

# **ECONOMIC OUTLOOK FOR 2010-11 AND 2011-12**

**SEPTEMBER 2010**

**(THIS REPORT INCORPORATES DOMESTIC AND INTERNATIONAL DATA RELEASED UP TO  
17 SEPTEMBER 2010)**

<b>Overview .....</b>	<b>3</b>
<i>Household consumption .....</i>	6
<i>Dwelling investment .....</i>	7
<i>Business investment .....</i>	7
<i>Public final demand .....</i>	8
<i>Exports, imports and the current account deficit .....</i>	9
<i>Employment, wages and inflation .....</i>	11
<b>Outlook for the international economy .....</b>	<b>13</b>
<i>World outlook .....</i>	13
<i>Country summaries .....</i>	14

## OVERVIEW

The outlook for the Australian economy remains robust over the forecast horizon, consistent with the forecasts released in the 2010 Pre-Election Economic and Fiscal Outlook (PEFO). In the June quarter of 2010, GDP grew 1.2 per cent, to be 3.3 per cent higher through the year. The strength of the quarterly result provides further evidence that a broad-based self-sustaining private sector recovery is gathering momentum as fiscal and monetary stimulus are withdrawn.

**Table 1: Key Domestic Forecasts – September compared with June**

	2009-10	2010-11		2011-12	
	Outcome (a)	June	September	June	September
Real GDP (b)	2.3	3	3 1/2	3 3/4	3 3/4
Nominal GDP (b)	3.6	9 1/4	9 1/4	4 3/4	5
Employment (b)	1.4	2 3/4	2 3/4	2	2
Unemployment rate (c)	5.2	5	4 3/4	4 3/4	4 1/2
CPI (d)	3.1	2 3/4	2 3/4	2 3/4	3
Underlying inflation (d)	2.7	2 3/4	2 3/4	2 3/4	3
WPI (b)	3.1	3 3/4	3 1/2	4	4
Terms of trade (b)	-1.0	16	16	-6 1/2	-4

(a) Calculated using original data.

(b) Year average.

(c) June quarter.

(d) Through-the-year growth rate to the June quarter.

Real GDP is forecast to grow at a little above trend over the next two years - 3½ per cent in 2010-11 (½ of a percentage point higher than in the June informal round, 'June') and 3¾ per cent in 2011-12 (unchanged from June). The upward revision to 2010-11 reflects stronger business investment intentions, and robust income growth, supporting stronger growth in household consumption.

The terms of trade are expected to reach their highest level on record in 2010-11, underpinned by high prices for Australia's bulk non-rural commodity exports. This will drive buoyant income growth, with nominal GDP forecast to grow by 9¼ per cent in 2010-11, the fastest pace in two decades. However, the rise in the terms of trade in 2010-11 is a little lower than at PEFO, with December quarter 2010 iron ore and metallurgical coal contracts settled below September quarter contract prices and rising supply expected to place further downward pressure on prices in the period ahead.

Solid growth in employment and wages, recent increases in household wealth from rising asset prices and high levels of consumer confidence are expected to result in above-trend consumption growth over the next two years, but with the household savings ratio expected to remain higher than observed prior to the crisis. However, the outlook for the dwellings sector has been revised down, given recent weakness in housing finance and approvals data and supply constraints in the sector which appear to be constraining construction activity.

Substantial downside risks continue to cloud the global outlook, with an increasing divergence between sluggish growth in large advanced economies, compared with the remarkable strength amongst our major trading partners (MTPs) in non-Japan Asia. While world growth is expected to remain above 4 per cent over the forecast horizon, there have been increasing fears of a 'double-dip' recession in the United States, weaker growth in Japan and downside risks in China as the Chinese authorities attempt to engineer a return to more sustainable growth rates. A key uncertainty is

whether our Asian trading partners can sustain their recent performance in coming years if, as expected, growth rates in much of the developed world remain anaemic for an extended period.

Ongoing strong demand from Asia for Australia's non-rural commodities is expected to drive solid export growth in both 2010-11 and 2011-12. Exports in 2010-11 are expected to be stronger than at June, reflecting an improved outlook for both rural and non-rural commodities, partially offset by weaker growth in exports of services and manufactured goods due to the higher exchange rate and downward revision to MTP growth. A stronger exchange rate and increasing business investment is expected to lift imports growth in 2010-11 compared with June. As such, net exports are expected to detract  $\frac{3}{4}$  of a percentage point from GDP growth in both 2010-11 and 2011-12.

The current account deficit (CAD) is forecast to narrow to  $2\frac{1}{2}$  per cent of GDP in 2010-11, around  $\frac{3}{4}$  of a percentage point lower than at June. The CAD is then expected to widen to 4 per cent of GDP in 2011-12 as prices for Australia's non-rural commodity exports decline.

The outlook for business investment remains strong. In particular, the rapid growth in mining profits supports strong capital expenditure intentions, with business investment expected to return to around previous highs as a proportion of GDP. In particular, engineering construction is expected to grow by a strong  $16\frac{1}{2}$  per cent in 2010-11 and 21 per cent in 2011-12, underpinned by the commencement of several large projects in the Liquefied Natural Gas (LNG) sector. The strength in the mining sector is expected to drive higher levels of investment in new machinery and equipment into 2011-12. By contrast, non-residential construction activity is forecast to remain subdued, given high office vacancy rates and the phase-down of the Building the Education Revolution (BER) program.

Consistent with the strong outlook for activity, employment growth is expected to remain solid over the forecast horizon, driving the unemployment rate down to  $4\frac{3}{4}$  in the June quarter of 2011 and  $4\frac{1}{2}$  per cent in the June quarter of 2012, a  $\frac{1}{4}$  of a percentage point lower than at June. As the labour market tightens, wages growth is expected to pick up, with through the year growth in the Wage Price Index expected to reach 4 per cent by the end of the forecast horizon.

The forecast strength in domestic demand, a buoyant labour market, and expected increases in administered prices have led to an upward revision to the inflation forecasts compared with June. Both the headline and underlying measures of inflation are expected to reach 3 per cent by June 2012 as the economy reaches full employment and capacity constraints become more pronounced.

While the central case is for Australia to continue its robust growth trajectory, there are some key risks to the outlook. A realisation of the abovementioned risks to the global economic recovery would weigh on Australia's growth outlook. Moreover, our forecasts for the terms of trade and income growth are heavily influenced by the prices of a small set of bulk commodities that are highly volatile and currently trading at historically high levels. A large unforeseen decline in key commodities prices would have major negative implications for national income and flow-on effects throughout the broader economy.

On the other hand, the strength of national income associated with an historically high terms of trade, combined with the substantial investment taking place in the mining sector, could lead to substantial capacity constraints and price pressures in the broader economy, with potential implications for interest rates. Similarly, further appreciation of the Australian dollar would place trade-exposed industries outside of the mining sector under additional strain.

**Table 2 – Domestic economy forecasts**

	Outcomes (a)			Forecasts			Outcomes (b)			Forecasts		
	Year average			Through the year								
	2009-10	2010-11	2011-12	June 2010	June 2011	June 2012	June 2010	June 2011	June 2012	June 2010	June 2011	June 2012
<b>Panel A - Demand and output(c)</b>												
Household consumption	2.7	3 3/4	3 1/2	3.2	3 1/2	3 1/2						
Private investment												
Dwellings	1.7	4 1/2	3	11.3	3 1/2	2 1/2						
Total business investment(d)	-2.8	8 1/2	13	0.0	14	12 1/2						
Non-dwelling construction(d)	-6.5	8	13 1/2	-3.7	12	14						
Machinery and equipment(d)	-3.1	8	15	0.1	18	12 1/2						
Private final demand(d)	1.5	4 3/4	5 3/4	2.9	5 1/2	5 1/2						
Public final demand(d)	9.5	1 1/2	- 1/4	13.5	-4 1/2	2 3/4						
Total final demand	3.3	4	4 1/4	5.3	3 1/4	5						
Change in inventories(e)	0.6	0	0	na	na	na						
Gross national expenditure	3.9	4	4 1/4	5.8	3 1/2	5						
Exports of goods and services	1.8	7 1/2	5	4.7	6	3 1/2						
Imports of goods and services	5.4	10 1/2	8	17.3	8	7 1/2						
Net exports(e)	-0.8	- 3/4	- 3/4	-2.5	- 1/2	-1						
Gross domestic product	2.3	3 1/2	3 3/4	3.3	3	4						
Non-farm product	2.3	3 1/4	4	3.3	2 3/4	4 1/2						
Farm product	1.1	10	-6	na	na	na						
Nominal gross domestic product	3.6	9 1/4	5	10.0	6 1/2	5 1/4						
<b>Panel B - Other selected economic measures</b>												
External accounts												
Terms of trade	-1.0	16	-4	24.5	2 1/4	-5 1/4						
Current account balance												
\$billion	-56.1	-34 1/2	-60 1/4	na	na	na						
Percentage of GDP(f)	-4.3	-2 1/2	-4	-1.7	-2 1/2	-4 3/4						
Labour market												
Employment (labour force survey basis)	1.4	2 3/4	2	2.4	2 1/2	2						
Unemployment rate (per cent)(f)	5.5	5	4 3/4	5.2	4 3/4	4 1/2						
Participation rate (per cent)(f)	65.3	65 1/2	65 1/2	65.3	65 1/2	65 1/2						
Prices and wages												
Consumer Price Index												
- headline	2.3	3	2 3/4	3.1	2 3/4	3						
- underlying	3.1	2 1/2	2 3/4	2.7	2 3/4	3						
Gross non-farm product deflator	1.5	5 3/4	1 1/4	6.9	3 1/2	1						
Wage Price Index	3.1	3 1/2	4	3.0	3 3/4	4						

(a) Calculated using original data unless otherwise specified.

(b) Calculated using seasonally adjusted data unless otherwise specified.

(c) Chain volume measure, except for nominal GDP.

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

(e) Percentage point contribution to growth in GDP.

(f) The outcomes and forecasts in the final three columns are the growth rates in the June quarter in 2010, 2011 & 2012 respectively.

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

## Outlook for the domestic economy

The forecasts for the domestic economy are underpinned by several technical assumptions. The exchange rate is assumed to remain around levels at the time the forecasts were prepared (a trade-weighted index of around 71 and a \$US exchange rate of around 93c). Domestic interest rates are assumed to rise slightly in line with market expectations. World oil prices (Tapis) are assumed to remain at around \$US82 per barrel. The farm sector forecasts are based on average seasonal conditions over the remainder of the forecasting period.

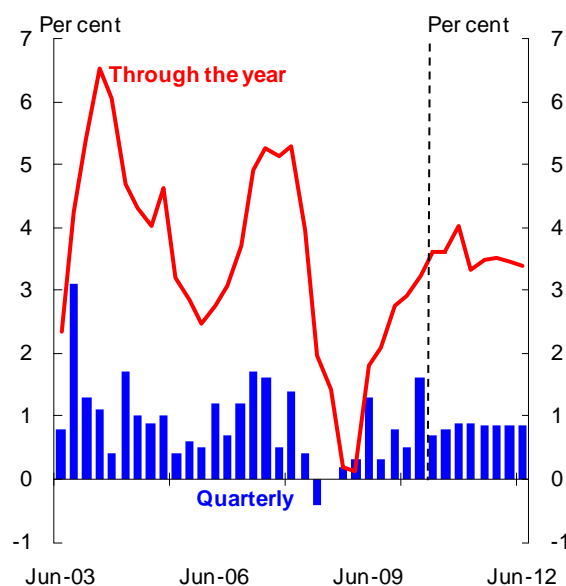
### Household consumption

A strengthening labour market underpins a stronger outlook for household consumption for 2010-11.

Consumption grew by 1.6 per cent in June, its fastest rate in three years. However, this result was bolstered by one-off factors, including the replacement of hail damaged vehicles in Victoria and Western Australia and gambling associated with the 2010 FIFA World Cup. While these factors are expected to unwind in the September quarter, dragging down near-term consumption growth, the strength of underlying drivers is consistent with a period of above-trend consumption growth.

Consumption is expected to grow by  $3\frac{3}{4}$  per cent in 2010-11 (up from 3 per cent at June), bolstered by a recovery in real wages and increases in household wealth over the last year. High levels of consumer confidence also point to consumption expenditure remaining robust in coming quarters. From this higher base, consumption growth is expected to ease to  $3\frac{1}{2}$  per cent in 2011-12 (down  $\frac{1}{4}$  of a percentage point from June). This is consistent with a more moderate outlook for population growth and growth in household wealth, based on an assumption that house prices grow in line with general inflation.

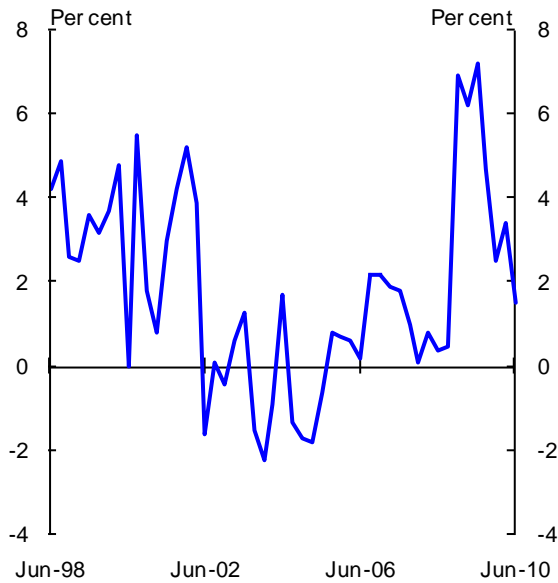
Chart 1: Household Consumption



Source: ABS Catalogue Number 5206.0.

The household saving ratio fell sharply in the June quarter (from 3.4 per cent to 1.5 per cent), notwithstanding strong growth in wage and salary income (**Chart 2**). While this decline can be explained in part by strong household consumption growth and higher interest payments, the main driver was a  $12\frac{1}{4}$  per cent fall in social assistance benefits that we understand will be revised significantly with the release of the September quarter National Accounts. Looking forward, therefore, we expect the household savings ratio to rebound in the near term and remain above the levels observed in the years preceding the crisis. This is consistent with our outlook for strong growth in household incomes, subdued household credit growth and surveys suggesting that households are more focused on paying down debt following the global financial crisis.

**Chart 2: Household saving ratio**



Source: ABS Catalogue Number 5206.0.

**Dwelling investment**

The near term outlook for dwelling investment has weakened since June. This has been driven by continued weakness in housing finance and approvals data, which imply lower growth over 2010-11.

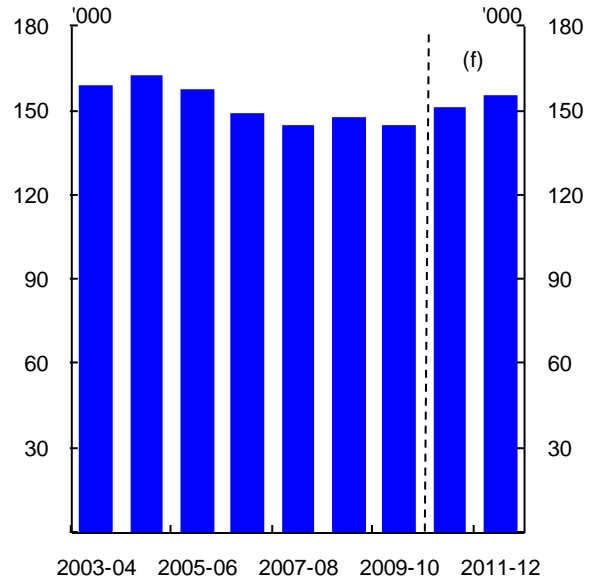
In the June quarter, new dwellings investment recorded its highest quarterly growth (12.5 per cent) since the September quarter of 2001. This would appear to represent a substantial proportion of the pipeline of residential construction activity that had built up over the previous 12 month period and had been expected to support investment through to the end of 2010. This has led us to revise down our near-term forecasts in line with the weak finance and approvals data.

Dwelling investment is expected to be supported by a positive employment outlook and pent up demand for housing stock arising from the strength of population growth in recent years relative to construction activity. However, supply constraints, namely skilled labour shortages, difficulties with the planning and approvals process and land supply issues will continue to weigh on growth over the forecast horizon.

As shown in **Chart 3**, the number of dwellings constructed annually in Australia over the last decade has remained within a relatively

narrow band, notwithstanding significant growth in demand drivers. Constraints in the sector may ease somewhat with slower population growth.

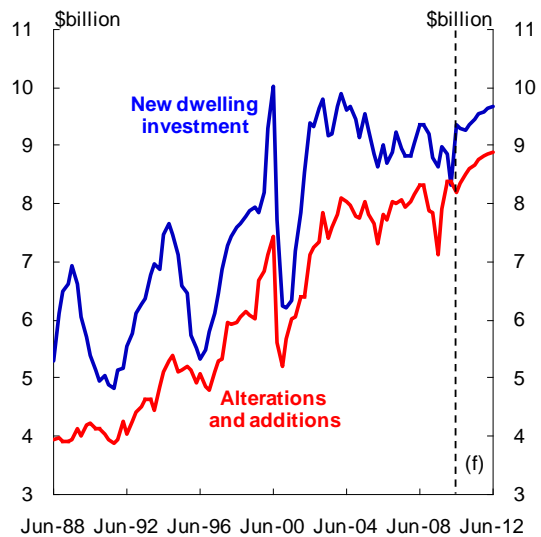
**Chart 3: Dwelling Completions**



Source: ABS Catalogue Number.

Dwelling investment is forecast to grow by 4½ per cent in 2010-11 and 3 per cent in 2011-12 (**Chart 4**), lower than the 5½ per cent forecast for both years at June.

**Chart 4: Private Dwelling investment**



Source: ABS Catalogue Number 5206.0.

**Business investment**

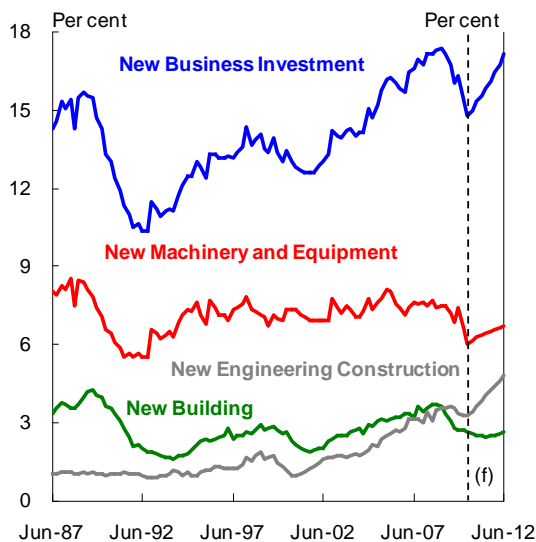
Recent strong increases in capital expenditure intentions, particularly in the mining sector,

provide further evidence that business investment will grow strongly in the period ahead. **New business investment** is expected to grow in 2010-11 and 2011-12 by 8½ and 13 per cent, slightly higher than at June, and is expected to return to previous highs as a proportion of GDP (**Chart 5**).

The most recent ABS CAPEX Survey indicated a significant rise in expected investment for 2010-11, with the third estimate for business investment in 2010-11 24 per cent higher than for the corresponding estimate for last year. Consistent with this strength, the latest business surveys indicate that business confidence, conditions and investment intentions remain robust.

The outlook for **machinery and equipment investment** remains robust, driven by necessary maintenance and replacement spending and strong demand for mining related equipment. This is expected to drive investment growth of 8 per cent in 2010-11 and 15 per cent in 2011-12.

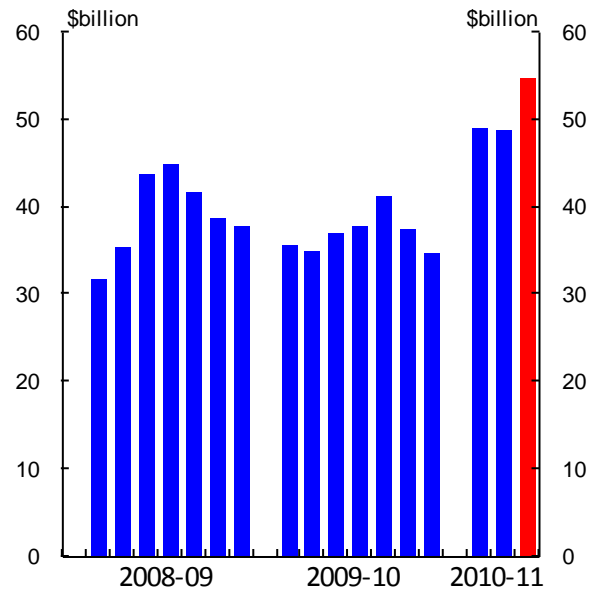
**Chart 5: Business investment to GDP ratio (nominal)**



Source: ABS Cat. No. 5206.0 and Treasury.

Expectations of a surge in **new engineering construction** investment have been reinforced by the latest CAPEX data for 2010-11, with the third estimate for the mining sector being almost 50 per cent higher than for the corresponding estimate for 2009-10 (**Chart 6**).

**Chart 6: CAPEX for the mining sector**



Source: ABS Cat. No. 5625.0

While a project-by-project analysis suggests that it is unlikely that all of this investment potential can be realised over the next year, it nonetheless supports very strong forecasts for engineering activity in 2010-11 and 2011-12. Engineering investment is now expected to increase by 16½ per cent in 2010-11 and 21 per cent in 2011-12. This is broadly consistent with June.

**Non-residential building** investment is expected to fall by 2½ per cent in 2010-11 before a modest recovery commences in 2011-12, with growth of 2 per cent. Investment in the sector has performed better than expected recently as activity under the Building the Education Revolution (BER) program reached its peak and builders completed projects approved before the global financial crisis. However, investment is expected to soften as BER-related construction declines. With limited new approvals adding to the pipeline and vacancy rates seemingly yet to peak, investment is expected to be weak during the rest of 2010 and into 2011. However, the strengthening economy and labour market is expected absorb vacant floor space over the next year and stimulate new demand, supporting modest growth in 2011-12.



**Public final demand**

The withdrawal of stimulus has detracted from growth so far in 2010, and further detractions are expected in 2010-11 and 2011-12. The withdrawal of the stimulus is expected to detract around 1 percentage point from GDP growth in 2010 and ¾ of a percentage point in 2011.

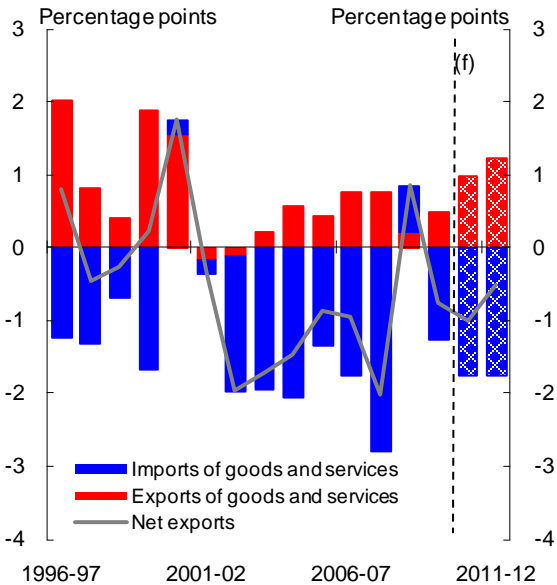
After peaking at 9.5 per cent in 2009-10, **public final demand** is forecast to grow by 1½ per cent in 2010-11, before falling ¼ of a per cent in 2011-12.

**Exports, imports and the current account deficit**

Ongoing strong demand from Asia for Australia’s non-rural commodities is expected to drive solid **export growth** in both 2010-11 and 2011-12. Exports in 2010-11 are expected to be stronger than at June – the result of an improved outlook for rural and non-rural commodities, partially offset by weaker growth in services and ETMs. A stronger exchange rate is expected to lift **imports growth** in 2010-11 compared with June.

**Net exports** are expected to detract ¾ of a percentage point from GDP growth in 2010-11 and 2011-12, similar to June (**Chart 6**).

**Chart 7: Net Exports – contribution to GDP growth**



Source: ABS Catalogue Number 5206.0 and Treasury.

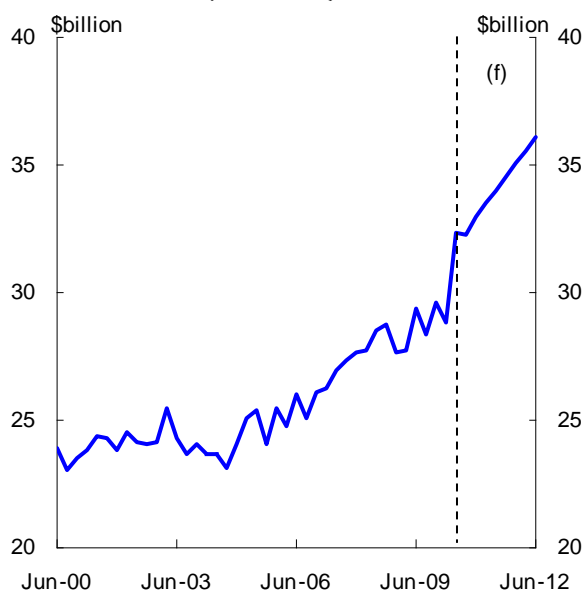
Non-rural commodity exports are expected to increase significantly over the forecast period, reflecting strong growth in Asia and as additional supply capacity comes on line.

Commodity exports grew markedly in the June quarter, led by a surge in metallurgical coal exports. One-off factors, namely the cyclones and flooding in Queensland during the March quarter, created a substantial backlog of shipments which were subsequently delivered during the June quarter. Nonetheless, the degree to which metallurgical coal exports grew in the quarter surprised on the upside. This reflects, in part, the recent expansion of port capacity at Dalrymple Bay Coal Terminal in Queensland. Oil exports also posted solid growth in the quarter, reflecting the ramp-up in crude oil exports from the Pyrenees and Van Gogh fields.

While steel production in China has declined in recent months as the Chinese Government’s stimulus package is withdrawn progressively, production remains at historically high levels. The outlook is for continued growth in Chinese steel production in 2010-11 providing ongoing demand for Australia’s bulk commodity exports. The expansion of iron ore capacity in Western Australia and the early completion of a number of thermal coal mines on the east coast of Australia will boost non-rural export volumes over the forecast horizon.

As a result, **non-rural commodity exports** are expected to increase by 11 per cent in 2010-11, stronger than at June. Non-rural commodity exports are expected to grow by a further 6½ per cent in 2011-12 (**Chart 7**).

**Chart 8: Non-rural commodities (Volumes)**



Source: ABS Catalogue Number 5302.0 and Treasury.

**Rural exports** are forecast to be stronger than at June, increasing by 12 per cent in 2010-11 before slowing to  $\frac{1}{2}$  a per cent in 2011-12. Higher volumes of rural exports are expected following favourable weather conditions in eastern Australia and higher wheat prices which should see existing inventories released to the market. A temporary export ban by Russia following adverse weather conditions in Eastern Europe has pushed up world wheat prices sharply, although the spike is expected to be relatively short lived.

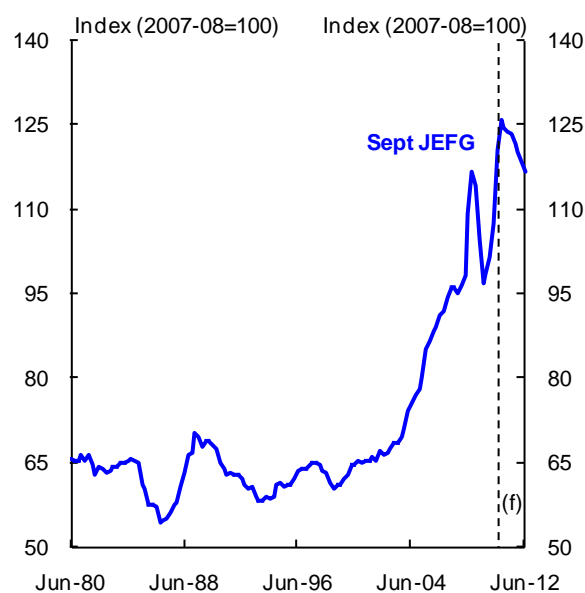
The slower-than-expected recovery of the world economy and a higher exchange rate have weakened the prospects for **elaborately transformed manufactures (ETMs) exports**. ETM exports are expected to grow by 4 per cent in 2010-11 and  $4\frac{1}{2}$  per cent in 2011-12, following a period of sustained weakness during the global financial crisis.

The weaker world outlook, stronger exchange rate and greater targeting of Australia's student intake are expected to weigh on the outlook for **services exports**. Services exports are now expected to decline by  $1\frac{1}{2}$  per cent in 2010-11 – a 2 percentage point turnaround since June – before recovering to grow by 6 per cent in 2011-12.

**Imports growth** is expected to be stronger than at June in 2010-11 – the result of a higher

Australian dollar and stronger domestic demand. Import volumes are now forecast to increase by  $10\frac{1}{2}$  per cent in 2010-11 reflecting significant capital imports associated with the expansion of the resources sector. While the level of imports is expected to be higher in 2010-11 compared with June, growth in 2011-12 is unchanged at 8 per cent.

**Chart 9: Terms of Trade**



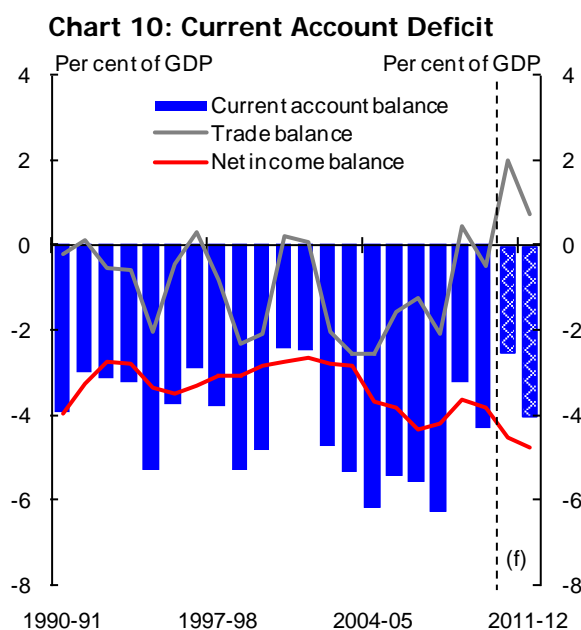
Source: ABS Catalogue Number 5206.0 and Treasury.

Several recent strong rises in the prices of iron ore and coal are expected to result in a 16 per cent rise in the **terms of trade** in 2010-11, reaching their highest level on record (**Chart 8**). Contributing to the downward revision are reports suggesting that December quarter 2010 metallurgical coal and iron ore contracts have been settled between 7 to 13 per cent below September quarter contract prices. Iron ore and metallurgical coal prices are expected to decline in 2011-12 as greater world supply comes on line.

The **trade balance** is expected to be in surplus in 2010-11 at 2 per cent of GDP,  $\frac{3}{4}$  of a percentage point higher than at June. The trade balance is forecast to record a surplus of  $\frac{3}{4}$  of a per cent of GDP in 2011-12, compared to a small deficit expected at June.

The **net income deficit (NID)** is unchanged in 2010-11, at  $4\frac{1}{2}$  per cent of GDP and is a  $\frac{1}{4}$  of a percentage point higher in 2011-12 at  $4\frac{3}{4}$  per cent of GDP.

In 2010-11, the **current account deficit (CAD)** is forecast to narrow further than at June, to 2½ per cent of GDP (**Chart 10**). The CAD is then expected to widen to 4 per cent of GDP in 2011-12 (¾ of a percentage point lower than at June).



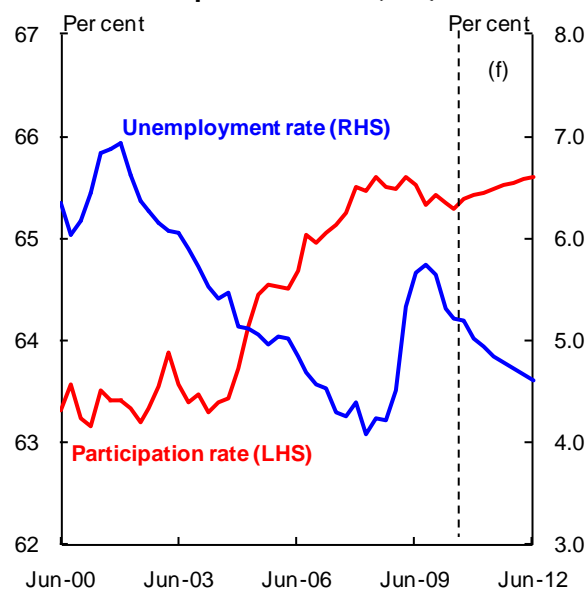
Source: ABS Catalogue Numbers 5206.0, 5302.0 and Treasury.

## Employment, wages and inflation

The employment outlook has been upgraded since the June round, reflecting better-than-expected labour market outcomes and a stronger outlook for non-farm GDP growth in the near-term. In line with this, the unemployment rate is now forecast to reach around 5 per cent by the end of 2010 and fall to 4½ per cent in mid-2012.

**Employment growth** is forecast to be 2½ per cent through the year to the June quarter of 2011, and 2 per cent through the year to the June quarter of 2012. The **unemployment rate** is now expected to fall to 4¾ in the June quarter of 2011 and 4½ per cent in the June quarter of 2012 (**Chart 11**).

**Chart 11: Unemployment and Participation Rates (s.a.)**



Source: ABS Catalogue Number 6202.0 and Treasury.

**Average hours** continue to recover gradually and, in line with June, are expected to approach trend levels in 2011-12.

The **participation rate** is forecast to rise gradually, to around 65½ per cent by the end of the forecast period. There has been a slight upgrade in the participation rate, reflecting unexpected strength in recent months.

The **Wage Price Index** is expected to grow by ¾ per cent through the year to the June quarter of 2011 and 4 per cent through the year to the June quarter of 2012.

The strengthening growth in wages over the next two years reflects an expectation that the labour market will be at full capacity towards the end of 2010 and will be facing capacity constraints thereafter.

Headline and underlying inflation forecasts have been revised up in the latter half of the forecast period since the June round. This reflects stronger domestic demand and labour market conditions that are expected to prevail over the forecast period compared with the June round.

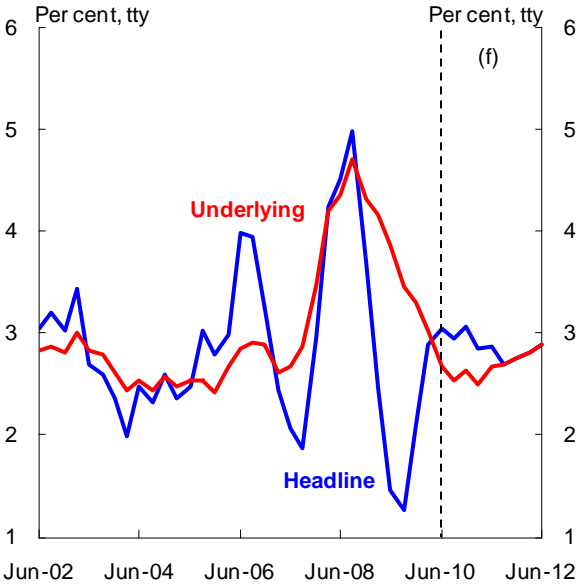
The June quarter **Consumer Price Index (CPI)** outcome saw an easing in underlying inflation, which reflected subdued price growth in the market-driven components of the CPI.

The prices of administered items, such as electricity, are likely to continue to grow strongly over the forecast period, while market price inflation is also expected to pick-up as spare capacity in the economy diminishes.

**Underlying inflation** is expected to be 2¾ per cent in the June quarter of 2011, before picking up to 3 per cent in the June quarter of 2012 (**Chart 11**). This compares with inflation of 2¾ per cent forecast for the June quarter of 2011 and 2012 at the June round.

Headline inflation is expected to rise in the near-term, reflecting a rise in utilities prices, and the remaining impact of the Federal excise and excise-equivalent customs duty on tobacco products. Headline inflation is then expected to resume its gradual decline to 2¾ per cent in the June quarter of 2011, before picking up to 3 per cent in the June quarter of 2012.

**Chart 12: Inflation**



Source: ABS Catalogue Number 6401.0, RBA and Treasury.

## OUTLOOK FOR THE INTERNATIONAL ECONOMY

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

	2009	2010		2011		2012	
	Actual	June	Sept JIEFG	June	Sept JIEFG	June	Sept JIEFG
United States	-2.6	3	2 3/4	2 1/2	2 1/4	2 1/2	2 1/2
Euro Area	-4.1	1	1 1/2	1	1 1/4	1 1/4	1 1/4
Japan	-5.2	3 1/4	3	1 1/2	1 1/4	1 1/2	1 1/4
China	9.1	10	9 3/4	9 1/2	9	9 1/2	9
India	5.7	8 1/2	9 1/4	8	8	8 1/4	8 3/4
Other East Asia (b)	-0.3	7 1/4	8	4 3/4	4 3/4	5 1/4	5 1/4
Major Trading Partners	0.0	5 3/4	6	4 1/2	4 1/4	4 3/4	4 1/2
World	-0.6	4 1/2	4 1/4	4	4	4 1/4	4 1/4

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

(b) Other East Asia is: Korea, Taiwan, Hong Kong, Singapore, Indonesia, Malaysia, Thailand, Vietnam and the Philippines.

Source: National statistical publications, IMF and Treasury.

### World outlook

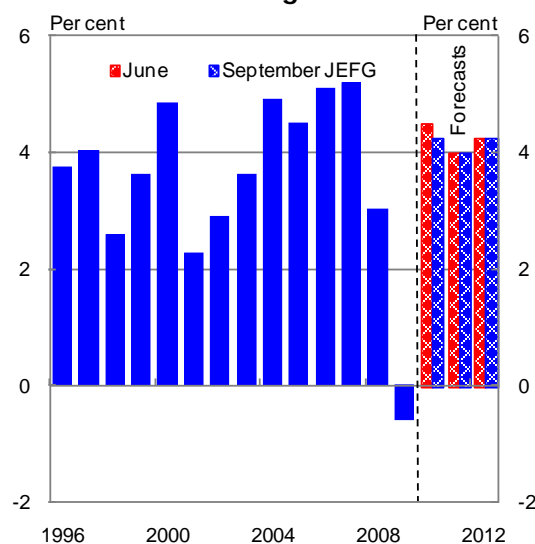
The outlook for the global economy has become less favourable since June. This is the result of some of the downside risks that were identified at the informal June round becoming more pronounced. In addition, since the June round there has been increasing concern over the possibility of a double-dip recession in the United States.

Outcomes in East Asia in the first half of 2010 have generally been stronger than expected. Growth in the euro area (led by Germany) and the United Kingdom has also surprised on the upside. By contrast, growth in the US and Japan in the June quarter was weaker than expected. The sum of these developments sees global growth for 2010 revised down by a ¼ of a percentage point from the June round to 4¼ per cent (Chart 11 and Table 3).

Global growth is forecast to ease to 4 per cent in 2011, unchanged from the informal June round. The June round forecasts had already built in some expectation of a moderation in US growth over the remainder of 2010, and the impact of fiscal consolidation in the euro area in 2011. The September JIEFG forecasts also incorporate a slowing in industrial production in China.

In addition, the moderation in growth in the US, China and the export-dependent NIEs and ASEAN-5, is partly offset by an upward revision to the 2011 growth forecast for the euro area.

**Chart 13: World GDP growth**



Source: IMF and Treasury.

The forecast easing of growth in 2011 also reflects the fading of temporary factors (fiscal stimulus and the inventory cycle) which have helped boost growth in 2010. While fiscal stimulus is now fading, subdued inflation in the advanced economies, means the current very accommodative stance of monetary policy

in these economies is likely to remain in place for some time.

Global growth of 4¼ per cent is forecast for 2012, unchanged from the informal June round, with most economies forecast to return to around trend growth rates. A notable exception is the euro area where fiscal consolidation and structural impediments are expected to weigh on growth.

While the global economy is forecast to continue growing at solid rates, an increasing level of uncertainty is starting to cloud the outlook. Perhaps the most prominent risk currently is increasing uncertainty about the durability of the US recovery, and increasing concern in markets about the possibility of a double-dip recession in the US. While we consider such an outcome unlikely, the possibility cannot be dismissed.

There is also the risk that the fiscal consolidation advanced economies are committing to in 2011 could prove excessive for economies where growth has been largely driven by policy stimulus, an inventory rebound, and exports.

There are also fears of overheating in China, and the risk of China experiencing a more severe slowdown than expected as Chinese authorities attempt to engineer a 'soft landing.'

Further, the ability and willingness of advanced economies to respond to any substantial slowing in growth, are constrained by weak fiscal positions and monetary policy rates that are already near zero. The constraint on further policy stimulus in the major advanced economies emphasises the importance of the developing economies in supporting global growth, if domestic demand in the G3 economies were to be persistently sluggish.

Financial markets conditions have improved somewhat since the sharp increase in market volatility and stress experienced in May, when the European sovereign debt crisis reached its peak. However, euro area periphery bond spreads remain elevated. These spreads suggest markets are pricing in a restructuring of Greek debt, despite the presence of the

European Financial Stability Facility. By contrast, the yields on 10-year bonds for a number of advanced economies, most notably the US, remain around historically low levels. These yields imply a significant degree of market pessimism about the prospects for major advanced economies.

Despite all of the downside risks, there is also a significant upside risk. If financial market sentiment were to rebound, real economic activity could be boosted substantially. The pre-conditions for such a response are in place, easy monetary conditions abound and there is plenty of liquidity available, especially in the US corporate sector and US banks. If a positive shock were to occur, say from a large sustained increase in private sector US payrolls, then this could see a rapid turnaround in market sentiment. This could then generate the confidence (in conjunction with improved real activity) to enable a rapid increase in lending growth and consequently boost output growth.

## Country summaries

The outlook for the **United States** has worsened slightly. The pace of recovery was always likely to moderate over the second half of 2010 given fading support from fiscal stimulus and the inventory cycle. However, soft consumer spending, weak jobs growth, a slowing industrial cycle and further housing market strains suggest that the slowing in growth may be more pronounced than originally anticipated. As a result, forecasts for 2010 and 2011 have been revised down slightly to 2¾ per cent and 2¼ per cent respectively. Growth is forecast at 2½ per cent for 2012.

Weak consumer spending continues to be the key driver of the subdued outlook. National accounts revisions showed that consumers spent significantly less than originally recorded over 2008, 2009 and early 2010, meaning that much of their recent 'resilience' was illusory. While consumers are now saving more, past balance sheet shocks and the likelihood of a protracted period of high unemployment mean that spending is likely to be restrained in the medium term. In turn, this means businesses – despite strong profits and

improving credit conditions – are unlikely to significantly ramp up investment outlays. Overall, subdued domestic demand suggests a further period of below-par GDP growth. While a ‘double dip’ recession is unlikely, heightened uncertainty about the sustainability of the recovery may itself weigh on confidence and activity, increasing the vulnerability of the economy to financial or other shocks.

The outlook for **China** has been marginally downgraded since the informal June round, due to an earlier-than-expected moderation in industrial activity, the enforcement of government restrictions on the property market, and a still uncertain global recovery. China’s economy is expected to grow 9¾ per cent in 2010, down from 10 per cent at the June round, and 9 per cent in 2011 and 2012. However, the moderation in growth is largely viewed as a Government-engineered correction to China’s recent high growth, as opposed to the commencement of a downturn.

The drivers of growth last year - industrial production, loan growth and investment - have all moderated as stimulus measures are gradually wound down. Consumption remains strong, supported by the continuation of Government subsidies. The rebound in net exports in 2010 is also expected to provide additional support to GDP growth. Overall, the moderation in growth is expected to provide a more stable and sustainable path over the forecast horizon.

Risks to growth include the effectiveness of the Government’s policies to address overheating, particularly in the property market, and the pace of recovery in developed countries. The Government has also indicated a stronger resolve to achieve its climate change commitments, placing restrictions on energy-intensive, highly polluting sectors. Although it is premature to assume any meaningful rebalancing of the economy, the Government has indicated that it will shift focus away from capital-intensive growth in the new five-year plan which commences next year.

The outlook for the **Japanese** economy is increasingly uncertain. The fragile nature of

Japan’s recovery, and its dependence on external demand as a driver of growth, were highlighted by the weaker-than-expected June quarter GDP outcome. This confirmed that the export rebound is easing, domestic demand remains weak and deflationary pressures are entrenched – with prices falling over the past year and a half. Unemployment, while it has likely peaked, remains high by Japanese standards. Business investment has begun a tentative recovery, but the sizeable output gap and prolonged deflationary pressures suggest growth is likely to remain subdued for some time.

The loss of momentum in Japan’s recovery has led to authorities turning to further monetary and fiscal easing. The Bank of Japan announced in August that it would increase the amount of funds available to banks under its fixed rate funding scheme, while the government announced an additional ¥920 billion fiscal stimulus package. The modest size of the new stimulus, equivalent to only 0.2 per cent of GDP, highlights the limited scope for additional fiscal expansion available to the government. This reflects Japan’s high public debt levels and the government’s commitment to its fiscal sustainability strategy announced earlier this year.

The Japanese economy is expected to grow 3 per cent in 2010, easing to 1¼ per cent in both 2011 and 2012. The above-trend growth forecast for 2010 is more a reflection of the strong growth already recorded following last year’s record annual fall in GDP, rather than any inherent strength in the Japanese recovery. Key downside risks relate to the potential for protracted weakness in domestic demand as Japan’s fiscal stimulus runs its course over 2011, as well as the potentially adverse impact on Japanese exports of a further strengthening in the yen.

The economic outlook for **India** is bright. Private consumption edged up in the June quarter, mirroring a measured run up in manufacturing output tied to final demand. Consumer price pressures are receding, owing to a favourable monsoon, while on the asset price side the risks around a sustained period of high inflation have subsided. The Indian economy is forecast to grow 9¼ per cent in

2010, before slowing to 8 per cent in 2011 and 8¾ per cent in 2012.

The moderation in growth in 2011 reflects a maturing of the recovery process and does not signal waning prospects. This implies that softer inflation and industrial activity give room for a pause on monetary tightening. Going forward it will not be all clear sailing, firms are reliant on external financing, which is vulnerable to any slowing in the global economy, and recent moderation in capital and infrastructure growth has begun to cause concern among policymakers.

Notwithstanding the sharp increase in activity in the June quarter 2010, growth in the **euro area** is expected to moderate as weaker world growth slows foreign trade. Increasing fiscal consolidation across the region from 2011 is likely to weigh on the labour market and household consumption, while weak credit conditions will subdue fixed investment. The recovery is expected to remain sluggish, with GDP forecast to grow 1½ per cent in 2010 before slowing slightly to 1¼ per cent in 2011 and 2012.

The **United Kingdom** economy grew 1.2 per cent in the June quarter 2010 – the fastest rate of growth since the March quarter 2001. While the UK has now recorded positive growth for the third successive quarter, the recovery is expected to be protracted, as growth is held back by fiscal consolidation and tight domestic credit conditions. After contracting by almost 5 per cent in 2009, GDP is forecast to record modest growth of 1½ per cent in 2010, 1¾ per cent in 2011 and 2¼ per cent in 2012.

As the **Newly Industrialised Economies (NIEs)** recover strongly from the global recession, they are facing new challenges stemming from a softening in export demand and a tightening of their fiscal positions. At the same time, they have to deal with very

large capital inflows which, having helped the NIEs to recover faster and stronger than expected, are also contributing to asset-price inflation.

Growth is expected to continue but at a slower pace. Real GDP is expected to grow 8½ per cent in 2010. While growth is expected to decelerate to 4¼ per cent in 2011 and 5 per cent in 2012, these growth rates remain much stronger than those expected for the advanced economies as a whole.

Economic activity in the **ASEAN-5** continued to strengthen over the first half of 2010, supported by strong domestic demand and the rebound in exports which propelled economies such as the Philippines and Malaysia to their strongest growth in recent years. However, economic growth is likely to have peaked and is expected to moderate over the remainder of the year, as export growth and industrial production moderate in line with slowing growth in the G7 economies.

Nonetheless, underlying momentum in the ASEAN-5 remains robust due to strength in domestic demand with credit growth, which has accelerated over the first half of this year, likely to lend support to domestic activity. Growth in the region is forecast to be 7½ per cent in 2010 before moderating to 5¾ per cent in 2011 and 6 per cent in 2012.

The **New Zealand** economy has entered its fourth quarter of recovery, with recent indicators of real activity suggesting that the composition of growth may be moving away from consumption towards exports. The main driver supporting New Zealand's positive outlook is its export sector, with relatively high international commodity prices and demand for New Zealand's main exports boosting New Zealand's terms of trade. New Zealand's economy is forecast to grow 2¾ per cent in 2010, 3¼ per cent in 2011 and 3 per cent in 2012.