fiscal stimulus package. Accordingly, forecasts for 2009 and 2010 have been revised up to -2¾ per cent and 1¼ per cent (up ¼ and 1 percentage point respectively).

Nevertheless, the recovery in the US economy is still expected to be sluggish and protracted compared to past recessions. In particular, the underlying weakness in consumer spending — by far the largest component of GDP — is likely to continue to weigh on growth. Household spending is expected to remain constrained in light of recent shocks to incomes, confidence and wealth. Tight credit conditions and protracted labour market weakness are also likely to add to the frail outlook for consumption. However, consumer spending could be firmer than anticipated if the incipient recovery in house prices supplements the boost to confidence likely to flow from the policy-aided macroeconomic stabilisation.

The most significant downside risk is that private demand will not recover sufficiently to support the economy as the impact of the fiscal stimulus package wanes from mid-2010. The extent of the recovery in private demand, and the timeliness and success of the withdrawal of other extraordinary policy measures, including Federal Reserve interventions, will be a key determinant of the outlook in 2010 and beyond.

The outlook for **China** has improved considerably since June. A substantial boost to domestic demand, driven by aggressive monetary and fiscal stimulus, contributed to a very strong GDP outcome for the June quarter. The Chinese economy is now forecast to grow by 8 per cent in 2009 (up from 6¾ per cent in June), accelerating to 9¼ per cent in 2010 and 9½ per cent in 2011.

China's stimulus has boosted the economy both sooner and more strongly than expected. Record high loan growth has supported a substantial increase in fixed asset investment, particularly by state owned enterprises. Infrastructure related investment is expected to be the main driver of growth over the forecast period, with private sector investment expected to make a modest recovery as fiscal stimulus winds down in late 2010. Consumption growth has remained relatively stable and is expected to remain so over the forecast horizon, while export performance is expected to improve, but remain subdued, as the outlook for China's major trading partners gradually strengthens.

The loosening of monetary policy and the injection of liquidity into the financial sector has raised potential risks to China's growth: excess liquidity has increased the risk of unproductive investments, non performing loans and asset price bubbles; and there is concern that China's private sector will not recover sufficiently to sustain solid economic growth once stimulus winds down. Weaker than expected global demand also continues to be a downside risk to growth, with China's export growth likely to remain modest, even into 2011.

The **Japanese** economy is showing some signs of recovery. Industrial production and exports have continued to pick up, due in part to demand for Japanese exports from China and the Newly Industrialised Economies of East Asia. Production has also been supported somewhat by a boost to domestic sales from both the preferential tax treatment for environmentally-friendly cars and the government's 'eco-points' system.

Despite these improvements, business investment is likely to remain depressed, as profits have plummeted and firms are saddled with excess capacity. Public investment, on the other hand, has increased as fiscal stimulus continues to be rolled out. These stimulus measures have provided some support to consumption, although consumption will be constrained by the unemployment rate reaching a record high and incomes being severely curtailed.

Forecasts for Japan have been revised upward. The economy is expected to contract by 5¾ per cent in 2009, before returning to growth of 1½ per cent in 2010 and 1 per cent in 2011, supported by sizeable fiscal stimulus and a modest increase in exports. Significant downside risks to the outlook remain, including the external environment, weak private demand amid negative wealth effects from a worsening employment situation and curtailed incomes, excess capacity, and deflation. Any recovery is from a very low base, and will be weak and prolonged.

Growth in the **Newly Industrialised Economies (NIEs)** weakened sharply over the second half of 2008. The contraction continued into the March quarter 2009, with Taiwan and Singapore reporting double digit declines in through the year GDP growth. While June quarter 2009 outturns were a significant improvement from the March quarter, there are a number of risks to the outlook.

Despite aggressive fiscal stimulus and monetary easing, weak export growth and a slow expansion in domestic demand will lead to GDP in the NIEs declining by a forecast 3 per cent in 2009, before accelerating to 3 per cent growth in 2010 and 4 per cent in 2011.

The recovery in the NIEs will be heavily influenced by China's performance, but will ultimately depend on the pace of recovery in private demand domestically and in the advanced economies, particularly the US and the Euro zone. Other obstacles to the recovery include the potential for oil prices to increase and the timing and design of government exit strategies that are adding uncertainty to the economic outlook.

The **Indian** economy remains resilient with growth of 5½ per cent forecast for 2009 and 6 per cent for 2010. Industrial production appears to have recovered as demand for India's manufacturing exports has stabilised. India's vast services sector, having provided strong support to growth in recent years, will also continue to put a floor under domestic demand. Agriculture, which accounts for around 20 per cent of GDP, remains the key risk to the outlook. With more than half of the country now in drought, agricultural output will be substantially lower in the second half of 2009 and possibly into 2010.

Although the authorities have so far responded to falling growth with timely and substantial expansionary fiscal and monetary policy, their capacity to provide further policy support remains very limited. Debt levels are high and renewed inflationary pressures resulting from food scarcity will limit further monetary policy loosening. India also continues to suffer from reduced foreign capital flows, a significant driver of investment growth in recent years. These factors will see India struggle to return to more rapid, pre-crisis rates of growth in the medium term. In 2011, growth is expected to continue at a relatively modest rate of 6¼ per cent.

Economic activity in the **ASEAN-5** region has begun to show signs of stabilisation as improved consumption, supported by accommodative monetary policy and discretionary fiscal support, led to positive June quarter GDP outturns across the region.

GDP for the ASEAN-5 is forecast to decline by ¼ of a per cent in 2009, before rebounding to 4½ per cent in 2010 and 2011.

Despite encouraging signs that a recovery is underway, downside risks to the outlook remain. These risks reflect the region's reliance on trade and sustained higher commodity prices. On the upside, accommodative monetary policy and discretionary fiscal support should continue to provide impetus to growth in the second half of 2009 and the first half of 2010, while a recovery of capital inflows and easing of financial market constraints should lend support to investment.

The improved **euro area** economic outlook also reflects a rebound in confidence in most sectors and countries, and stabilisation in the manufacturing sector given increased global demand and trade. Accommodative monetary and fiscal policy combined with the progressive ending of the destocking process has also contributed to the improved short term outlook. As such, the 2009 forecast for the euro area has been revised up to a contraction of 4 per cent.

However, major headwinds to economic growth remain. Financial and monetary conditions remain tight and rising unemployment rates and negative wealth effects are likely to continue to depress private consumption, despite low price pressure supporting household incomes. Also, given necessary corporate balance sheet adjustments, record low capacity utilisation rates and still weak demand, investment is expected to continue to drag on growth in the near term. However, positive growth in emerging economies and fading financial market tensions should support a modest recovery in 2010, with GDP growth of ½ per cent.

Growth prospects for the **United Kingdom** have also improved, with GDP expected to grow in the second half of 2009, largely due to a turn in the inventory cycle. However, the recovery is expected to be weak and protracted as growth is held back by tight credit conditions as banks repair their balance sheets. Past falls in asset prices, and high levels of public and private debt, along with the eventual need to unwind the large policy stimulus currently in place will also weigh on the recovery. GDP is forecast to contract by 4½ per cent in 2009, before recording modest growth of ¾ of a per cent in 2010.

The outlook for **New Zealand** has improved slightly in recent months. China is playing an important role with its strong demand for New Zealand's exports. The recent appreciation of the New Zealand dollar is however, a downside risk, as is increasing unemployment which will constrain private consumption.

Looking ahead to 2010, the resurgence in New Zealand's exports is going to be heavily influenced by the movement in dairy prices. Strong net migration to New Zealand in 2009 has boosted the underlying demand for housing and is likely to support a recovery in residential investment.