ECONOMIC DEVELOPMENTS SINCE THE 2012-13 MYEFO

International Outlook

- The international economy appears to have stabilised recently, but the outlook is still relatively subdued. Risks remain tilted to the downside, although to a lesser degree than in the latter half of last year.
- Since the MYEFO, actual outcomes on the real global economy have, on balance, been slightly weaker than expected.
  - The IMF's January World Economic Outlook Update revised its forecasts for global growth down slightly, from 3.3 to 3.2 per cent for 2012 and from 3.6 per cent to 3.5 per cent for 2013, relative to their forecasts in October.
- In contrast, global financial markets have become rather optimistic recently, largely due to the global economy having avoided a worst-case scenario in recent months and the subsequent reduction in global tail risks. The sustained program of quantitative easing by a number of the major advanced economies has also likely had an impact in raising global sentiment, including by helping raise global asset prices.
  - Much of the change in the global outlook since MYEFO relates more to a shift in the balance of risks than to growth expectations as such.
- The increase in market optimism is not without broader foundation, given recent developments in a number of major economies.
- In January, the United States Congress reached an agreement to avert the worst of the short-term consequences of the 'fiscal cliff', and passed a bill to extend the legislated debt ceiling to 19 May. The US Federal Reserve announced additional asset purchases in December, and the housing market continues to gather momentum.
- The existential threat of a breakup of the euro area has been removed by the ECB's actions. In addition, European policymakers have made some progress towards addressing the underlying causes of the crisis, for example through the December agreement to a pan-European banking regulator, as well as pursuing a range of product and labour market reforms.
- In the December quarter the Chinese economy recorded an acceleration of its through-the-year growth rate for the first time in two years, providing further evidence the Chinese economy has stabilised.
- In January, the newly-elected Japanese government announced a fiscal stimulus package focussed on public works. The Bank of Japan also made a January announcement, that it would pursue a higher inflation target and commence open-ended asset purchases in 2014 once the current round of asset purchases is complete.
- However, as encouraging as these developments are, a number of downside risks still cloud the global outlook.

- While the US Congress' agreement on the fiscal cliff averted a worst case scenario, uncertainty remains concerning the resolution of scheduled in expenditure cuts in March, and around the threat of protracted negotiations on the debt ceiling in May.
- The crisis in the euro area is still far from resolved and downside risks continue to dominate.
  - Risks remain around whether European governments will be able to implement and maintain the array of necessary structural reforms, but also about whether the sustained hardship in many societies could lead to an electoral backlash that could derail efforts to maintain the union.
- Geopolitical tensions regarding the Middle East remain unresolved, and accordingly the risk lingers that these tensions could escalate, generating a surge in global oil prices
- So in summary, there is reason to be cautiously optimistic about the global outlook, and that global economic growth should pick up over the course of this year, albeit moderately.
  - However, achieving this modest outcome requires that the key risks I've outlined are avoided.

Domestic Outlook

- Against this backdrop, the outlook for the Australian economy remains favourable. In terms of major developments since MYEFO, there are four that are worth touching on.
- The first are the <u>natural disasters</u> in late January and early February, including the floods in north eastern Australia and the fires in the southern states.
  - At the local level, this summer's floods and fires have been devastating in many areas and have had a significant impact on communities.
  - However, unlike those seen two years ago, this summer's natural disasters are not expected to have a material impact on the economy in aggregate.
- The second is the receipt of the <u>September quarter National Accounts</u> in early December, which revealed that, although real GDP growth remained strong, nominal GDP growth was weaker that we had anticipated.
  - Nominal GDP, that is, the dollar value of the output of the Australian economy, grew by 1.9 per cent through the year to the September quarter 2012, compared with 3.1 per cent for the real economy.
  - As the Deputy Prime Minister showed in his press conference in mid-December, the level of nominal GDP was some $4 billion weaker in the September quarter than we had anticipated at MYEFO, lining up with the weakness in tax collections to that point.
  - This weakness in nominal GDP growth reflected two factors: the decline in global prices for our key commodity exports (namely, iron ore and coal); and weaker than anticipated growth in domestic prices.

- Our assessment is that this weakness in domestic prices reflects a combination of the competitive pressures on import competing industries due to the high exchange rate and subdued demand outside of the resources sector.

• The third major development is the continuation of significant <u>volatility in global commodity prices</u>.

- MYEFO was released shortly after an episode of very weak iron ore prices. While prices in November tracked in line with expectations, prices rose rapidly in December and January, climbing by 27 per cent.

- The decline and subsequent recovery can be broadly linked to the apparent slow down and then acceleration in China's output growth over recent months.

- However, the high degree of volatility also reflects a strong inventory cycle, with stocks held at Chinese steel mills and ports running down to very low levels towards the end of 2012.

- This episode has again shown that global commodity prices are highly volatile and therefore difficult to predict, particularly over short time horizons.

- However, it still remains our view that – notwithstanding the likelihood of continued volatility in global commodity markets in the period ahead – the medium-term trend in iron ore and coal prices will be down as substantial new supply comes on line, with Australia's terms of trade also trending downwards as a result.

• The final development that I wanted to mention is the release of the <u>December quarter Consumer Price Index</u>.

- As I mentioned earlier, an area where recent outcomes have diverged from our forecasts is the weakness in domestic prices.

- This was the case for the deflators in the September quarter National Accounts. The most recent CPI outcomes, while broadly consistent with our MYEFO forecasts, have also been subdued, with underlying inflation currently at 2.3 per cent and headline inflation at 2.2 per cent.

  : This includes the carbon price impacts, which appear to have broadly been in line with our modelling.

- Again, we can link recent subdued inflation outcomes to the pressure that businesses are under due to the high exchange rate, but also other factors like the increased household savings rate, changed consumer preferences and a more cautious approach towards taking on new debt.

• Looking beyond these four factors at the broader suite of data released since MYEFO, it continues to be our view that the real economy will grow at around its trend rate over the next two years, but that nominal GDP growth will be below trend as the terms of trade decline and domestic price pressures remain subdued.

- – Underpinning these forecasts are an assessment that as resources investment peaks over the next year, we will see strong growth in commodity exports, continued solid growth in household consumption and some pickup in both dwelling construction and non-mining investment.

- The most substantive risks to this outlook are the international fragilities that I described earlier, although we are also attuned to the possibility that the transition from resources investment to other growth drivers may not be as smooth as is presented in our forecasts.