

ECONOMIC OUTLOOK FOR 2010-11, 2011-12 AND 2012-13

DECEMBER 2010

(THIS REPORT INCORPORATES DOMESTIC AND INTERNATIONAL DATA RELEASED UP TO
9 DECEMBER 2010)

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OVERVIEW

The economic outlook has not changed markedly since the September 2010 JIEFG, although recent subdued household consumption growth and a re-profiling of the business investment forecasts have driven a downward revision to forecast GDP growth in 2010-11. While economic growth slowed in the September quarter, other indicators suggest that any near-term weakness in activity will be temporary. The labour market has continued to strengthen, while recent project announcements and the September quarter CAPEX survey have reaffirmed that mining investment and commodity exports will be key drivers of growth over the forecast horizon. The key risks to Australia's economic outlook relate to the timing of resources investment and the possibility that sovereign credit concerns in Europe could cause wide-spread disruptions to global credit markets.

Table 1: Key Domestic Forecasts – December compared with September

	2009-10	2010-11		2011-12		2012-13
	Outcome (a)	September	December	September	December	December
Real GDP (b)	2.2	3 1/2	3	3 3/4	3 3/4	3 1/4
Nominal GDP (b)	2.3	9 1/4	8 1/4	5	6	5 1/2
Employment (d)	2.4	2 1/2	2 3/4	2	2	1 1/2
Unemployment rate (c)	5.2	4 3/4	5	4 1/2	4 3/4	4 3/4
CPI (d)	3.1	2 3/4	2 3/4	3	3	3
Underlying inflation (d)	2.7	2 3/4	2 3/4	3	2 3/4	3
WPI (d)	3.0	3 3/4	3 3/4	4	4	4
Terms of trade (b)	-4.4	16	16 1/4	-4	- 3/4	-2 3/4

(a) Calculated using original data except for employment, the unemployment rate and WPI.

(b) Year average.

(c) June quarter.

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

The outlook for global growth is marginally stronger in 2010, but little changed in the final two forecast years. The main external risks are associated with sovereign credit concerns in Europe and the possibility that planned fiscal consolidation in 2011 will be excessive. On a more positive note, the risk of a double dip recession in the United States has receded for the present and Chinese authorities have thus far succeeded in tightening macroeconomic policy without generating too-abrupt a slowdown in economic growth. These risks aside, the central forecasts for Australia's Major Trading Partners (MTPs) have not changed markedly since September, with MTP growth forecast to be 6¼ per cent in 2010, 4¼ per cent in 2011 and 4½ per cent in 2012.

In this context, Australia's economic growth is forecast to strengthen from 3 per cent in 2010-11 to 3¾ per cent in 2011-12. In 2010-11, this represents a downgrade of ½ a percentage point since the September JIEFG, with a higher exchange rate weighing on real GDP growth in the near-term and consistent with further evidence that households are taking a more cautious approach to their finances in the wake of the global financial crisis. The recent weakness of machinery and equipment investment is also weighing on forecast GDP growth in 2010-11, with some of the investment indicated by the September quarter CAPEX for 2010-11 unlikely to materialise until 2011-12. The real GDP growth forecast for 2011-12 is unchanged from September.

The December JIEFG report includes 2012-13 as a forecast year for the first time, with real GDP forecast to grow at 3¾ per cent, or slightly above trend. Project level analysis suggests continued strong growth in mining investment and bulk commodity exports through to the middle of this decade, led by LNG and supported by high, albeit declining, coal and iron ore prices. Strong growth in mining-related construction activity and export incomes are expected to add to demand and inflationary pressures. Accordingly, it is anticipated that monetary conditions will remain restrictive over the

forecast horizon (through a combination of above average interest and exchange rates), holding down growth in dwellings investment, commercial building activity, and exports of services and manufactures and promoting the movement of the factors of production towards the resources sector.

Nominal GDP is expected to grow by $8\frac{1}{4}$ per cent in 2010-11, 1 percentage point slower than the September forecast, reflecting lower real GDP growth and more moderate domestic price growth, partly offset by a slightly higher terms of trade. The terms of trade are expected to rise by $16\frac{1}{4}$ per cent in 2010-11 – up from the 16 per cent rise forecast in September – and then decline a little more slowly than previously forecast, consistent with market perceptions that the increase in global supply of the main non-rural commodities will come on line more gradually than previously anticipated. Consequently, nominal GDP growth is now forecast to be 6 per cent in 2011-12 (compared with the September round forecast of 5 per cent) and $5\frac{1}{2}$ per cent in 2012-13.

Household finances are well-supported by the strength of the labour market and consumer confidence is above its long-term average. However, modest personal and housing credit growth and subdued retail sales suggest that households have adjusted their spending behaviour in the wake of the financial crisis. This has driven a downward revision to forecast growth in household consumption, which is now forecast to be close to trend across the forecast horizon. The household savings ratio is expected to fall only gradually, remaining at around 9-10 per cent over the forecast horizon.

Dwelling investment is forecast to be weaker in 2010-11 than anticipated in September, reflecting continued soft readings from leading indicators of activity, recent subdued growth in house prices and a larger-than-anticipated increase in standard variable mortgage interest rates in November. Looking ahead, it is anticipated that growth in dwelling investment will be weighed down by tighter monetary settings and increased competition for skilled labour as mining-related construction activity gains pace.

Mining investment is still expected to be a key driver of growth over the forecast period, underpinned by high prices for Australia's bulk non-rural commodity exports. Recent project announcements have added to the pipeline of mining-related investment and the CAPEX survey continues to point to a strong pick up in investment this financial year, consistent with recent strong growth in engineering construction activity. However, an unanticipated fall in machinery and equipment investment in the September quarter has led to a re-profiling of the business investment forecasts, with slightly weaker growth in 2010-11 followed by stronger growth in 2011-12. Meanwhile, with the BER winding down, high vacancy rates and a continuation of difficult credit conditions for developers, the outlook for the commercial property sector remains subdued.

Recent adverse weather has disrupted Queensland's metallurgical coal supply chain and affected both the quantity and quality of the wheat harvest, weighing on commodity exports in the September and December quarters. Looking ahead though, significant expansions to mine and infrastructure capacity are still expected to underpin strong growth in non-rural commodity exports. The outlook for exports of elaborately transformed manufactures (ETMs) and services is weaker than at September, with volumes growth for both sectors adversely affected by the higher exchange rate.

Imports are expected to grow strongly due to the recent exchange rate appreciation and large requirement for capital equipment in resource projects, although the delayed pickup in machinery and equipment investment and the lower consumption forecasts result in lower estimated import growth for 2010-11 than at the September round. The current account deficit is forecast to narrow sharply in 2010-11 to 2 per cent of GDP, then widen to $3\frac{1}{2}$ per cent and $5\frac{1}{4}$ per cent of GDP in 2011-12 and 2012-13.

Recent employment growth and labour market participation outcomes have exceeded expectations, with the participation rate now at record levels. Combined with a minor downgrade to the employment outlook, in line with lower forecast non-farm GDP growth, increased workforce participation has driven a slower forecast reduction in the unemployment rate. The unemployment rate is forecast to be 5 per cent in the June quarter 2011 and $4\frac{3}{4}$ per cent in the June quarters of 2012

and 2013. Forecast growth in the wage price index remains unchanged from the September round, rising to 4 per cent by the June quarter 2012.

With the economy approaching full capacity in 2011-12, inflationary pressures are expected to build over the forecast horizon. Although underlying pressures are a little weaker than at the September round, growth in utility prices and broader administered price pressures appear set to add to headline inflation for the next couple of years, leaving the headline inflation forecasts unchanged.

The major risks to the December round forecasts centre around the global risks outlined above. Domestically, the weak outcome for real GDP in the September quarter is a reminder that the after-effects of the crisis continue to influence the Australian economy, with households saving more and the expected recovery in business investment materialising more slowly than previously forecast. Notwithstanding the strong signals that large value projects are being progressed, the lumpiness of mining-related investment also raises the risk that economic growth could be volatile from quarter to quarter in the period ahead.

Overall, the inflationary risks associated with capacity constraints have lessened a little this round, given the slower forecast fall in the unemployment rate as increasing participation meets labour demand. However, a slower global supply response to high commodity prices could support resource revenues for longer and provide a longer-lived boost to domestic incomes.

The structural adjustment in the economy as the mining sector expands and places strains on other sectors is a source of further uncertainty in the forecasts. These strains could also result in localised effects that are not reflected in economy-wide averages.

Consistent with the 2010-11 Mid Year Economic and Fiscal Outlook, the medium-term projections are for real GDP to grow by 3 per cent, inflation to be at the middle of the target band and the terms of trade to fall by 20 per cent over the 15 years from 2012-13. However, there has been a change to the methodology for determining the exchange rate assumption at this round. The exchange rate will continue to be held constant at the prevailing level during the forecast period, but will now move in line with the long-term historical relationship between the terms of trade and the real effective exchange rate in the projection period, achieving greater consistency. In practice, this represents a minor change, with the current terms of trade projections implying a fall in the real exchange rate of 0.85 per cent per annum over the projection period (equal to 0.6 times the 1.4 per cent projected annual decline in the terms of trade). This change in methodology is detailed in Box 1.

Table 2 – Domestic economy forecasts

	Outcomes (a)				Forecasts				Outcomes (b)				Forecasts			
			Year average				Through the year				Through the year					
	2009-10	2010-11	2011-12	2012-13	June 2010	June 2011	June 2012	June 2013	June 2010	June 2011	June 2012	June 2013	June 2010	June 2011	June 2012	June 2013
Panel A - Demand and output(c)																
Household consumption	2.1	3 1/4	3 1/2	3 1/2	2.5	3	3 1/2	3 3/4								
Private investment																
Dwellings	2.1	2 1/2	2	2	11.7	0	2	2								
Total business investment(d)	-4.9	6 1/2	15 1/2	13	-1.8	12	17 1/2	11								
Non-dwelling construction(d)	-8.2	13	19	16	-3.5	14	23 1/2	11								
Machinery and equipment(d)	-4.8	1 1/2	16	12 1/2	-2.7	13	15	12 1/2								
Private final demand(d)	0.6	3 3/4	6	5 3/4	2.1	4 1/2	6 1/2	5 1/4								
Public final demand(d)	7.0	2	- 1/2	0	10.8	-2 3/4	2 1/4	-1 1/2								
Total final demand	2.1	3 1/4	4 1/2	4 1/2	4.1	2 3/4	5 1/2	3 3/4								
Change in inventories(e)	0.2	0	0	0	na	na	na	na								
Gross national expenditure	2.3	3 1/2	4 1/2	4 1/2	4.5	3 1/4	5 1/4	3 3/4								
Exports of goods and services	5.3	5 1/2	5	3 1/2	8.6	5	2	4								
Imports of goods and services	5.0	7 1/2	9	8 1/2	17.8	4	11	7 1/2								
Net exports(e)	0.1	- 1/2	- 3/4	-1 1/4	-1.7	1/4	-2	- 3/4								
Gross domestic product	2.2	3	3 3/4	3 1/4	3.1	3 1/4	3 1/4	3								
Non-farm product	2.3	2 3/4	3 3/4	3 1/4	3.2	3 1/4	3 1/4	3								
Farm product	-0.9	12	-5	2	1.3	5	4	1								
Nominal gross domestic product	2.3	8 1/4	6	5 1/2	8.7	6 3/4	5 1/4	5 1/4								
Panel B - Other selected economic measures																
External accounts																
Terms of trade	-4.4	16 1/4	- 3/4	-2 3/4	20.0	5	-3 1/2	-2 1/2								
Current account balance																
\$billion	-54.1	-28 1/2	-53 1/4	-80 1/2	na	na	na	na								
Percentage of GDP(f)	-4.2	-2	-3 1/2	-5 1/4	-1.6	-1 3/4	-4 1/2	-5 1/2								
Labour market																
Employment (labour force survey basis)	1.4	3	2	1 3/4	2.4	2 3/4	2	1 1/2								
Unemployment rate (per cent)(g)	5.5	5 1/4	5	4 3/4	5.2	5	4 3/4	4 3/4								
Participation rate (per cent)(g)	65.3	65 3/4	66	66	65.3	66	66	66								
Prices and wages																
Consumer Price Index (original)																
- headline	2.3	2 3/4	3	3	3.1	2 3/4	3	3								
- underlying	3.1	2 1/2	2 3/4	3	2.7	2 3/4	2 3/4	3								
Gross non-farm product deflator	0.1	5 1/4	2 1/4	2 1/4	5.4	3 1/4	2	2 1/4								
Wage Price Index	3.1	3 1/2	4	4	3.0	3 3/4	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 four columns are the percentage of GDP in the June quarter in 2010, 2011, 2012 & 2013 respectively.

(g) The outcomes and forecasts in the final four columns are the rate in the June quarter in 2010, 2011, 2012 & 2013 respectively.

Note: The forecasts for the domestic economy are underpinned by several technical assumptions. The exchange rate is assumed to remain around its level at the time the forecasts were prepared, with a trade-weighted index of around 74 and a \$US exchange rate of around 98c. Domestic interest rates are assumed to rise slightly, in line with market expectations. World oil prices (Tapis) are assumed to remain around \$US94 per barrel. The farm sector forecasts are based on average seasonal conditions over the remainder of the forecast period.

OUTLOOK FOR THE DOMESTIC ECONOMY

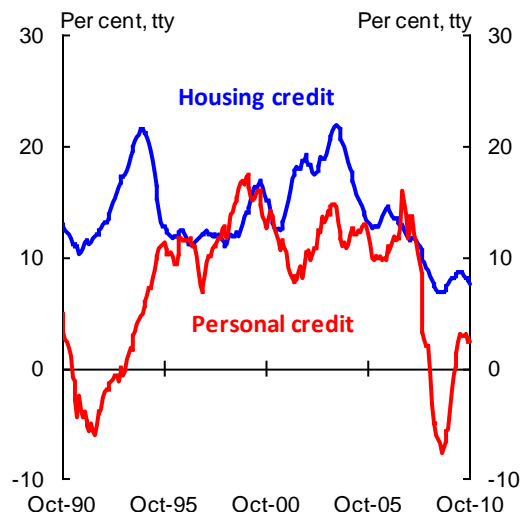
Australia's economic growth is forecast to strengthen from 3 per cent in 2010-11 to 3¾ per cent in 2011-12. The forecast for 2010-11 represents a ½ a percentage point downgrade since the September JIEG, due to a higher exchange rate weighing on growth in the near-term and further evidence that households are taking a more cautious approach to their finances. The recent weakness of machinery and equipment investment is also weighing on forecast GDP growth in 2010-11. The real GDP growth forecast for 2011-12 is unchanged from September.

Household consumption

Household consumption is expected to grow around trend over the forecast period supported by solid income growth, rising wealth and relatively stable interest rates. Consumption is forecast to grow by 3¾ per cent in 2010-11, and 3½ per cent in 2011-12 and 2012-13.

The elevated household saving ratio and subdued personal credit growth suggest that households are continuing to consolidate their balance sheets following the adverse impact of the global financial crisis on household wealth (Chart 1). The latest information from the retail trade survey and business liaison underscores a cautious approach to consumer spending, with retail turnover growing at below-trend rates. On the other hand, a strong Australian dollar is allowing retailers to reduce prices, which should support consumption in the near term.

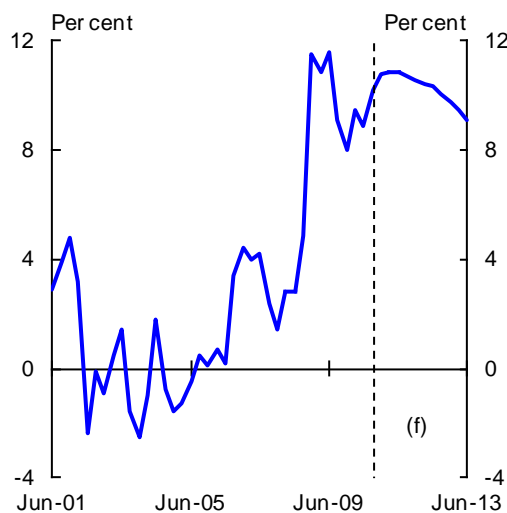
Chart 1: Credit growth



Source: RBA.

In 2010-11 and 2011-12, a continued cautious approach to household finances, slower population growth and above-average interest rates are expected to see consumption growing close to trend. With household disposable income continuing to grow strongly the household saving ratio is expected to remain at its current high levels (Chart 2).

Chart 2: Household saving ratio



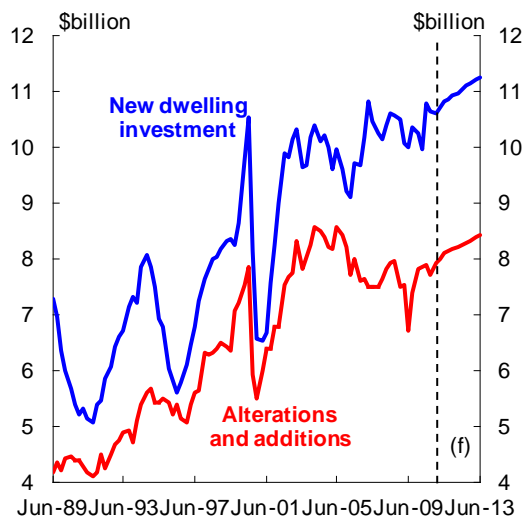
Source: ABS Catalogue Number 5206.0 and Treasury.

Dwelling investment

The outlook for dwelling investment is weaker than at the September round, driven by continued weakness in forward indicators and above-average interest rates. Dwelling investment is forecast to grow by 2½ per cent in 2010-11, compared with 4½ per cent at the

September round. Dwelling investment is expected to grow by 2 per cent in both 2011-12 and 2012-13 (Chart 3).

Chart 3: Dwelling investment



Source: ABS Catalogue Number 5206.0 and Treasury.

Dwelling investment grew by 2.1 per cent in 2009-10 – its strongest pace since 2004, largely due to strong growth in alterations and additions (up 4.2 per cent). New dwelling investment only increased marginally (up 0.6 per cent).

Dwelling investment was weak in the September quarter, with falls in both new dwelling investment (down 1.3 per cent) and alterations and additions (down 2.5 per cent). Leading indicators released in the September quarter also point to a weaker outlook for dwelling investment in the near term, with approval numbers down for the second consecutive quarter in September.

Over the forecast period higher interest rates and supply constraints (namely skilled labour shortages, difficulties with the planning and approvals process and land supply issues) will continue to weigh on growth.

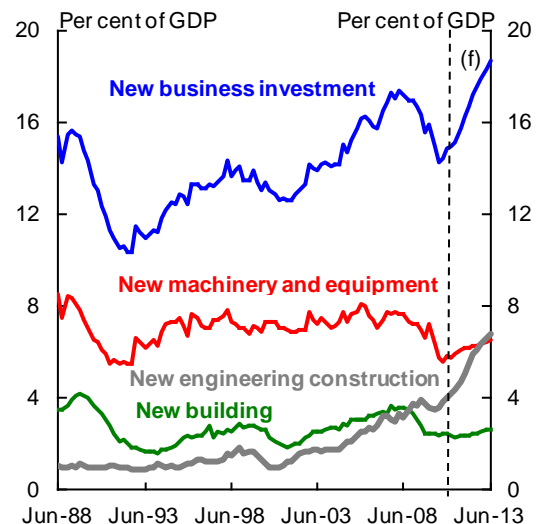
Business investment

The outlook for business investment remains very strong. Further resource projects have been added to the investment pipeline in recent weeks, and the September quarter CAPEX survey pointed to a strong pick up in investment in 2010-11, underpinned by expectations of continued high commodity

prices. While the transition from public investment to private investment remains on track, an unanticipated decline in machinery and equipment investment has led to a re-profiling of the forecasts. **New business investment** is expected to be slightly weaker in 2010-11, growing by 6½ per cent. However, growth in 2011-12 is expected to be stronger at 15½ per cent. The continued robust outlook for mining investment is expected to see growth maintained at 13 per cent in 2012-13 (Chart 4).

In recent months, survey measures of business conditions, business confidence and investment intentions have stabilised around long-run average levels. These surveys have also highlighted significant differences across the economy, with the resources sector well ahead of other sectors.

Chart 4: Business investment to GDP



Source: ABS Catalogue Number 5206.0 and Treasury.

The outlook for **new machinery and equipment investment** is weaker in the near-term than forecast in the September round, with a further decline in the September quarter suggesting delays. After recording strong growth in the previous estimate, the latest CAPEX survey estimate for 2010-11 rose only marginally and now implies soft growth this financial year. Despite this, machinery and equipment investment is still expected to rebound strongly over coming years driven by mining-related activity and necessary maintenance and replacement spending. Machinery and equipment investment is now expected to grow by 1½ per cent in 2010-11, before accelerating with

growth of 16 per cent in 2011-12 and 12½ per cent in 2012-13.

Strong growth in **new engineering construction** investment over the past two quarters suggests that the anticipated surge in mining investment is underway. Forecasts have been revised upwards since the September round following the announcement of positive final investment decisions for a number of projects including Rio Tinto and Fortescue Metals' US\$7.2 billion and US\$8.4 billion Pilbara iron ore expansions and BG's US\$15 billion Queensland Curtis LNG project. Engineering construction investment is now expected to grow by 19½ per cent in 2010-11, 29 per cent in 2011-12 and 19½ per cent in 2012-13.

Investment in **new non-residential building** during 2010 has been driven by activity under the Building the Education Revolution (BER) program and a stronger-than-expected run-down of the existing stock of work. As a result, new building investment is forecast to grow by 3 per cent in 2010-11. However, underlying conditions in the sector remain weak with the pipeline of future projects contracting further and continued high vacancy rates weighing on the sector. These conditions are expected to continue into 2011. Accordingly the sector is only expected to grow 1½ per cent in 2011-12. As the economy expands and labour demand continues to grow strongly, underlying demand for new floor space is expected to rebound, leading to growth in investment of 7½ per cent in 2012-13.

Public final demand

The withdrawal of stimulus continued to detract from growth in the September quarter 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 2010-11 and ½ of a percentage point in 2011-12.

After peaking at 7.0 per cent in 2009-10, growth in public final demand is forecast to be 2 per cent in 2010-11. Growth has been upgraded since September, reflecting stronger

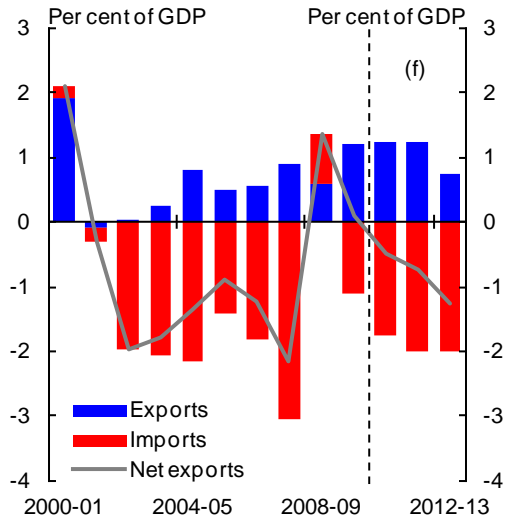
growth expectations for Commonwealth investment due to an increase in estimated NBN investment. Public final demand is forecast to fall ½ per cent in 2011-12, and remain flat in 2012-13.

Exports, imports and the current account deficit

While ongoing strong demand for Australia's bulk commodity exports still underpins the export forecasts, export volumes growth in 2010-11 is expected to be lower than at September, largely reflecting the effect of recent heavy rains in Queensland – reducing non-rural commodity export volumes. Total exports are expected to increase by 5½ per cent in 2010-11, 5 per cent in 2011-12 and 3½ per cent in 2012-13.

Net exports are expected to detract ½ of a percentage point from GDP growth in 2010-11, a smaller subtraction than September, reflecting weaker import volumes, and ¾ of a percentage point in 2011-12, the same as at September. Net exports are set to detract 1¼ percentage points from GDP growth in 2012-13.

Chart 5: Net exports – contribution to GDP growth



Source: ABS Catalogue Number 5206.0 and Treasury.

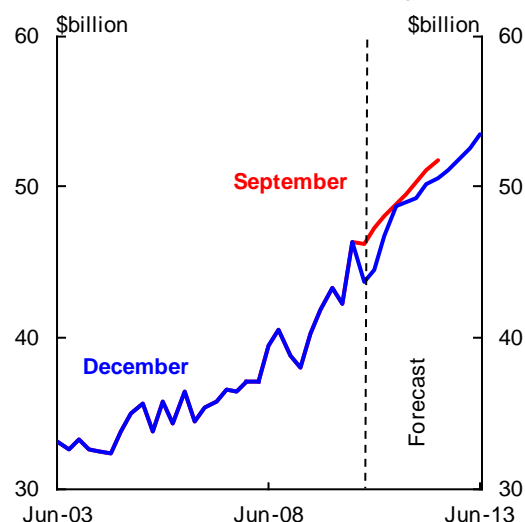
Rural exports are expected to grow rapidly in 2010-11 (and stronger than at September), increasing by 15 per cent, before declining by 4½ per cent in 2011-12 and 3½ per cent in 2012-13. Good rainfall for much of the winter has led to a strong upgrade to expected winter

crop production for 2010-11. This, along with higher prices resulting from unfavourable weather across producing countries, is expected to lead to higher export volumes as farmers export from existing inventories in addition to the current harvest. However, continued heavy rainfall through spring across eastern Australia has reduced the quality of the winter crop, and more recent flooding represents a downside risk to the size of the crop, and thus export volumes. The falls in export volumes in 2011-12 and 2012-13 reflect lower farm production in those years – consistent with a return to more normal seasonal conditions

Non-rural commodity exports are expected to increase strongly over the forecast period, as ongoing expansions to mine and infrastructure capacity allow for greater export volumes. Growth is expected to be 5½ per cent in 2010-11, followed by 8½ per cent and 5 per cent in 2011-12 and 2012-13.

The forecast for 2010-11 is lower than at September, largely reflecting the recent weather-related disruptions to Queensland's metallurgical coal supply chain. The September quarter 2010 saw non-rural commodity exports record their largest fall in over a decade (albeit to the second highest level on record), largely reflecting lower metallurgical coal volumes. Thus far in the December quarter, ongoing heavy rains in Queensland's key coal mining regions have disrupted mine production, and forced the closure of a major rail line that services key Queensland coal ports. Over the forecast period, significant expansions to mine and infrastructure capacity are expected. In particular, the anticipated completion of BHP's Rapid Growth Project 5 in early 2011-12 is expected to provide a substantial boost to iron ore exports.

Chart 6: Non-rural commodity exports



Source: ABS Catalogue Number 5302.0 and Treasury.

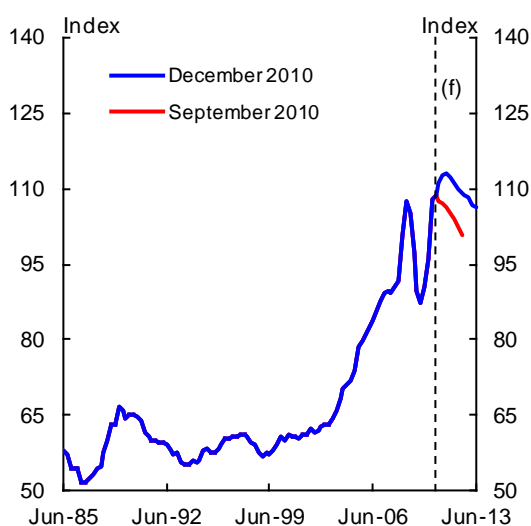
The outlook for exports of **elaborately transformed manufactures (ETMs)** and **services** is weaker than at September, with volumes growth for both sectors adversely affected by the higher exchange rate. ETMs exports are expected to grow by 1 per cent in 2010-11 and 4 per cent in both 2011-12 and 2012-13. For services, further declines in student commencements forewarn of continued weakness in Australia's education-related exports. This reflects reduced demand from key markets in South Asia – in addition to a higher exchange rate. Services exports are expected to fall by 1 per cent in 2010-11, before growing by a weak 1½ per cent in 2011-12 and ½ per cent in 2012-13.

Import volumes are expected to increase strongly over the forecast period, supported by the high exchange rate and driven by capital equipment imports for the resources sector – particularly, for the construction of major LNG projects. With the re-profiling of forecast investment in machinery and equipment, the forecast for import volumes has growth weaker in 2010-11 (at 7½ per cent), but stronger in 2011-12 (at 9 per cent), compared with the September forecasts. In 2012-13, import volumes are expected to increase by 8½ per cent.

The forecast for **terms of trade** growth is slightly higher than at September on the back of an improved outlook for bulk commodity prices. The terms of trade are expected to rise by 16¼ per cent in 2010-11, before declining by

½ of a percentage point in 2011-12 and 2¾ per cent in 2012-13 – as commodity prices start to come off in line with increased global supply. The expected decline in commodity prices is a little more muted than at September. This reflects a growing view amongst market analysts that much of the expected global mine supply of iron ore and coal is unlikely to come on line as previously scheduled, including in Australia. Over the forecast period, continued rail-related infrastructure bottlenecks in Queensland and New South Wales are expected to limit the potential of coal exports whilst mine and port capacity expand – providing support to coal prices.

Chart 7: Terms of Trade



Source: ABS Catalogue Number 5206.0 and Treasury.

The **current account deficit** is expected to narrow sharply in 2010-11 to 2 per cent of GDP – with the trade balance moving into surplus, partly offset by a wider net income deficit. Thereafter, the current account deficit is expected to widen to 3½ per cent of GDP in 2011-12 and to 5¼ per cent of GDP in 2012-13, reflecting a decline in the trade surplus and a wider net income deficit.

The **trade balance** is expected to reach a surplus of 2½ per cent of GDP in 2010-11, driven by increased prices for non-rural commodity exports. This is higher than at September, largely reflecting lower capital import volumes related to the resources sector. The trade surplus is expected to decline to 1½ per cent of GDP in 2011-12 before reaching balance in 2012-13 – with

prices for non-rural commodities declining slightly, and import volumes continuing to increase at a strong pace.

The **net income** deficit is expected to widen in 2010-11 and 2011-12, as was the case at September, with a considerable proportion of the increased income from non-rural commodity exports flowing to foreign investors. The net income deficit is expected to widen to 4¼ per cent of GDP in 2010-11 and to 5 per cent of GDP in 2011-12, and 2012-13.

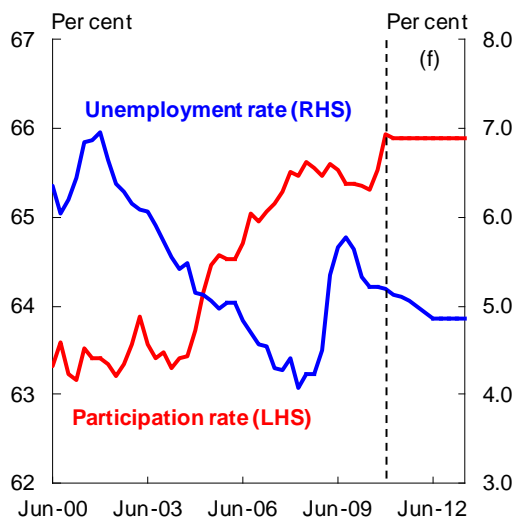
Employment, wages and inflation

Forecasts for **employment growth** are largely unchanged since the September round. While the outcomes to date in the December quarter 2010 have been strong, this has been offset by a weaker outlook over the remainder of the forecast horizon in line with the downgrade to GDP growth. The labour market is now expected to approach capacity during 2011-12, with the unemployment rate expected to be 5 per cent in the June quarter 2011 and 4¾ per cent in the June quarters of 2012 and 2013. The forecasts for the unemployment rate are slightly higher than at September, largely reflecting a higher participation rate throughout the forecast period (Chart 8).

Employment growth is forecast to be 2¾ per cent through the year to the June quarter of 2011, 2 per cent to the June quarter of 2012, and 1½ per cent to the June quarter of 2013.

The **participation rate** is forecast to be 66 per cent at the end of the forecast period. The upgrade in the participation rate reflects the unexpectedly strong outcomes of recent months and the ongoing trend of increasing participation by people 55 and over.

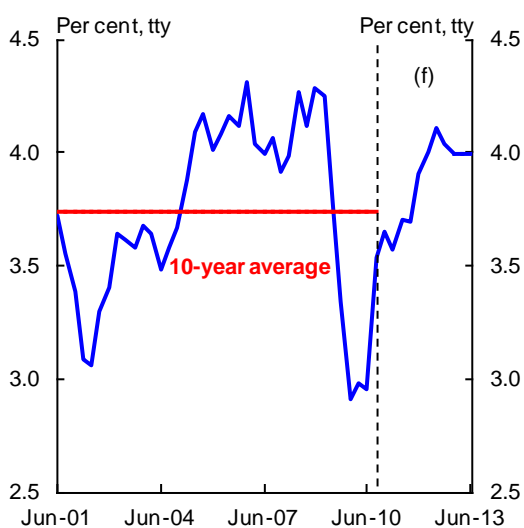
Chart 8: Unemployment and Participation Rates



Source: ABS Catalogue Number 6202.0 and Treasury.

Forecasts for wages are broadly unchanged since the September round. Following a stronger-than-expected outcome for the September quarter, wages have recovered during 2010 to close to trend growth rates.

Chart 9: Wage Price Index growth



Source: ABS Catalogue Number 6345.0 and Treasury.

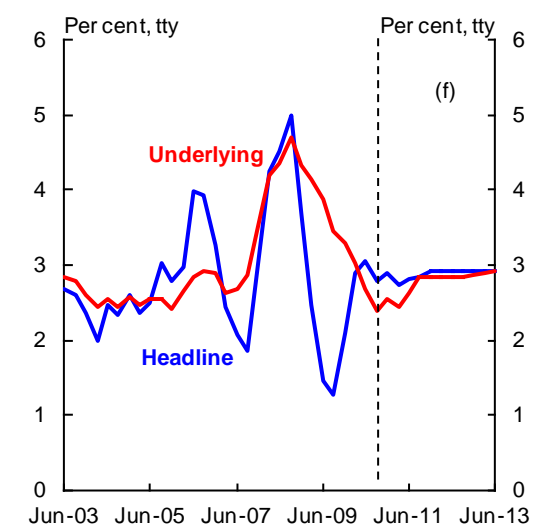
The **Wage Price Index** is expected to grow by 3¾ per cent through the year to the June quarter of 2011, and 4 per cent through the year to the June quarters of both 2012 and 2013. These forecasts reflect an expectation that the labour market will reach full capacity in 2011-12 and that the terms of trade will remain high, supporting wages in resource-related industries (Chart 9).

Headline and underlying inflation forecasts are little changed since the September round, with rising inflation toward the end of the forecast period reflecting an economy approaching capacity in 2011-12. The labour market is expected to be relatively weaker than at the September round, reducing pressure on underlying inflation, while persistent increases in administered prices are expected to contribute to headline inflation throughout the forecast period.

Consumer Price Index (CPI) inflation eased in the September quarter with through-the-year measures of headline and underlying inflation slowing, reflecting weakness in market-driven components and a seasonal slowing in the growth in the prices of administered items. However, administered prices, particularly utilities, are expected to grow strongly over the forecast period, exerting upward pressure on headline CPI even as market price growth remains moderate.

Underlying inflation is expected to be 2¾ per cent through the year to the June quarters of both 2011 and 2012, before picking up to 3 per cent through the year to the June quarter of 2013. **Headline inflation** is expected to be 2¾ per cent through the year to the June quarter of 2011, before picking up to 3 per cent through the year to the June quarters of 2012 and 2013. (Chart 10).

Chart 10: Inflation



Source: ABS Catalogue Number 6401.0 and Treasury.

BOX 1: THE TERMS OF TRADE AND EXCHANGE RATE PROJECTIONS

Treasury’s economic estimates consist of around 2-3 years of forecasts and around 20 years of projections which are based upon medium-term assumptions. From this round, the exchange rate assumption has been changed in the projection period. In the forecast period, Treasury will continue its current methodology of keeping the exchange rate constant, while in the projection period the exchange rate will be linked to the projected terms of trade.

In their seminal paper, *Empirical exchange rate models of the seventies: Do they fit out of sample?*, Meese and Rogoff (1983) demonstrate that over the short-run (around one year) exchange rates move unpredictably and the current spot rate is the best predictor of the future exchange rate. However, in the medium-term, exchange rates are likely to move in line with economic fundamentals. This is now the standard view of modelling exchange rates, with these findings having since been repeated frequently in the literature.

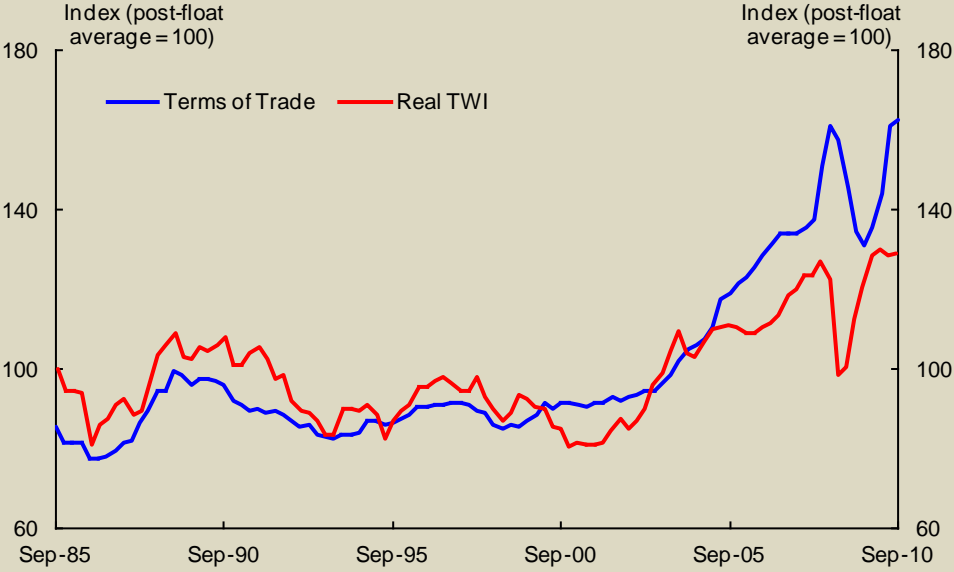
Prior to the December 2010 JIEFG, Treasury had adopted the assumption that the best predictor of the future exchange rate is the current rate. The exchange rate was therefore held constant over the forecast horizon and the projection period. This remains Treasury’s preferred methodology over the forecast horizon.

In the longer term, Australia’s exchange rate is determined by factors such as the terms of trade and interest rate differentials. Over the projection period, the terms of trade is assumed to fall by around 20 per cent over 15 years. The current high prices and continued strong demand for Australia’s bulk commodities are expected to elicit a global supply response which will see global prices (and the terms of trade) decline.

Such a substantial change in the terms of trade will likely be reflected in the real effective exchange rate. There are a range of estimates in the literature of the relationship between the Australian dollar and the terms of trade. These, combined with Treasury modelling, suggest that a 1 per cent fall in the terms of trade will lead to a 0.6 per cent fall in the real effective exchange rate on average.

As such, the real effective exchange rate is now projected to decline by around 0.85 per cent (0.6 times the 1.4 per cent annual decline in the terms of trade) each year over the projection period.

Chart A: Terms of trade and real TWI



OUTLOOK FOR THE INTERNATIONAL ECONOMY

Table 3: International GDP growth forecasts^(a)

	2009	2010		2011		2012	
	Actual	Sept JIEFG	Dec JIEFG	Sept JIEFG	Dec JIEFG	Sept JIEFG	Dec JIEFG
United States	-2.6	2 3/4	2 3/4	2 1/4	2 1/4	2 1/2	2 1/2
Euro Area	-4.1	1 1/2	1 3/4	1 1/4	1 1/4	1 1/4	1 1/4
Japan	-6.3	3	4 1/4	1 1/4	1 1/4	1 1/4	1 1/4
China	9.1	9 3/4	10	9	8 3/4	9	9
India	5.7	9 1/4	10	8	8 3/4	8 3/4	8 3/4
Other East Asia (b)	0.3	8	7 1/2	4 3/4	5	5 1/4	5 1/2
Major Trading Partners	-0.2	6	6 1/4	4 1/4	4 1/4	4 1/2	4 1/2
World	-0.7	4 1/4	4 3/4	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 (which were also previously used for other East Asia, including in the September 2010 JIEFG round).

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

Source: National statistical publications, IMF and Treasury.

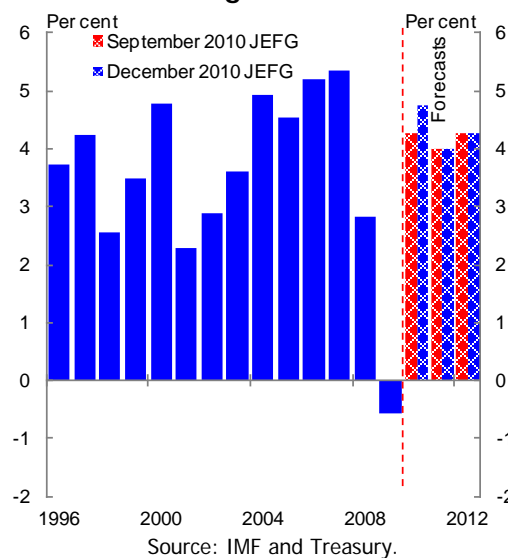
World outlook

As in the 2010-11 MYEFO, the global economy is forecast to continue growing at solid rates over the forecast horizon, with the two-speed global recovery expected to persist. Since the September JIEFG round, however, the global outlook has become more uncertain and downside risks still predominate.

The 2010 **global growth** forecast has been revised up to 4¾ per cent (Table 3 and Chart 11), reflecting in large part, continued upside surprises from major East Asian economies and the United Kingdom. Australia's **major trading partners** are forecast to grow at 6¼ per cent, the fastest annual rate in more than 20 years.

However, growth in 2010 is off an historically low base and has been assisted by temporary factors such as fiscal stimulus and inventory rebuilding. Accordingly, global growth is forecast to ease to 4 per cent in 2011, as these temporary supports abate. Emerging economies are forecast to continue to grow strongly and at more sustainable rates.

Chart 11: World GDP growth



Fiscal stimulus in advanced economies is being progressively removed, with recent developments in the United States an exception. However, ongoing moderate rates of growth and subdued inflation mean that very accommodative monetary policy settings will remain in most advanced economies for some time, most notably in the US.

The global growth forecast for 2012 of 4¾ per cent is unchanged from September JIEFG, with most economies assumed to return to around trend rates. A notable exception is the euro area, where fiscal consolidation and

structural impediments will continue to weigh on growth.

There are some clear downside risks to the outlook. Planned fiscal consolidation in 2011 may prove excessive, and ill-timed for some advanced economies. The euro area periphery's sovereign debt problems are another well known risk.

Market concerns persist over the risk of contagion from Ireland to Portugal, and possibly to Spain. The persistent uncertainty in global financial markets regarding the periphery may reflect the ad hoc nature of the bailouts to date which have not addressed the periphery's underlying debt problems. The prospect of a debt restructuring cannot be ruled out, a scenario that could prove very disruptive not just to the rest of Europe, but to the global financial system.

However, so far there is no evidence that the problems in the euro area periphery are affecting economic performance in the core euro area countries, or causing disruption to the financial markets or the real economies of the UK, US or Asia.

Financial market conditions more broadly are also being influenced by the adoption of a second round of quantitative easing (QE2) in the US. The implementation of QE2 raises the prospect of even larger capital flows and further asset and consumer price pressures in high-growth emerging economies as investors seek higher yields. While one of QE2's transmission channels is downward pressure on the US dollar and a boost to US exports, this effect may be offset by any flight to safety to US assets (and therefore US dollars) by global investors, say due to European sovereign debt concerns.

In addition to the downside risks identified above tensions among G20 members regarding perceived currency manipulation and large and volatile capital flows have emerged as an additional risk. While these tensions appear to have abated in the aftermath of the G20 summit in Seoul in early November, they remain unresolved.

If these concerns were to flare up again they present a risk of permanent capital controls and protectionism, thus stifling global capital and trade flows and hindering global growth.

While the balance of risks is on the downside, as at September JIEFG there is one significant upside risk. If a 'circuit breaker' could be found to the current uncertainty, financial market sentiment could quickly rebound. Given the volume of liquidity, particularly the very high levels of profits and excess reserves held by US corporates and banks respectively, a sharp upward shift in sentiment could see lending rebound rapidly, substantially boosting real economic activity.

A positive development has been the diminishing of two downside risks since September JIEFG. The recent run of largely positive partial data suggests that the imminent prospect of a double dip recession in the US has passed. Similarly, the risk of China experiencing a more severe near-term slowdown than expected due to a rapid policy tightening appears to have passed. However, China still faces pressure to tighten macro policy to address rising inflation and excess liquidity.

Country summaries

The outlook for the **United States** has improved since September JIEFG, with previous concerns over a double-dip recession abating. Consumer spending has picked up modestly, and indicators of future business investment have improved following mid-year lows. However, high unemployment and a depressed housing sector will continue to weigh upon consumer and business confidence, and contribute to a subdued recovery in the US. As such, GDP growth forecasts remain unchanged at 2¾ per cent in 2010, 2¼ per cent in 2011 and 2½ per cent in 2012.

In response to the slow economic recovery and historically low underlying inflation, in early November the US Federal Reserve announced a further US\$600 billion in asset purchases (known as 'QE2'). However, while QE2 may boost consumer demand and encourage

business investment through lower interest rates and higher asset prices, its impact on the real economy is expected to be small, as it will do little to address the underlying demand deficit. US businesses and banks are already sitting on large reserves of cash, and will be reluctant to increase investment and lending respectively until consumption increases. This, in turn, will be dependent on a fall in the unemployment rate, further repair of consumer balance sheets, and a recovery in the housing market – the outlook for all three remains subdued.

Overall, the US economy is expected to grow below trend over the forecast horizon, with some upside risk if the impact of QE2 on consumer and business confidence and activity is better than expected.

Since the finalisation of the forecasts, the US government has legislated a fiscal package that includes a combination of business tax incentives, a deferral of income tax rate increases, payroll tax cuts, tax credits, and a further extension of unemployment benefits. This has led to an upgrading of market forecasts for US growth in 2011.

The outlook for **China** remains broadly unchanged from September JIEG. China's economy is expected to grow by 10 per cent in 2010 and by 8¾ per cent in 2011. The marginal downward revision to 2011 growth is primarily due to expectations that recent Government efforts to rein in accelerating inflation – a result of excess liquidity and disruptions in food supplies from natural disasters – may result in a slower pace of expansion. The outlook for growth in 2012 of 9 per cent remains unchanged.

As the Government's infrastructure-focused stimulus measures wind down and energy intensity reduction targets are enforced, last year's drivers of growth – industrial production, loan growth and investment – continue to moderate as expected. Efforts to engineer a slower pace for growth and reduce inflationary pressures suggest the Government is confident with the fundamental drivers of the economy, with authorities aiming for more stable and sustainable growth. Strong domestic demand is expected to continue

driving growth, while net exports, after detracting from growth in 2009, are expected to make a small positive contribution between 2010 and 2012.

Risks to growth largely depend on the effectiveness of the government's response to accelerating inflation. Authorities have recently introduced a range of measures aimed at reducing excess liquidity and food price inflation. These include raising the reserve requirement ratio by 150 basis points during November and December to date, increasing benchmark interest rates by at least 25 basis points, and enacting price controls. Tightening measures are expected to continue in 2011, including further interest rate increases. A slower-than-expected recovery in developed countries, leading to sluggish demand for Chinese goods, may also adversely impact on growth.

Japan's outlook remains uncertain. Stronger than expected growth in the September quarter combined with sharp upward revisions to growth over the past year indicate that Japan's recovery has been stronger than previously thought. However, the September quarter pickup reflects temporary factors to some degree – with recent data across a range of indicators pointing to flat or negative growth in the December quarter and possibly some softness early next year. Strong underlying deflationary pressures remain, despite a recent increase in headline inflation rate due to tax changes. Overall, the Japanese economy is expected to slow sharply from an estimated 4¼ per cent growth in 2010 to 1¼ per cent in both 2011 and 2012.

The **Indian** economy has grown strongly over the past year. Reflecting a stronger than expected September quarter, India's economy is now forecast to grow by 10 per cent in 2010, before slowing to 8¾ per cent in both 2011 and 2012. While there are signs that industrial sector growth may be moderating, private domestic demand is expected to remain strong, supported by robust labour market conditions and rising disposable income. Going forward, the large fiscal deficit and high inflation are likely to be the main macroeconomic pressure points affecting India's growth performance.

Since September JEFEG, economic activity in the **euro area** has slowed in line with expectations. The two-speed economy that has emerged in the region is expected to continue. The recent depreciation in the euro will boost exports, while increasing private sector demand in the core economies should also support growth. However, persistent high unemployment, additional fiscal consolidation efforts in 2011, and ongoing weakness in the periphery will offset part of the strength in the core. GDP is forecast to grow 1¾ per cent in 2010 before slowing to 1¼ per cent in 2011 and 2012.

The **United Kingdom** economy has grown more strongly than expected so far in 2010. Looking forward, however, the recovery is expected to be protracted, as growth is held back by the Government's fiscal consolidation measures and efforts to reduce private sector indebtedness. After contracting by 5 per cent in 2009, GDP is forecast to record modest growth of 1¾ per cent in both 2010 and 2011, before stronger growth of 2¼ per cent in 2012.

The **Newly Industrialised Economies (NIEs)** have recovered strongly from the global financial crisis and growth is expected to continue, albeit at a slower pace. Fiscal stimulus and capital inflows have helped the stronger-than-expected recovery. Going

forward, the governments of the NIEs are seeking sustainable growth, and have taken measures to address risks related to strong capital flows and associated asset-price inflation. Real GDP is expected to grow by 8 per cent in 2010, 4¾ per cent in 2011 and 5 per cent in 2012.

Economic activity in the **ASEAN-5** rebounded strongly in the first half of 2010, supported by strong domestic demand and a rebound in exports which propelled economies such as the Philippines and Malaysia to their strongest growth rates in recent years.

However, economic activity is now returning to more sustainable levels, with trade, industrial production and domestic demand all moderating over recent months. Economic growth for the year has peaked, with GDP in Thailand, Malaysia and the Philippines contracting in the September quarter and coming in below market expectations, while growth in Indonesia also moderated. Nevertheless, the policy environment remains largely accommodative and will help to underpin growth going forward. Growth in the region is forecast to be 6¾ per cent in 2010 before moderating to 5¾ per cent in 2011 and 6 per cent in 2012.