



Australian Government

The Treasury

FORECASTING REPORT

JUNE 2012

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

This report incorporates Domestic and International data released up to 8 June 2012.

OVERVIEW

The outlook for the economy is broadly unchanged compared with Budget. Real GDP is now expected to grow 3¼ per cent in 2011-12 following the slightly stronger-than-expected March quarter outcome and upward revisions to previous quarters. With robust recent outcomes in the labour market, employment growth is expected to be slightly stronger and the unemployment rate slightly lower in 2011-12 than was anticipated at Budget. Notwithstanding the positive recent GDP growth and labour market outcomes, the economic outlook is largely unchanged for 2012-13 and 2013-14, with slightly stronger expected growth in export volumes offset by slightly weaker expected growth in new business investment. However, downward historical revisions to the level of the terms of trade resulting in a weaker increase in 2011-12 and a softening in expectations for domestic price growth have led to a downgrade in nominal GDP growth over the forecast period (Table 1).

Internationally the euro area sovereign debt crisis continues to cast a shadow over the global economic outlook, with the Greek debt crisis yet to be resolved even as new concerns are emerging regarding the fragility of the Spanish banking system. Nevertheless, the central forecasts for global growth are unchanged, with the ongoing euro area weakness largely factored in at Budget. Notwithstanding some softness in recent economic data out of China, growth forecasts for Australia's major trading partners (export weighted) have been upgraded slightly to 4½ per cent in 2012, reflecting a slightly improved near-term outlook for our region, but are unchanged in 2013 and 2014.

Although the outlook for the Australian economy remains positive, the potential for the situation in the euro area to escalate into a major financial crisis will continue to pose a downside risk to the domestic and international outlook. Domestically, the structural transition taking place in the economy will continue to pose a particular risk for the labour market via the potential for changing and uneven patterns of labour demand to generate temporarily higher unemployment, particularly in sectors and regions not benefiting from the mining boom.

Table 1: Key Domestic Forecasts^(a) – June compared with Budget

	2010-11	2011-12		2012-13		2013-14	
	Outcome	Budget	June	Budget	June	Budget	June
Real GDP	1.9	3	3 1/4	3 1/4	3 1/4	3	3
Nominal GDP	8.2	5 1/2	4 3/4	5	4 3/4	5 1/4	5
Unemployment rate	5.0	5 1/4	5	5 1/2	5 1/2	5 1/2	5 1/2
Employment	2.2	1/2	3/4	1 1/4	1 1/4	1 1/2	1 1/4
CPI	3.6	1 1/4	1 1/4	3 1/4	3	2 1/2	2 1/2
WPI	3.8	3 1/2	3 1/2	3 3/4	3 1/2	3 3/4	3 3/4
Terms of trade	20.6	3 1/4	1 1/4	-5 3/4	-5 1/2	-3 1/4	-3 3/4

a) Real GDP, nominal GDP and the terms of trade are year average growth. Employment, CPI and the WPI are through-the-year growth to the June quarter. The unemployment rate is the average rate in the June quarter.

INTERNATIONAL ECONOMIC OUTLOOK

While highly uncertain, the central-case forecast for global growth is largely unchanged from Budget. World GDP growth is expected to pick up over the forecast horizon, albeit from a position of weakness, as strong expected growth in emerging economies moderates and the expected recovery in the large advanced economies gathers momentum. The world economy is still forecast to grow 3½ per cent in 2012, 4 per cent in 2013 and 4¼ per cent in 2014. Following a slight upgrade to near-term growth forecasts, major trading partners are expected to grow a solid 4½ per cent in 2012 and a robust 5 per cent in both 2013 and 2014 (Table 2).

Table 2: International GDP growth forecasts^(a)

	2011	2012		2013		2014	
	Actual	Budget	June	Budget	June	Budget	June
United States	1.7	2	2	2 1/4	2 1/4	2 1/2	2 1/2
Euro area	1.5	- 3/4	- 3/4	3/4	1/2	1 1/4	1 1/4
Japan	-0.7	2 1/4	2 1/2	1 3/4	1 3/4	1 1/4	1 1/4
China ^(b)	9.2	8 1/4	8 1/4	8 1/2	8 1/2	8 1/4	8
India ^(b)	7.1	6 1/4	6 1/4	7 3/4	7 3/4	7 1/2	7 1/2
Other East Asia ^(c)	4.3	3 3/4	4	5	5	5	5
Major Trading Partners	4.3	4 1/4	4 1/2	5	5	5	5
World	3.9	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 April 2012, Thomson Reuters and Treasury.

At Budget, Treasury had a more pessimistic view on the outlook for the euro area than the IMF and Consensus. Events since Budget confirm our views at that time but also suggest that the weakness in the euro area is likely to be even more protracted. As such, growth forecasts for the euro area have been downgraded by a ¼ of a percentage point to ½ per cent in 2013. The euro area sovereign debt crisis continues to pose a major threat to the global outlook. The potential for a tumultuous Greek exit from the euro area has receded in the near term following the election of a pro-bailout minority government. However, with the new government seeking to renegotiate the bailout plan there is considerable uncertainty around Greece's future financial position. Elsewhere, euro area finance ministers have agreed to an injection of up to €100 billion into Spain's ailing banking sector. However, many of the details of this injection have not yet been agreed and the Spanish government itself may ultimately require a bail out.

The recovery in the United States economy is slowly taking hold as expected and the outlook is largely unchanged. However, the large fiscal contraction legislated to take place at the end of 2012 poses a significant risk to this recovery. While the legislated expenditure reductions and the expiration of tax cuts is expected to be partly or wholly deferred, this is yet to be agreed by legislators and could lead to further instability as the deadline approaches.

The outlook for the Chinese economy is also broadly unchanged. Weaker-than-expected production and consumption data in China suggest that economic growth is moderating slightly faster than anticipated. However, in response, the Chinese government is accelerating the implementation of the infrastructure projects outlined in its 12th five-year plan, easing monetary conditions and providing subsidies to households to support consumption. These measures are expected to maintain growth as

forecast at Budget. While the Chinese government has further capacity to support growth as required potential downside risks have increased.

DOMESTIC ECONOMIC OUTLOOK

Australia's economic outlook is broadly unchanged since Budget, notwithstanding some slight differences in the components of growth.

Real GDP growth for 2011-12 has been upgraded by $\frac{1}{4}$ of a percentage point to $3\frac{3}{4}$ per cent, largely reflecting the slightly stronger-than-expected March quarter outcome and upward revisions to earlier quarters. The Australian economy grew 1.3 per cent in the March quarter, driven by stronger-than-expected growth in both business investment and household consumption, partly offset by negative contributions from net exports and dwelling investment. Public final demand rose marginally in the quarter, but was weaker than expected at Budget, with state and local government expenditure particularly weak. The near-term labour market outlook has also improved slightly since Budget, with stronger-than-expected employment growth over the past few months. Employment growth forecasts have been upgraded by $\frac{1}{4}$ of a percentage point to $\frac{3}{4}$ of a per cent through the year to the June quarter of 2012 and the unemployment rate is now forecast to be 5 per cent.

Notwithstanding the positive recent labour market and real GDP growth outcomes, the outlook beyond 2011-12 is largely unchanged.

Australia's **real GDP growth** is forecast to be $3\frac{3}{4}$ per cent in 2012-13 before easing slightly to 3 per cent in 2013-14, underpinned by strong growth in resources-related business investment and solid growth in exports and consumption. However, as at Budget, public final demand and dwelling investment is expected to remain subdued. Similarly, the outlook for the labour market is largely unchanged. Employment growth is expected to be $1\frac{1}{4}$ per cent through the year to the June quarter of 2013 and $1\frac{1}{2}$ per cent June quarter of 2014 and the unemployment rate is expected to be $5\frac{1}{2}$ per cent in the June quarter of both 2013 and 2014.

However, while the outlook for real GDP growth is largely unchanged, nominal GDP growth has been downgraded over the forecast horizon. This reflects downward historical revisions to the level of the terms of trade, resulting in a weaker increase in 2011-12, and a softening in expectations for domestic price growth, particularly in household and government consumption deflators. Nominal GDP growth is forecast to be $4\frac{3}{4}$ per cent in both 2011-12 and 2012-13 and 5 per cent in 2013-14. Compared with Budget, forecast growth in nominal GDP has been revised down $\frac{3}{4}$ of a percentage point in 2011-12 and $\frac{1}{4}$ of a percentage point in both 2012-13 and 2013-14. The level of the GDP deflator has also been revised down by 1 percentage point across the forecast period. (Further details on implications for the components of nominal GDP are provided at Attachment A.)

Household consumption growth forecasts have been upgraded slightly since Budget, following the surprisingly strong March quarter outcome. Growth of 1.6 per cent in the quarter was underpinned by strong growth in real incomes over the year to the March quarter which allowed households to boost consumption while at the same time continue to save at historically high rates. However, looking beyond 2011-12, the outlook for consumption growth is largely unchanged since Budget. Household real net worth remains lower than in early 2011, with ongoing weakness in the housing market and the share market. Household consumption is expected to grow broadly in line with disposable incomes resulting in the saving rate remaining elevated. Household consumption is forecast to grow $3\frac{1}{2}$ per cent in 2011-12, $3\frac{3}{4}$ per cent in both 2012-13 and 2013-14.

The outlook for **dwelling investment** has deteriorated somewhat since Budget, with downgrades to growth forecasts for 2011-12 and 2012-13, only partly offset by an upgrade in 2013-14. Near-term

forecasts have been downgraded in line with weak commencements and a continued deterioration in building approvals data released since Budget. While housing finance commitments for new dwellings improved marginally in the March quarter, they remain well below levels seen before the global financial crisis as continuing consumer caution towards debt moderates demand for new houses. Recent interest rate cuts are expected to boost dwelling investment over coming years but any substantial recovery is unlikely before 2013-14. Dwelling investment is now forecast to contract 3 per cent in 2011-12, remain flat in 2012-13 and grow 4½ per cent in 2013-14.

The outlook for new **private business investment** is largely unchanged, with forecast growth of 20½ per cent in 2011-12, 11 per cent in 2012-13 and 6 per cent in 2013-14 resulting in investment reaching record highs as a share of GDP. The forecasts continue to be underpinned by surging resources investment, with the most recent CAPEX survey again demonstrating the resilience of investment intentions in the sector despite ongoing global uncertainty and easing commodity prices. However, the latest CAPEX survey highlights further weakness in the non-mining parts of the economy, which continue to track below trend.

The outlook for business investment is broadly unchanged since Budget, with higher expected growth in 2011-12 largely offset by lower expected growth in 2012-13 and 2013-14. The upgrade to 2011-12 reflects stronger-than-expected engineering construction investment over recent quarters. While the aggregate expenditure of major resources projects continues to track broadly in line with our expectations, the allocation of investment appears to have been more heavily weighted towards engineering construction in recent quarters than previously expected. Engineering construction investment growth forecasts have been upgraded in 2011-12 and downgraded in 2012-13 and 2013-14 accordingly. This realignment, along with weakness in the latest CAPEX estimate for machinery and equipment outside the resources sector, has resulted in downgrades to machinery and equipment investment growth in 2011-12 and 2012-13. Forecasts for non-residential building investment continue to remain weak and are broadly unchanged since Budget.

Total **exports** are expected to grow 3½ per cent in 2011-12 and 5 per cent in both 2012-13 and 2013-14, representing a downgrade in 2011-12 and an upgrade in 2012-13. Forecast growth in 2011-12 has been downgraded since Budget largely due to weaker crude oil and coal export volumes. Industrial disputes, particularly in Queensland, are likely to continue affecting coal export volumes over coming quarters with the recent significant run down of coal inventories, combined with the closure of the Norwich Park coal mine, expected to result in subdued exports this year even if industrial disputes were to cease. This is expected to have a flow-on effect on new capacity coming online, in addition to delays already experienced due to the slower-than-expected recovery from the 2011 floods, lowering estimated coal exports growth over the forecast horizon.

The outlook for elaborately transformed manufactures export volumes is broadly unchanged from Budget, while growth forecasts for rural goods and non-bulk non-rural commodities have been upgraded. However, services export volume forecasts have been downgraded in line with the high Australian dollar and weak growth in advanced economies leading to continued weakness in tourist arrivals and education-related travel services.

Total **import** volumes growth forecasts have been downgraded slightly over the forecast horizon, albeit from a high rate, in line with the recent depreciation of the Australian dollar. Total imports are expected to grow 12 per cent in 2011-12, 7 per cent in 2012-13 and 5½ per cent in 2013-14, with the level of imports now expected to be lower across all years than forecast at Budget.

With higher forecast growth in exports and weaker imports growth, **net exports** are now expected to detract 1¾ percentage points from real GDP growth in 2011-12, ¾ of a percentage point in 2012-13 and

$\frac{1}{4}$ of a percentage point in 2013-14. This is a slightly smaller detraction in 2011-12 and 2013-14 than forecast at Budget. Forecasts for the **current account deficit** remain in line with Budget.

Forecasts for the **terms of trade** have been downgraded since Budget, with the level of the terms of trade now expected to be around 2 per cent lower across the forecast period. The terms of trade are forecast to increase $1\frac{1}{4}$ per cent in 2011-12, followed by declines of $5\frac{1}{2}$ per cent in 2012-13 and $3\frac{3}{4}$ per cent in 2013-14. The forecast downgrade reflects revisions to the historical series (due to an ABS methodological change to how coal export prices are seasonally adjusted) combined with higher import prices, partly offset by higher export prices. For bulk commodity prices, the outlook remains broadly unchanged since Budget, with iron ore prices relatively stable over recent months, while weakness in thermal coal prices driven by low natural gas prices in the United States has been offset by higher metallurgical coal prices due to the ongoing industrial action across many parts of the Queensland coal chain.

The outlook for inflation is slightly weaker than Budget owing to further indications of weak prices across the economy. **Headline inflation** is forecast to be $1\frac{1}{4}$ per cent through the year to the June quarter of 2012, and 3 per cent through the year to the June quarter of 2013, before easing to $2\frac{1}{2}$ per cent through the year to the June quarter of 2014. **Underlying inflation** is forecast to be $1\frac{3}{4}$ per cent through the year to the June quarter of 2012, and $2\frac{1}{2}$ per cent through the year to the June quarter of both 2013 and 2014.

Forecast growth in the **Wage Price Index** has been downgraded $\frac{1}{4}$ of a percentage point to $3\frac{1}{2}$ per cent through the year to the June quarter of 2013, in line with the slight downgrade to inflation forecasts, but remains unchanged at $3\frac{3}{4}$ per cent through the year to the June quarter of 2014.

While the outlook remains positive, the potential for a major financial crisis emanating from the euro area poses a significant downside risk for the domestic economy and recent events have done little to alleviate this risk. Australia's trade is primarily with Asia, however, Australia has significant financial links with the weaker advanced world economies and negative events in the euro area and United States have been shown to pass rapidly through to financial asset prices and confidence in Australia. In addition, even Australian trade would not be expected to be immune from a sharp deterioration since the euro area itself is a major export market for the economies of our region. Commodity prices would be a likely casualty of such a slowdown and the fall could be significant. For example, during the global financial crisis bulk commodity prices fell around 50 per cent in Australian dollar terms over a nine month period.

Domestically, the transition taking place in the economy continues to pose a particular risk for the labour market. There were further declines in employment in the manufacturing and construction industries in the three months to May, while employment growth in the retail sector was subdued. With this transition expected to continue, there remains an ongoing risk that employment growth in the rapidly expanding, but less labour intensive resources and resources-related sectors will not be sufficient to offset the weakness in employment in other parts of the economy.

Table 3 – 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 1/2	3 1/4	3 1/4
Private investment				
Dwellings	3.0	-3	0	4 1/2
Total business investment(d)	5.2	20 1/2	11	6
Non-dwelling construction(d)	7.9	36	13 1/2	4
Machinery and equipment(d)	3.0	12	10	8 1/2
Private final demand(d)	3.2	6 1/2	5	4
Public final demand(d)	3.4	- 3/4	- 1/4	0
Total final demand	3.2	4 3/4	3 3/4	3 1/4
Change in inventories(e)	0.5	1/4	0	0
Gross national expenditure	3.7	5	3 3/4	3 1/4
Exports of goods and services	0.4	3 1/2	5	5
Imports of goods and services	10.4	12	7	5 1/2
Net exports(e)	-2.0	-1 3/4	- 3/4	- 1/4
Real gross domestic product	1.9	3 1/4	3 1/4	3
Non-farm product	1.9	3 1/4	3 1/4	3
Farm product	2.8	7	3	1
Nominal gross domestic product	8.2	4 3/4	4 3/4	5
Panel B - Other selected economic measures				
External accounts				
Terms of trade	20.6	1 1/4	-5 1/2	-3 3/4
Current account balance				
\$billion	-33.2	-45 3/4	-76 1/2	-98 3/4
Percentage of GDP	-2.4	-3	-5	-6
Labour market				
Employment (labour force survey basis)(f)	2.2	3/4	1 1/4	1 1/4
Unemployment rate (per cent)(g)	5.0	5	5 1/2	5 1/2
Participation rate (per cent)(g)	65.6	65 1/4	65 1/4	65 1/4
Prices and wages				
Consumer Price Index (h)	3.6	1 1/4	3	2 1/2
Gross non-farm product deflator	6.0	1 1/2	1 3/4	2 1/4
Wage Price Index(f)	3.8	3 1/2	3 1/2	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 74 and a \$US exchange rate of around 98 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\$108 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.

ATTACHMENT A: FORECAST GROWTH IN NOMINAL GDP

Nominal GDP is forecast to grow $4\frac{3}{4}$ per cent in 2011-12 and 2012-13 and 5 per cent in 2013-14. These forecasts are weaker than Budget due to softer domestic price growth, particularly for consumption goods and services, and the impact of historical revisions to the terms of trade (due to an ABS methodological change to how coal export prices are seasonally adjusted). The forecast for nominal GDP growth in 2011-12 is $\frac{3}{4}$ of a percentage point lower than Budget, with the weaker terms of trade and domestic prices partly offset by higher forecast growth in real GDP. The forecast for nominal GDP growth in 2012-13 is $\frac{1}{4}$ of a percentage point lower than Budget driven by softer domestic price growth. Forecast growth in 2013-14 is $\frac{1}{4}$ of a percentage point lower due to a slightly larger fall in the terms of trade.

Abstracting from the 2011-12 base (given the government has received 11 months of finalised taxation collections in 2011-12), the forecast level of nominal GDP is lower by \$5.1 billion in 2012-13 and \$5.4 billion in 2013-14. Again abstracting from base effects, the forecast level of GDP at factor cost (which is closer to the tax base for revenue forecasting purposes) is lower by \$2.0 billion in 2012-13 and \$3.5 billion in 2013-14.

Total corporate gross operating surplus (GOS) is expected to grow $2\frac{3}{4}$ per cent in 2011-12, $3\frac{3}{4}$ per cent in 2012-13 and $5\frac{1}{2}$ per cent in 2013-14. Forecast growth in GOS for 2011-12 has been revised down since Budget due to weakness in the March quarter National Accounts outcome and weaker-than-expected growth in mining sector profits due to the lower terms of trade. Forecast GOS growth in 2012-13 is $\frac{1}{4}$ of a percentage point weaker than Budget forecasts while growth in 2013-14 has been revised upwards by $\frac{3}{4}$ of a percentage point. However, compared with 2011-12, the level of GOS is expected to be around \$1.9 billion lower in 2013-14 than anticipated at Budget.

Compensation of employees is forecast to grow $7\frac{1}{4}$ per cent in 2011-12, $5\frac{1}{2}$ per cent in 2012-13 and $4\frac{3}{4}$ per cent in 2013-14. This growth is $\frac{3}{4}$ and $\frac{1}{2}$ of a percentage point higher in 2011-12 and 2012-13 reflecting stronger-than-expected employment growth over recent months and the strong March quarter National Accounts outcome. Forecast growth in 2013-14 has been revised down $\frac{1}{2}$ of a percentage point reflecting softer forecast wage growth combined with slower forecast employment growth.

Gross mixed income which includes the wages and profits of farm and other unincorporated enterprises, is forecast to experience flat growth in 2011-12 and 2012-13 before growing by $3\frac{1}{4}$ per cent in 2013-14. These growth forecasts represent a downgrade to Budget estimates across all forecast years due to extended weakness in profit growth for non-farm enterprises and a lower expected level of farm profits in 2012-13 and 2013-14 arising from expected lower world agricultural prices.