



Australian Government

The Treasury

FORECASTING REPORT

ECONOMIC OUTLOOK FOR 2012-13, 2013-14 AND 2014-15

JUNE 2013

This report incorporates Domestic and International data released up to 31 July 2013.

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OVERVIEW

The Australian economy is forecast to grow a little below trend, with real GDP expected to increase by 2½ per cent in 2013-14, rising to 3 per cent in 2014-15. Compared with Budget, forecast growth has been revised lower by ¼ of a percentage point in 2013-14, with weaker household consumption and business investment only partly offset by lower import growth and stronger non-commodity exports owing to the lower Australian dollar. The unemployment rate is forecast to rise to 6¼ per cent by mid-2014 before stabilising as economic growth strengthens. While real activity is expected to remain solid, nominal GDP growth is forecast to be substantially weaker than expected at Budget owing to sharp falls in world commodity prices and softer wage growth.

The global economy has weakened further since Budget, and the outlook remains challenging with global growth expected to remain well below trend in 2013. While signs of a strengthening in activity in the United States and Japan are encouraging, this is being offset by continued weakness in Europe. While China is still expected to drive global growth in coming years, growth is expected to be somewhat more moderate than at Budget.

Table 1: Key Domestic Forecasts^(a)

	2011-12	2012-13 (b)		2013-14		2014-15	
	Outcome	Budget	June	Budget	June	Budget	June
Real GDP	3.4	3	2 ¾	2 ¾	2 ½	3	3
Nominal GDP	5.0	3 ¼	2 ½	5	3 ¾	5	4 ½
Unemployment rate	5.1	5 ½	5.6	5 ¾	6 ¼	5 ¾	6 ¼
Employment	1.2	1 ¼	1.3	1 ¼	1	1 ½	1 ½
CPI	1.2	2 ½	2.4	2 ¼	2 ½	2 ¼	2
Underlying inflation	2.2	2 ¼	2.4	2 ¼	2 ½	2 ¼	2 ¼
WPI	3.7	3 ½	3 ¼	3 ½	3 ¼	3 ½	3 ¼
Terms of trade	0.4	-7 ½	-10 ½	-¾	-5 ¾	-1 ¾	-3 ¾

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

(b) The unemployment rate, employment growth, and headline CPI and underlying inflation are ABS outcomes.

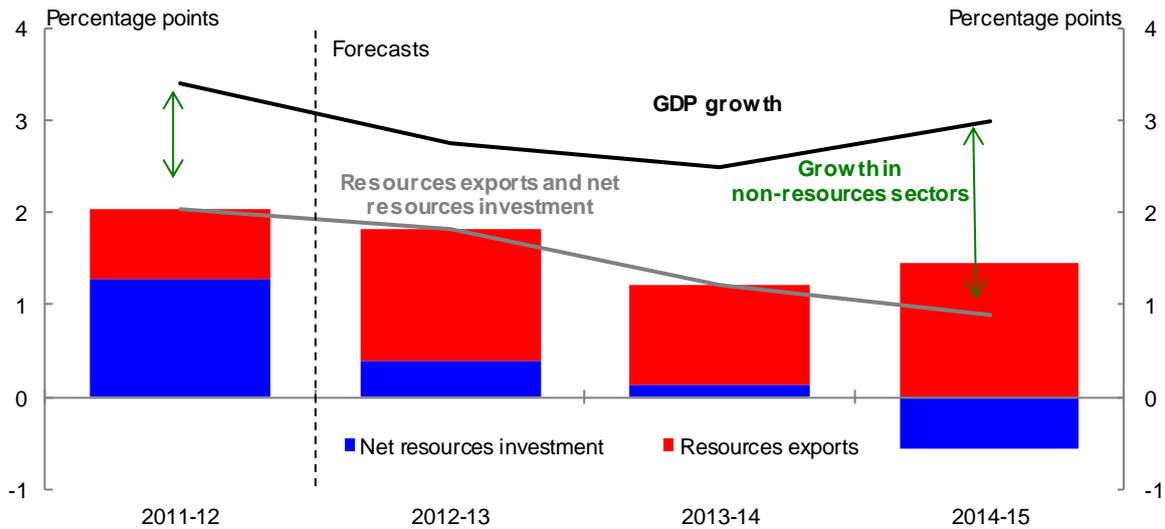
Source: ABS cat. No. 5206.0, 5302.0, 6202.0, 6345.0, 6401.0 and Treasury.

The economy is expected to undergo two large transitions over the forecast period. Most notably, the passing of the resources investment peak will see economic activity in the resources sector shift towards production and exports. This will see a decline in the contribution to growth from resources investment net of imports, and an increase in the contribution from resources exports (Chart 1). At the same time, a rebalancing of economic growth towards non-resources sectors is expected to take place, supported by low interest rates and the lower Australian dollar. These transitions are mostly evolving as expected although the peak in resources investment has been further revised down, and the recovery in the non-resources sector has been slow to take hold.

Resources investment has been revised down since Budget, reflecting slower-than-expected progress on some existing projects and a reassessment of the outlook for new project commencements as the sector becomes more cautious in the allocation of capital. Outside the resources sector, there have been some signs of improvement to the outlook for investment since Budget. The latest CAPEX survey indicated growth in non-mining investment for 2013-14 and the lower exchange rate is expected to help boost demand for non-mining goods and services over time. However, with measures of business conditions and capacity utilisation sitting around four year lows, it is expected to take some time before businesses have the confidence and need to increase their level of investment significantly.

Dwelling investment is responding to supportive monetary conditions, with strong growth in the construction of new dwellings offsetting ongoing weakness in alterations and additions. The emerging recovery is expected to gather momentum over the forecast period, supported by continued low interest rates, strong population growth, rising rental yields and low vacancy rates. Nonetheless, elevated unemployment expectations and fragile consumer confidence could weigh on this recovery in the near term. Supply side constraints also remain a risk to dwelling investment.

Chart 1: Contribution to real GDP growth



Note: Assumes that resources investment has an import share of 50 per cent.
 Source: ABS cat. No. 5206.0 and Treasury.

Household consumption will continue to support economic growth over the next two years, although forecast growth has been revised down since Budget reflecting weaker household income growth. Consumers are expected to face higher prices as a result of the lower Australian dollar and how they respond to their reduced purchasing power will be key to the outlook. The forecast for consumption growth is supported by a sharper than previously expected fall in the household saving ratio. Should households choose to be more cautious, consumption growth could be lower still.

The outlook for exports remains broadly unchanged since Budget. Stronger non-commodity exports owing to the lower exchange rate have been broadly offset by downgrades to resources exports, with a modest delay in the expected ramp-up in coal exports and slightly weaker volumes for non-bulk commodity exports only being partially offset by an upgrade in iron ore exports. Nonetheless, non-rural commodity exports are still expected to grow strongly, growing by 22 per cent over the rest of the forecast period. Import growth expectations have been lowered over the forecast period reflecting the dampening effect of the lower exchange rate on the demand for imports and lower investment in the resources sector.

The terms of trade have been revised down sharply since Budget, reflecting significant falls in world commodity prices in recent months due to slowing Chinese economic growth. Much like the underestimation of the increase in commodity prices during the terms of trade boom, Treasury (and others) have underestimated the pace at which commodity price have fallen since their peak in 2011. To put recent declines into context, US dollar bulk commodity prices at Budget were anticipated to fall by around 12 per cent over the whole forecast period to June 2015. Since the Budget forecasts were finalised, US dollar commodity prices have already fallen by around this magnitude, notwithstanding the recent restocking led bounce back in iron ore prices.

While the lower Australian dollar is helping to cushion the fall when prices are measured in Australian dollars, it has not been enough to offset the magnitude of the US dollar declines. The magnitude and speed of recent declines has prompted a reassessment of the level commodity prices will reach at the end of the forecast period. A softer outlook for Chinese economic growth, increased supply and lower global costs of production have lowered the expected price levels for metallurgical coal, iron ore and thermal coal at the end of the forecast period.

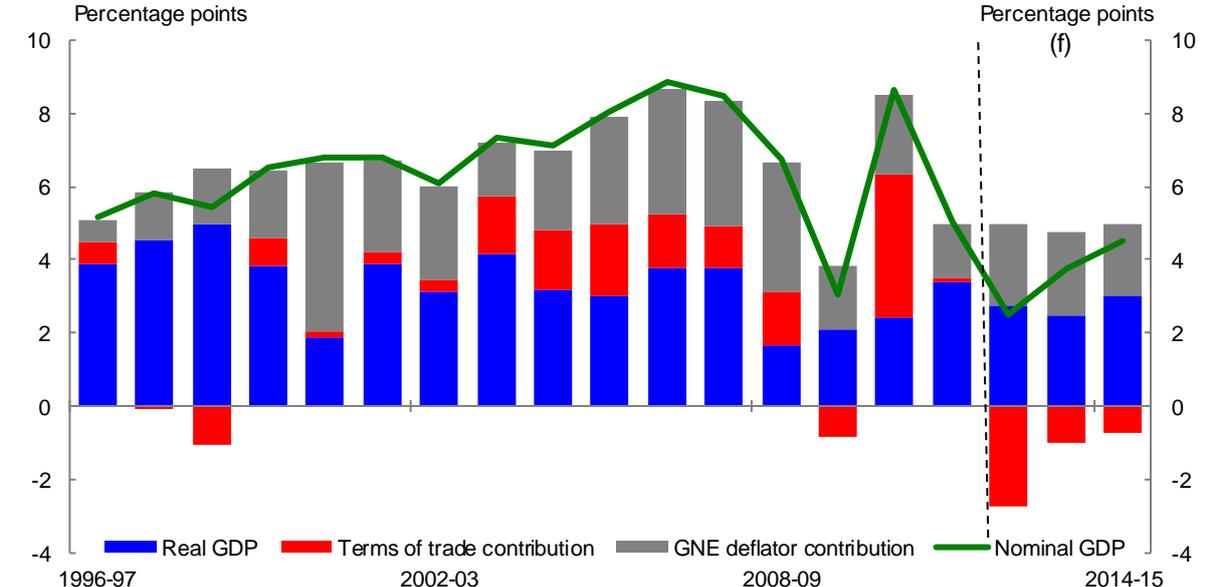
The revisions to the terms of trade, along with a weaker outlook for wage growth, have led to a substantial downgrading of nominal GDP growth across the forecast period. Weaker wages growth is expected to feed back into weaker growth in the investment deflators, more than offsetting the effect of higher import prices from the lower exchange rate. Nominal GDP is now expected to grow by 2½ per cent in 2012-13, 3¼ per cent in 2013-14 and 4½ per cent in 2014-15, downgrades of ¾ of a percentage point in 2012-13, 1¼ percentage points in 2013-14 and ½ of a percentage point in 2014-15.

The weakness in nominal GDP over the past couple of years has largely been concentrated in company profits. However, over the past year, wage growth has slowed. Reflecting this, wage growth has been revised down to 3¼ per cent through the year to the June quarters of 2013, 2014 and 2015. The weakness in wages is broadly a consequence of the same pressures that are weighing on profits; namely, the ongoing impact from the elevated Australian dollar, other competitive pressures on the profit margins of businesses and slower national income growth due to the falling terms of trade. With businesses focusing on containing costs, slower wages growth is being facilitated by spare capacity in the labour market, and is an important mechanism for helping the real economy adjust.

The outlook for the labour market has weakened since Budget, with lower forecast real GDP growth expected to flow through to weaker employment growth. Employment growth has been revised down to 1 per cent through the year to the June quarter 2014, but is still expected to pick up to 1½ per cent to the June quarter 2015 as economic growth improves. The unemployment rate is expected to rise to 6¼ per cent by mid-2014, up ½ of a percentage point from Budget, owing to the weaker forecast employment growth and the current rate of unemployment being a little higher than expected. The unemployment rate is expected to stabilise at 6¼ per cent through 2014-15.

Near-term forecasts for inflation have been revised up since Budget, reflecting the impact of the recent exchange rate depreciation on the prices of imported goods and services. However, domestic price pressures remain modest, and consistent with the subdued labour market outlook, inflationary pressures are expected to remain contained within the RBA’s target band. The forecasts for headline and underlying inflation have been revised up by ¼ of a percentage point to 2½ per cent through the year to the June quarter of 2014. The move to a floating carbon price in 2014-15 is expected to lower headline inflation by around ½ of a percentage point and underlying inflation by less than ¼ of a percentage point through the year to the June quarter 2015. Headline inflation is expected to be 2 per cent and underlying inflation 2¼ per cent through the year to the June quarter 2015.

Chart 2: Contributions to nominal GDP growth



Source: ABS catalogue number 5206.0 and Treasury.

While significant risks to the outlook continue to stem from the external environment, domestic risks have become more pronounced since Budget. Internationally, near term fiscal risks in the United States have abated, with the debt ceiling deadline pushed back to September at the earliest. However the crisis in the euro area is far from resolved and it remains the key risk to the global economic outlook. There is lingering uncertainty about whether the Bank of Japan’s large scale quantitative easing (QE), and so-called ‘Abenomics’ as a whole, will successfully lift Japan out of deflation and onto a sustained growth path. Markets are also anxious about the prospects for a near term unwinding of the US Federal Reserve’s own QE program, as well as financial developments in China.

Domestically, the decline in resources investment following its peak could be more pronounced than expected, and the transition to new drivers of growth less than seamless. Despite the revisions to the

terms of trade, the transmission of volatility abroad to commodity prices continues to present considerable risks to Australian incomes. It is also possible that weaker income growth may weigh more heavily on domestic demand than currently expected. The sharper expected decline in the terms of trade is likely to outweigh any boost to demand, and therefore incomes, from the recent fall in the exchange rate in the near term. The lower exchange rate will also reduce the purchasing power of Australian households where domestic substitutes are not readily available for higher-priced imports. Household expenditure available for domestically produced goods may therefore decrease. However, as households identify cheaper domestic alternatives over time, their demand is expected to increase, helping to boost the income of domestic producers. But this may not be enough to offset the income lost from the accelerated decline in the terms of trade. Further falls in the exchange rate may be necessary to provide the boost to demand and income which will support a sustained recovery in the non-mining economy. Additionally, should the pickup in non-resources drivers of growth occur more sluggishly than currently anticipated, monetary policy does retain room to move to support growth.

Table 2: Domestic economy forecasts^(a)

	Outcomes (b)	Forecasts		
	2011-12	2012-13 (c)	2013-14	2014-15
Panel A - Demand and output(d)				
Household consumption	3.3	2 1/2	2 1/2	3
Private investment				
Dwellings	-3.6	1 1/2	5	5 1/2
Total business investment(e)	20.8	6 1/2	1 1/2	- 1/2
Non-dwelling construction(e)	37.6	14 1/2	1	-4 1/2
Machinery and equipment(e)	10.1	-2 1/2	1/2	3
Private final demand(e)	6.2	3 1/2	2 1/4	2 1/2
Public final demand(e)	2.3	-1 1/2	3/4	1
Total final demand	5.3	2 1/4	2	2
Change in inventories(f)	-0.1	- 1/4	0	0
Gross national expenditure	5.2	2	2	2
Exports of goods and services	4.7	7	6 1/2	7
Imports of goods and services	11.9	0	4	3
Net exports(f)	-1.3	1 1/2	1/2	1
Real gross domestic product	3.4	2 3/4	2 1/2	3
Non-farm product	3.3	3	2 1/2	3
Farm product	8.8	-6	4	1
Nominal gross domestic product	5.0	2 1/2	3 3/4	4 1/2
Panel B - Other selected economic measures				
External accounts				
Terms of trade	0.4	-10 1/2	-5 3/4	-3 3/4
Current account balance				
\$billion	-40.2	-46	-58 1/4	-62 1/4
Percentage of GDP	-2.7	-3	-3 3/4	-3 3/4
Labour market				
Employment (labour force survey basis)(g)	1.2	1.3	1	1 1/2
Unemployment rate (per cent)(h)	5.1	5.6	6 1/4	6 1/4
Participation rate (per cent)(h)	65.3	65.3	65 1/4	65 1/4
Prices and wages				
Consumer Price Index (i)				
- headline	1.2	2.4	2 1/2	2
- underlying	2.2	2.4	2 1/2	2 1/4
Gross non-farm product deflator	1.7	- 1/2	1 1/4	1 1/4
Wage Price Index(g)	3.7	3 1/4	3 1/4	3 1/4

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

(b) Calculated using original data unless otherwise indicated.

(c) Employment growth, the unemployment rate and the participation rate, headline and underlying inflation are ABS outcomes.

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

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

(f) Percentage point contribution to growth in GDP.

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

(h) Seasonally adjusted rate for the June quarter.

(i) 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 71 and a \$US exchange rate of around 92 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\$114 per barrel. The farm sector forecasts for 2014-15 are based on an assumption of average seasonal conditions.

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

OUTLOOK FOR THE DOMESTIC ECONOMY

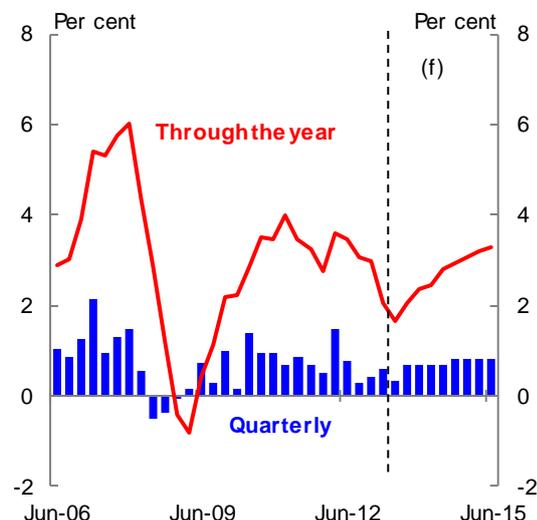
Household consumption

The outlook for **household consumption** has weakened since Budget reflecting slower household income growth. Household income growth has been downgraded due to a softening in the outlook for wages. Fragile consumer sentiment has also re-emerged as a risk to the consumption outlook, with consumer confidence retracing the strong gains made at the start of the year.

Consumption is forecast to grow by 2½ per cent in 2012-13, unchanged since Budget, but has been downgraded by ½ of a percentage point to 2½ per cent in 2013-14 (Chart 3). Consumption growth is expected to rebound to 3 per cent in 2014-15, supported by low interest rates and improving employment growth.

While households are expected to remain cautious, they face reduced purchasing power due to weaker income growth and higher prices. This is expected to result in a larger than previously expected decline in the household saving ratio though it will remain at elevated levels. The household saving ratio is expected to decline from around 10 per cent to around 7 per cent by 2014-15, unwinding some of the increase since the GFC. If households choose to be more cautious, this presents downside risks to the outlook for consumption growth.

Chart 3: Household consumption (chain-volume measure)

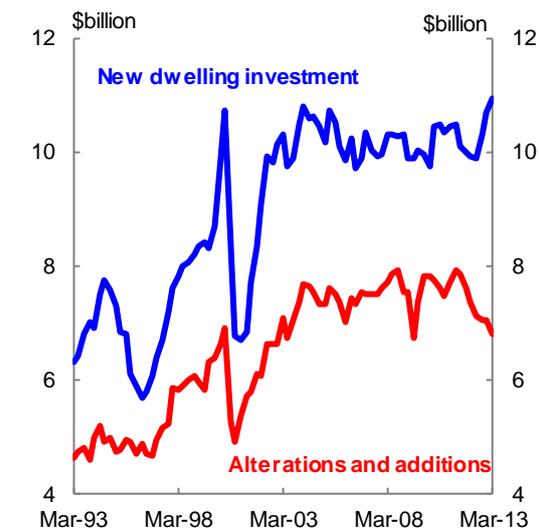


Source: ABS cat. no. 5206.0 and Treasury.

Dwelling investment

The outlook for **dwelling investment** has been upgraded by 1 percentage point in 2012-13 and remains unchanged in 2013-14 and 2014-15. The upgrade in 2012-13 reflects upward revisions to historical growth in the first half of 2012-13 more than offsetting a slightly weaker than expected March quarter outcome. Dwelling investment was flat in the March quarter, reflecting a continued divergence in performance between the new dwelling and alterations and additions sectors (Chart 4). While new dwelling investment rose 2.2 per cent in the March quarter to reach a 10-year high in through-the-year growth terms, alterations and additions fell 3.4 per cent to record its fifth consecutive decline in through the year terms.

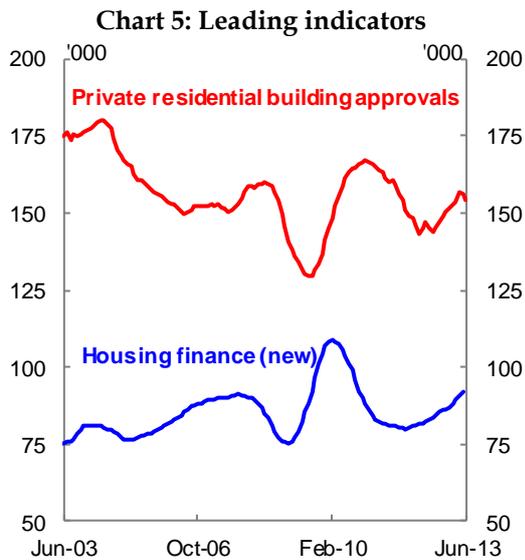
Chart 4: New dwelling investment and alterations and additions



Source: ABS cat. no. 5206.0 and Treasury.

Near-term forward indicators continue to track broadly as expected at Budget (Chart 5), with new housing finance, private building approvals and dwelling prices all trending higher. These indicators, combined with favourable economic fundamentals (such as low interest rates, strong population growth and a tight rental market), are consistent with the emerging recovery in dwelling investment which is expected to continue gaining momentum over the forecast period. However, heightened concerns around unemployment expectations and fragile consumer confidence pose downside risks to the outlook. Dwelling investment is expected to grow 1½ per cent in

2012-13, 5 per cent in 2013-14 and 5½ per cent in 2014-15.



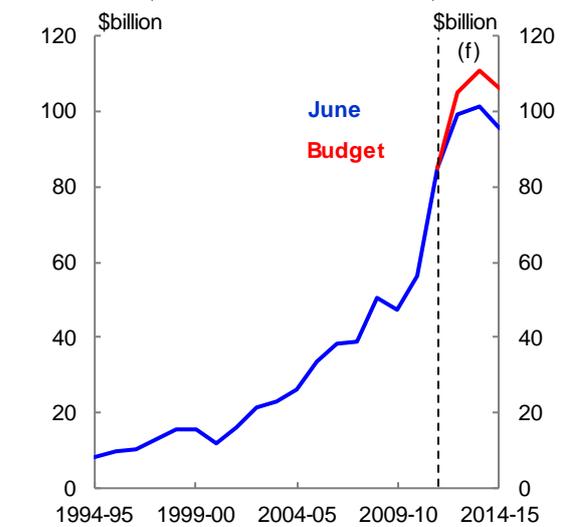
Note: Annual rolling sum
Source: ABS cat. no. 8731.0, 5609.0 and Treasury.

Business investment

The outlook for **new business investment** has been downgraded since Budget, reflecting weaker than expected outcomes and lower forecast resources investment. Investment outside of the resources sector is expected to remain modest in 2013-14 before gaining some momentum in 2014-15, with low interest rates and the lower exchange rate boosting demand for goods and services from the non-mining economy. New business investment is forecast to grow 6½ per cent in 2012-13 and 1½ per cent in 2013-14 before falling ½ of a per cent in 2014-15 as resources investment passes its peak.

Forecasts of new **engineering construction** growth have been downgraded across the forecast period. This reflects weaker than expected outcomes, a shift in the timing of expected capital expenditure on existing resources projects and a revised outlook for commencements of further large projects (Chart 6). As a result, engineering construction is predicted to peak at a lower level than previously expected. New engineering construction is forecast to grow 17½ per cent in 2012-13 and 1 per cent in 2013-14, before falling 7 per cent in 2014-15.

Chart 6: New engineering construction (chain-volume measure)



Source: ABS cat. no. 5206.0 and Treasury.

Investment in **machinery and equipment** has been revised lower across the forecast period, reflecting recent weak outcomes, weaker forecast resources investment and an expected dampening in demand for machinery and equipment from higher import prices. While the latest CAPEX survey suggests that investment in machinery and equipment will continue to be supported by firms servicing the resources sector, there are early signs of a modest pick-up in some services sectors. However, with measures of capacity utilisation around four year lows, the immediate need for new capital is likely to be modest. New machinery and equipment investment is forecast to decline by 2½ per cent in 2012-13, before recovering modestly, growing by ½ of a per cent in 2013-14, and by 3 per cent in 2014-15.

The forecast for investment in **non-residential buildings** has been upgraded for 2012-13 following stronger than expected outcomes in recent quarters. However, growth in 2013-14 has been revised downwards, driven by weak investment intentions in the CAPEX survey. Investment in new buildings is expected to grow modestly in 2014-15 consistent with improving labour market conditions. Investment in new buildings is forecast to grow by 7½ per cent in 2012-13, remain flat in 2013-14, before growing 3 per cent in 2014-15.

Public final demand

Public final demand is forecast to decline by 1½ per cent in 2012-13, with recent State budget estimates and weakness in the March quarter outcome pointing to a larger than expected consolidation. However, growth has been upgraded in 2013-14 and 2014-15 in line with revised Commonwealth and State budget expenditure plans. Public final demand is forecast to grow by ¾ of a per cent in 2013-14 and 1 per cent in 2014-15.

Exports, imports and the current account deficit

The outlook for **exports** remains unchanged since Budget, with a boost to non-commodity exports from the lower exchange rate helping to offset slightly weaker resources exports. Nonetheless, expanding production from the resources sector, supported by recovering non-commodity exports is expected to drive strong export growth of 7 per cent in 2012-13, 6½ per cent in 2013-14 and 7 per cent in 2014-15.

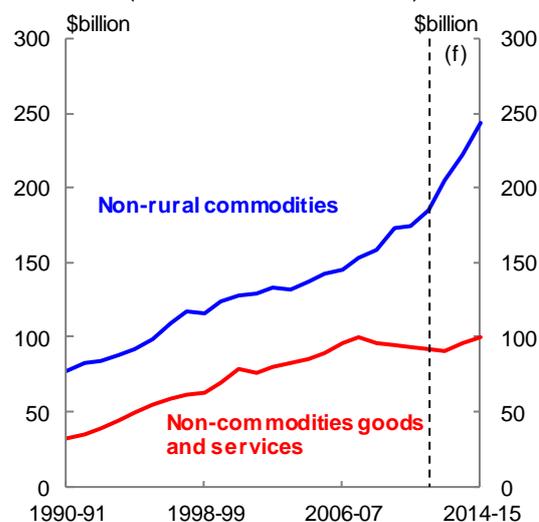
Non-rural commodity export volumes have been downgraded slightly since Budget. Recent indicators point to a softer outlook for coal, which has been revised downwards in 2012-13 and 2013-14, and a number of non-bulk commodities. Partially offsetting these downgrades is a modest upgrade in iron ore export volumes, reflecting an upwards revision to expected production. In aggregate this has resulted in a 1 per cent downgrade to non-rural commodity export volumes in 2013-14, with a slight upgrade in 2014-15 of ½ a percentage point. Non-rural commodity exports are expected to increase by 22 per cent over the rest of the forecast period (Chart 7).

Growth in **non-commodity exports** has been upgraded since Budget with the recent decline in the exchange rate expected to provide a boost to trade-exposed exporters. The lower exchange rate will improve the competitiveness of Australian non-commodity exports, helping to boost demand over time. Non-commodity exports are forecast to decrease by 1 per cent in 2012-13 before growing by 6 per cent in 2013-14 and 3½ per cent in 2014-15.

Services exports have also been upgraded since Budget due to the lower exchange rate. Service exports are expected to be around 4 per cent higher by the end of the forecast period compared with Budget, reflecting strengthening business services, tourism and a return towards trend growth in the international student sector. In 2012-13, services exports are forecast to decrease by ½ per cent before recovering in 2013-14 and 2014-15, growing by 5 per cent and 4 per cent respectively.

Following a decline in output in 2012-13, farm production is expected to increase modestly in 2013-14, largely reflecting stronger crop production due to improved seasonal conditions. However, **rural exports** are expected to remain weak in 2013-14 and 2014-15 reflecting poor wheat production in 2012-13 and a reduction in stock drawdowns that have supported 2012-13 exports.

Chart 7: Export volumes (chain-volume measure)



Source: ABS cat. no. 5302.0 and Treasury.

Import growth has been downgraded since Budget reflecting a weaker than expected March quarter, the dampening effect of the lower exchange rate on the demand for imports and lower resources investment. Growth in import volumes is forecast to be flat in 2012-13, before growing by 4 per cent in 2013-14 and 3 per cent in 2014-15.

The forecast for the contribution of **net exports** to GDP growth has been revised up in 2012-13 and 2013-14 with no change in 2014-15,

consistent with the expectation of weaker imports growth. Net exports are expected to contribute 1½ percentage points to real GDP growth in 2012-13, ½ of a percentage point in 2013-14 and 1 percentage point in 2014-15.

The **terms of trade** have been downgraded sharply since Budget and are forecast to fall by 10½ per cent in 2012-13, 5¾ per cent in 2013-14 and 3¾ per cent in 2014-15 (Chart 8). The deterioration largely reflects significant falls in world commodity prices over recent months and a reassessment of the level commodity prices will reach at the end of the forecast period.

To put recent declines into context, bulk commodity prices at Budget were anticipated to fall by around 12 per cent over the whole forecast period to June 2015. Since the Budget forecasts were finalised, commodity prices have already fallen by around this magnitude, notwithstanding the recent restocking led bounce in iron ore. While the lower exchange rate is helping to cushion the fall when prices are measured in Australian dollars, it has not been enough to offset the magnitude of the US dollar declines.

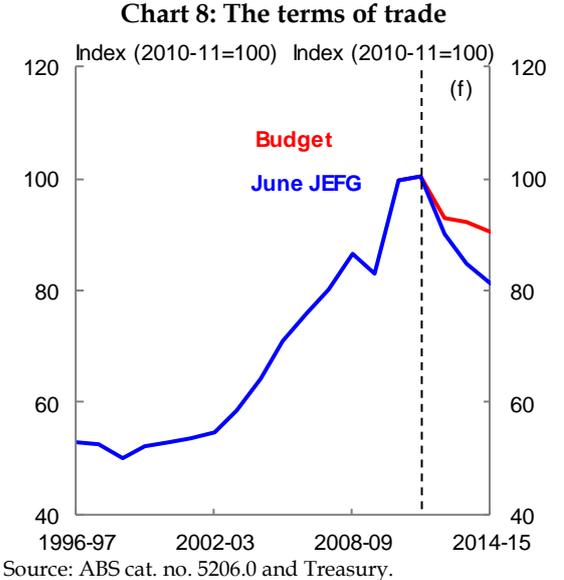
Both iron ore and metallurgical coal prices fell in the June quarter at a time when seasonal factors usually maintain strong steel demand in China. Chinese economic growth this year has been weaker than previously expected and resulted in many steel mills running down raw material inventories to conserve cash.

The weaker outlook for Chinese growth and the speed and magnitude of recent commodity price falls has prompted a reassessment of the level commodity prices will reach at the end of the forecast period.

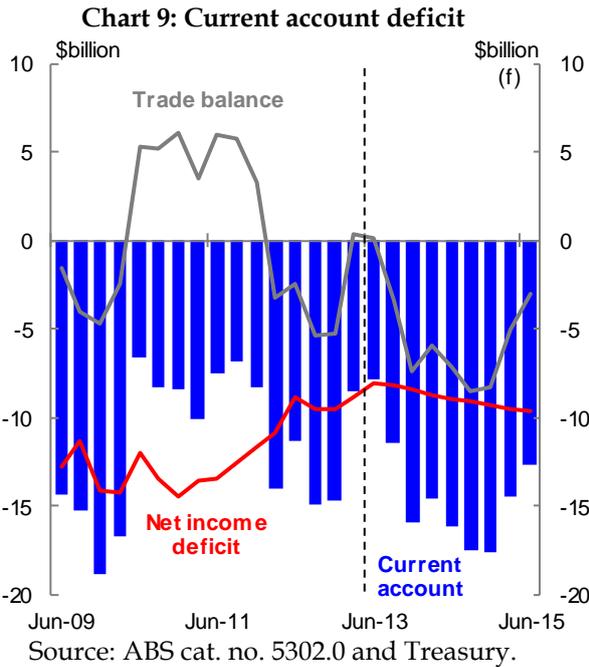
Metallurgical coal prices have fallen below levels that were previously considered sustainable, but significant cost cutting appears achievable on the part of producers, with production levels remaining steady. As a result, while the price of metallurgical coal is still expected to increase over the forecast period, in the June quarter 2015 the price has been downgraded by around \$US30 (FOB hard coking coal) compared with Budget.

By the June quarter 2015 iron ore prices are now expected to fall to \$US95 (FOB), around \$US10 lower than expected at Budget. Thermal coal price forecasts have also been revised down modestly, with June quarter 2015 prices forecast \$US5 lower than Budget.

The recent depreciation of the exchange rate is expected to be broadly neutral on the terms of trade, with higher export prices being offset by higher import prices when measured in Australian dollar terms.

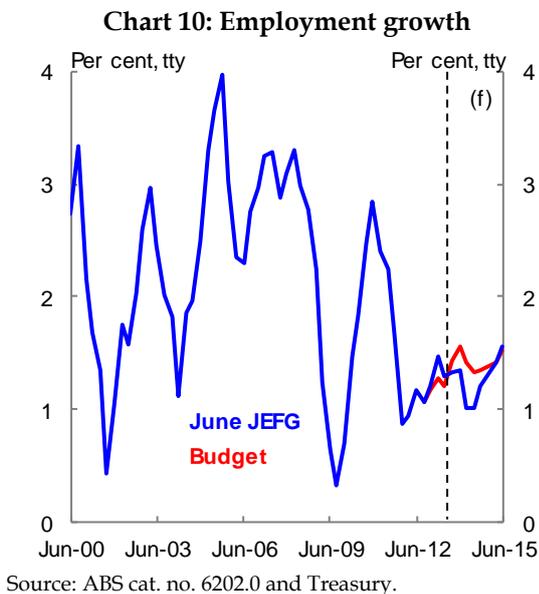


The outlook for the **current account deficit** has weakened since Budget. The revisions largely reflect the weaker outlook for the trade balance over the forecast period owing to lower commodity prices. The net income deficit is also expected to widen slightly over the forecast period reflecting the depreciation of the Australian dollar on Australia’s position as a net debtor. The current account deficit is now expected to be 3 per cent of GDP in 2012-13 and 3¾ per cent of GDP in 2013-14 and 2014-15 (Chart 9).



Employment, wages and inflation

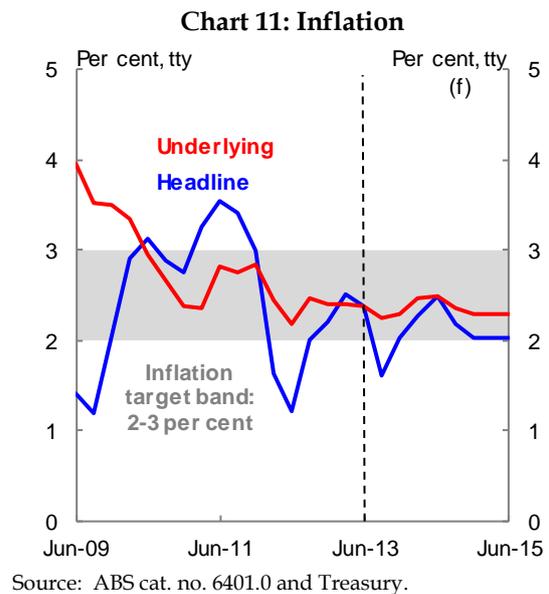
Employment growth is forecast to remain below trend at 1 per cent in 2013-14, before rising to 1½ per cent in 2014-15 (Chart 10), consistent with improving economic growth. The **unemployment rate** is expected to rise from 5½ per cent in the June quarter 2013 to 6¼ per cent in the June quarter 2014, and stabilise at that level through to the June quarter 2015. The upward revision of ½ of a percentage point in 2014 and 2015 reflects the recent rise in the unemployment rate to 5.7 per cent, which is a little higher than previously expected, and weaker real economic growth in 2013-14.



Wage growth is expected to remain subdued over the forecast period, consistent with recent weak outcomes and the forecast for below-trend employment growth. Income tax withholding data, information from Treasury's business liaison program, and advice from the ABS that earlier wages data was boosted by redundancies, suggest there is an underlying softness in wages growth that is expected to persist. Growth in the Wage Price Index has been revised down to 3¼ per cent through the year to the June quarters of 2014 and 2015.

Near-term forecasts for consumer price **inflation** have been revised up since Budget, reflecting the impact of the recent exchange rate depreciation on the prices of imported goods and services. However, domestic price pressures are expected to remain contained due to ongoing spare capacity in the labour market, subdued wage growth and solid productivity improvements. Inflationary pressures are expected to be contained within the Reserve Bank's target band for the remainder of the forecast period.

Headline inflation is expected to be 2½ per cent through the year to the June quarter of 2014 before easing to 2 per cent through the year to the June quarter 2015 owing to the lower forecast carbon price (Chart 11). Underlying inflation is expected to be 2½ per cent through the year to the June quarter of 2014 and 2¼ through the year to the June quarter 2015.



OUTLOOK FOR THE INTERNATIONAL ECONOMY

Table 1: International GDP growth forecasts^(a)

	2012	2013		2014		2015	
	Actual	Budget	June	Budget	June	Budget	June
China ^(b)	7.8	8	7 1/4	7 3/4	7 1/2	7 3/4	7 1/2
India ^(b)	3.8	5 3/4	5	6 1/2	6 1/2	6 1/2	6 1/2
Japan	1.9	1 1/4	1 1/2	1	1	1	1
United States	2.2	2	2	2 1/2	2 1/2	2 1/2	2 1/2
Euro area	-0.6	- 1/2	- 3/4	1	1	1 1/2	1 1/2
Other East Asia ^(c)	3.9	4 1/2	3 3/4	4 3/4	4 3/4	5	5
Major Trading Partners	4.1	4 1/2	4	4 3/4	4 1/2	4 3/4	4 3/4
World	3.1	3 1/4	3	4	3 3/4	4	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 Update* July 2013, Thomson Reuters and Treasury.

World outlook and risks

Global economic conditions have been weaker than expected since Budget. The forecast for 2013 global GDP growth has been revised down a ¼ percentage point to 3 per cent, reflecting downward revisions for China, the euro area, India, and other East Asia. The global growth forecast for 2014 has been revised down a ¼ percentage point, to 3¾ per cent, due, largely due to the downward revision to the forecast for China. MTP GDP growth for 2013 has therefore been revised down a ½ percentage point to 4 per cent, and the 2014 MTP growth forecast has been revised down a ¼ percentage point.

While China's growth outlook has been revised down since Budget, some downside risks persist. There are considerable uncertainties about how recent financial market developments will play out. In particular, it remains unclear what the spike in interbank rates in June implies about the People's Bank of China's (PBoC) future policy stance, although some tightening in credit conditions is factored into the near term forecasts.

The deadline for addressing the United States Government's legislated debt ceiling has been pushed back to September 2013 at the earliest, due to the independent Congressional Budget Office (CBO) substantially revising down the

forecast deficit for the current fiscal year. In contrast, developments in Cyprus, Italy and most recently Portugal, have highlighted that the euro area's crisis is far from resolved and it remains the key downside risk to the global outlook.

Financial market sentiment was reasonably calm in early 2013, but has been tested more recently by concerns around monetary policy settings in the US and Japan.

On 19 June, United States Federal Reserve Chairman Ben Bernanke stated that, assuming the Fed's central tendency economic projections are met, he expects a tapering of quantitative easing (QE) would commence later this year and that the QE program, in terms of new asset purchases, would end around mid-2014. Bernanke also emphasised that any rise in the federal funds rate is still some way off. Bernanke noted that this timeline is not pre-ordained and that the tapering of QE is ultimately dependent on the evolution of actual economic outcomes relative to the Fed's objectives.

Bernanke has been careful to emphasise the gradual nature of the eventual tapering of QE. A smooth tapering of QE, at least in terms of the market's reaction to such policy movements, will remain a challenge and the Fed's communications strategy will be crucial.

Following the Bank of Japan's (BoJ) 4 April announcement that it would double the size of its balance sheet through asset purchases, Japanese Government Bond (JGB) yields have risen noticeably and become more volatile. Were such volatility and rises in JGB yields to be sustained, this would have adverse consequences for Japanese banks, which hold around 40 per cent of JGBs, Japan's growth prospects and its fiscal sustainability.

China's GDP growth forecasts have been revised down to 7¼ per cent in 2013, and to 7½ per cent in both 2014 and 2015. Compared with Budget, the forecasts are ¾ of a percentage point lower in 2013 and ¼ of a percentage point lower in both 2014 and 2015.

China's economy grew at a weaker than expected pace in the first half of 2013, with through-the-year growth falling to 7.5 per cent in the June quarter – the slowest rate since the global financial crisis. The large expansion in aggregate credit that took place in early 2013 has not provided the support to real activity that was anticipated at Budget, with much of the additional credit being channelled into existing assets rather than new business investment. The ongoing softness in economic conditions among advanced economies has also been a drag on China's economic growth, through reduced demand for Chinese exports. Exports declined by 3 per cent over the past year – the first decline in more than a decade – contributing to a build-up of excess capacity in China's export oriented industrial sector.

Recent actions by the Chinese authorities to address risks in the 'shadow banking system' are also expected to weigh on near term economic growth. These actions contributed to a substantial tightening in interbank market conditions and a spike in short term interest rates in mid-June. While interbank interest rates have since eased, the authorities have indicated they will continue to take steps to curb the aggressive expansion of off-balance sheet lending that has taken place in the shadow banking system. While this may be a positive development for China's financial stability and longer term economic growth prospects, it is also likely to lead to somewhat higher interest rates than prevailed prior to

mid-June and dampen real activity in the near term.

China's growth is expected to strengthen slightly in both 2014 and 2015 as the forecast pick-up in advanced economy growth stimulates China's export sector. The slight downgrade to growth in 2014 and 2015 from Budget recognises that recent policy actions by financial market regulators are part of a concerted push by China's new administration to achieve a more sustainable pattern of growth. In particular, public statements by senior figures in China's new administration show an increasing acceptance that the reforms required to achieve a more balanced economy may mean somewhat lower rates of growth in coming years. More moderate rates of growth are also consistent with supply-side estimates of China's evolving growth potential, which reflect the fading benefits of past reforms and technological catch-up, and the projected easing in the growth of China's urban labour supply.

While China's growth outlook remains positive, problems in its financial system and the government's ability to manage a smooth transition to a more sustainable pattern of growth remain the key risks to the outlook. Added to these internal risks is China's exposure to the ongoing uncertainty among advanced economies. While the Chinese Government still has the fiscal policy space to respond to short-term adverse impacts, authorities are unlikely to deploy any significant stimulus unless there was a marked rise in unemployment.

The euro area remains in a protracted recession, with March quarter GDP contracting even more than expected. Despite some improvement in recent months, forward looking indicators nonetheless imply that conditions for the region as a whole will remain weak in the near term. The 2013 forecast has therefore been revised down a ¼ percentage point to a contraction of ¾ of a per cent. With real conditions weak and considerable political impediments to necessary structural reforms, risks to the region's outlook remain on the downside.

The European Central Bank's (ECB) as yet unutilised bond buying program, the Outright Monetary Transactions (OMT) program, continues to calm financial conditions in the region. However, a further weakening of the real economy could put further pressure on already fragile banking systems, and potentially sovereign balance sheets, and also test whether the ECB is genuinely prepared to deploy the OMT if needed.

In the United States, conditions remain encouraging, and the forecasts for US GDP growth are unchanged from Budget. Near term fiscal risks have abated due to the extension of the debt ceiling deadline, although the debt ceiling will still need to be addressed later this year. Fiscal drag will be considerable in the short term, with the CBO estimating that this will shave roughly 1½ percentage points off GDP growth in 2013.

Meanwhile, the private sector component of the US economy continues to perform solidly, notwithstanding a downward revision to March quarter GDP growth reported in the final estimate. Private consumption has held up, despite tax hikes on 1 January 2013, the labour market continues its gradual improvement, and the housing sector remains a potential upside to growth. A potential headwind, given current market jitters, is how the economy will cope with the eventual scaling back of the Federal Reserve's QE program.

Japan's economy continues to show signs that the combination of the BoJ's monetary stimulus and the government's fiscal stimulus is having a positive effect on activity. Consumer sentiment and manufacturing activity have improved noticeably since late 2012, and GDP growth of 1.0 per cent in the March quarter was slightly above expectations. In addition to the positive economic outcomes flowing from recent policy actions, December quarter 2012 growth was separately revised up. Subsequently, the forecast for 2013 GDP growth has been revised up a ¼ percentage point to 1½ per cent.

For growth to be sustained, the Japanese Government, led by Prime Minister Shinzo Abe, will need to follow through on its

structural reform aspirations, as the 'third arrow' of so called 'Abenomics'. While Prime Minister Abe outlined a strategy of such measures in a speech in early June, the implementation of any substantive reform was dependent on the outcome of the Upper House elections, which were held on 21 July. With Abe's government now having secured a majority in the Upper House, this should bolster the prospects for the government's reform agenda. Nonetheless, risks remain including that the government may use its political majority to focus on issues such as constitutional reform rather than much needed economic reforms. Combined with the ructions in the JGB market, and evidence Japanese investors are selling out of Japanese equities, there appears to be lingering uncertainty about whether Abenomics will succeed in putting Japan onto a sustained growth path.

Elsewhere in Asia, India's GDP growth for 2013 has been revised down ¾ of a percentage point to 5 per cent. March quarter growth was noticeably weaker than expected, with investment projects increasingly being deferred and structural bottlenecks likely to continue to deter a more robust upturn in investment. Agricultural output and overall growth are expected to lift in the second half of 2013 on the expectation that monsoon conditions will be better than previously anticipated and flow through to higher GDP growth for 2014.

Outcomes in other East Asia since Budget have also generally been weaker than expected. The forecast for 2013 GDP growth for other East Asia has been revised down ¾ of a percentage point to 3¾ per cent. Growth in the region is nevertheless expected to remain relatively robust over the forecast period. The ASEAN-5 economies, such as Indonesia, are still underpinned by healthy domestic demand. And the more export oriented economies, such as Singapore and Korea, will benefit from the gradual improvement in global growth over the forecast period. While the outlook for emerging Asia overall is relatively robust, a number of these economies face the risk of sharp capital outflows if US interest rates were to rise abruptly.