RECENT ECONOMIC DEVELOPMENTS

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Economic developments since the publication of the Pre-election Economic and Fiscal Outlook (PEFO) have been mixed.

Looking first at the global economy, global growth prospects remain subdued. While still contributing the majority of global growth, emerging markets have slowed. Partially offsetting this has been a pickup in activity in major advanced economies, although there are a range of risks including the possibility of further fiscal battles in the US in early 2014, and a re-escalation of the crisis in Europe.

The Chinese near term growth outlook has improved, with stronger-than-expected activity supported by state-led infrastructure spending and tax cuts, as well as improvements in external demand.

Chinese GDP grew by 7.8 per cent through the year (tty) to September quarter 2013, up from 7.5 per cent tty growth in the previous quarter.

China is firmly on track to achieve its official 2013 growth target of 7.5 per cent, with market expectations for 2013 now edging above this (Treasury PEFO forecast – 7¼ per cent, before rising to 7½ per cent in 2014).

In the US, the Federal Reserve surprised markets in September by not announcing a tapering of its US$85 billion a month asset purchases program. This has given some respite to emerging market economies, particularly Indonesia and India, which saw capital outflows and currency depreciation in anticipation of tapering.

Nevertheless, Indonesia and India remain vulnerable to capital flight given their relatively large current account deficits and the large presence of foreign investors in their equities and bond markets.

The Fed's decision not to taper underlined concerns about the strength of the US recovery.

There has also been significant uncertainty around US fiscal policy, with a federal government shutdown running into last minute debt ceiling negotiations.

The direct impact of the US Government shutdown is expected to be relatively minor. Of more concern is the picture such debates paint of US Congress' apparent inability to come to grips with a credible medium term fiscal strategy for the US.

The US economy continues to show modest growth despite fiscal tightening during the first half of the year. Barring further adverse developments, the US is poised for stronger economic growth.

The euro area has recently enjoyed its most sustained period of financial market calm since the start of the common-currency crisis and recent economic data for Europe has been surprisingly positive.

In the June quarter, the euro area recorded its first positive GDP growth after 1½ years of contraction, and forward-looking indicators of activity have improved noticeably since mid-year.

Nevertheless, euro-area unemployment remains at an historical high over 12 per cent, credit conditions remain tight, and fiscal consolidation will continue to weigh on growth, while the euro area's inflation rate is currently lower than Japan's.

Looking to the domestic economy, investment in the resources sector is now expected to slow more rapidly than previously expected. Furthermore, the transition to non-mining sources of growth also appears to be occurring at a slower pace than previously expected, in part a consequence of the continued unhelpfully high level of the Australian dollar.

The Australian economy grew by 2.6 per cent in 2012-13 after growth of 3.6 per cent in 2011-12. Net exports made the largest contribution to growth, followed by a solid contribution from household consumption and total business investment. Public final demand detracted from growth.

New private business investment grew by 6.2 per cent in 2012-13, after extremely strong growth of 22.1 per cent in 2011-12.

Nominal GDP grew by 2.4 per cent in 2012-13 – weaker than real GDP growth of 2.6 per cent – after growth of 5.6 per cent in 2011-12.

There have yet to be signs of a material pick up in investment intentions outside the resources sector.

The June quarter 2013 Capital Expenditure Survey showed that firms outside of the resources sector expect to invest $56.4 billion on buildings and structures and machinery and equipment in 2013-14. If the appropriate long run realisation ratio is applied to this estimate, this would see non-mining investment decline by 2.5 per cent in 2013-14, and remain below the levels of investment seen in 2007-08.

By contrast, the dwellings sector continues to show signs of recovery.

Finance commitments for new dwellings are 12.0 per cent higher than a year ago.

While monthly private residential building approvals are volatile, the overall trend has improved noticeably from their trough in early 2012.

Private approvals rose 14.2 per cent in September, to be 18.2 per cent higher than a year ago.

Rising dwelling prices and auction clearance rates provide further support that activity in the dwellings sector is picking up.

There are also early signs of improvement in household consumption.

Retail trade volumes grew strongly in the September quarter (up 0.7 per cent), after a 0.1 per cent fall in the June quarter.

Conditions in the labour market remain subdued, with the unemployment rate reaching 5.7 per cent in October, up from 5.4 per cent in October 2012.

Employment was flat in October (up 1,100 persons), to be only 0.8 per cent (89,200 persons) higher through the year.

The participation rate was unchanged at 64.8 per cent in October, its lowest level since 2006.

Consistent with overall spare capacity in the labour market, the Wage Price Index grew by 2.7 per cent through the year to the September quarter 2013 – its slowest rate of growth for thirteen years (since the March quarter 2000). Looked at more positively, soft wages growth will continue to support employment growth, and will continue to support contained outcomes for consumer price inflation.

Furthermore, adding a more optimistic tone to the outlook, measures of both household and business confidence have increased noticeably in recent months.

The Westpac-Melbourne Institute Index of Consumer Sentiment has been above its ten year average for three months now. Whilst expectations that the unemployment rate will rise have fallen for five consecutive months, the Westpac-Melbourne Institute Survey of Unemployment Expectations indicates that unemployment expectations are still above their ten year average.

The most recent NAB Monthly Business Survey, for October, showed a slight fall in business confidence after the highest result since April 2010 was recorded in the month of September.