

ECONOMIC OVERVIEW

prospects for world economic growth to 2010

Jammie Penm and Brian S. Fisher

- **World economic growth is assumed to ease from an estimated 4.6 per cent in 2004 to 3.7 per cent in 2005 and 3.6 per cent in 2006. Over the medium term (to 2010) world economic growth is assumed to average around 3.5 per cent a year.**
- **Considerable risks remain in the outlook for global economic performance. A further sharp depreciation of the US dollar or an economic slowdown in China could adversely affect world economic growth.**
- **Economic performance in Australia is assumed to remain relatively robust, with growth of 3.0 per cent in 2004-05 and 3.3 per cent in 2005-06. Over the medium term, Australian economic growth is assumed to average around 3.3 per cent a year.**

World economic outlook

World growth strengthened in 2004

The global economy experienced significant growth in 2004. Early in the year, economic growth in the United States was strong and activity in Japan's economy increased substantially. The economic upturn was also rapid in non-OECD Asia (excluding Japan and the Republic of Korea), with strong economic growth recorded in China, Chinese Taipei, Thailand and Malaysia.

But then came the announcement from China's government of its determination to implement

policy measures to moderate economic growth to a more sustainable pace. Considerable financial market concerns were raised because of fears of a significant weakening in China's economic performance. Following the announcement, activity eased in a number of manufacturing industries, including aluminium, cement and car manufacturing, but growth in China's general economic activity remained strong.

Economic activity in China increased by 9.5 per cent in the December quarter 2004, compared with 9.1 per cent in the September quarter and 9.7 per cent in the June quarter.

Growth began to ease in some other major world economies in the second half of 2004, partly as a result of a sharp increase in world oil prices. The price of the commonly quoted 'West Texas Intermediate' crude oil increased by over 35 per cent from around US\$40 a barrel in July 2004 to a high of US\$55 a barrel in late October, before a partial reversal to under US\$45 a barrel in December.

Sharply higher oil (and hence petrol) prices adversely affected consumers' purchasing power on other goods and services and increased production costs for businesses.

Despite sharply higher oil prices, economic growth in the United States remained relatively strong, with annualised growth of 3.1 per cent in the December quarter, following growth of 4.0 per cent in the September quarter. In contrast, economic growth weakened markedly in Japan in mid-2004, with slow annualised growth of

• Jammie Penm • +61 2 6272 2030 • jpenm@abare.gov.au

0.1 per cent in the September quarter after a contraction of 0.6 per cent in the June quarter. In western Europe, economic growth reached a plateau of below 2.0 per cent. Economic growth in Germany and Italy, for example, was around an annual rate of 1.3 per cent in the September quarter, compared with growth of 1.9 per cent in France in the same quarter.

In year average terms, world economic growth is estimated to have been around 4.6 per cent in 2004, compared with 3.7 per cent in 2003. The estimated world growth in 2004 is the highest since 2000.

Economic growth to moderate in 2005

World economic growth is expected to ease in 2005. Partial indicators released recently have provided support for this assessment.

In the largest world economy, the United States, the pace of economic expansion in 2005 is expected to be slower than that achieved in 2004. As the Federal Reserve will continue to tighten monetary policy to prevent an increase in inflationary pressures, economic growth is likely to slow to levels that are more consistent with its medium term potential of 3.0–3.5 per cent.

In Japan and western Europe, economic growth is also expected to ease in 2005. The economies of Japan and western Europe are vulnerable to higher oil prices and a sharply weaker US dollar. Together with relatively high unemployment rates and overregulated domestic markets, a significant increase in economic activity in 2005 appears unlikely.

In the principal economies of east and south east Asia, including Chinese Taipei, Thailand,

Income and population of major world economies, 2004

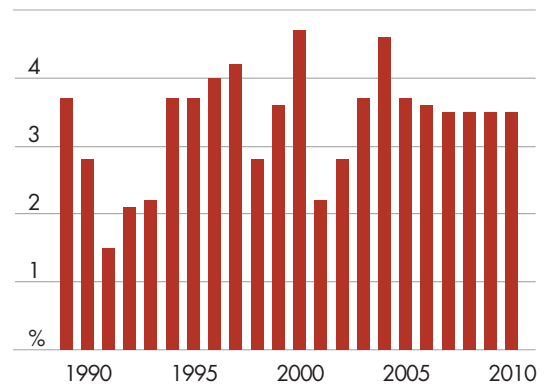
	Gross domestic product a			Population b		
	Value	World share	World ranking	Number	World share	World ranking
	US\$b	%	no.	'000	%	no.
United States	11 175	21.1	1	295 734	4.6	3
Japan	3 612	6.8	3	127 417	2.0	10
Germany	2 318	4.4	5	82 431	1.3	14
France	1 671	3.1	6	60 656	1.0	20
United Kingdom	1 665	3.1	7	60 441	0.9	21
Italy	1 582	3.0	8	58 103	0.9	23
Spain	939	1.8	13	40 187	0.6	29
Canada	1 018	1.9	11	32 805	0.5	35
Australia	582	1.1	16	20 090	0.3	52
China	6 913	13.0	2	1 306 314	20.5	1
India	3 096	5.8	4	1 080 264	17.0	2
Korea, Rep. of	887	1.7	14	48 423	0.8	24
Indonesia	768	1.4	15	241 974	3.8	4
Chinese Taipei	565	1.1	17	22 894	0.4	48
Thailand	483	0.9	21	65 444	1.0	19
Philippines	370	0.7	25	87 857	1.4	12
Malaysia	252	0.5	34	23 953	0.4	46
Singapore	105	0.2	56	4 426	0.1	119
Brazil	1 449	2.7	9	186 113	2.9	5
Mexico	973	1.8	12	106 203	1.7	11
Argentina	444	0.8	24	39 537	0.6	31
Russian Federation	1 370	2.6	10	143 420	2.3	8
Poland	444	0.8	23	28 635	0.4	32
Ukraine	270	0.5	31	47 425	0.7	25

a Based on purchasing power parity (PPP) valuation of country GDP. b As at September 2004.

Malaysia and Indonesia, economic performance is assumed to remain relatively robust in 2005. The recent tsunami in southern Asia is not expected to markedly affect regional economic growth. While tourism could be adversely affected in the short term, the effects on general economic activity are likely to be offset by the follow-on reconstruction activity.

While the easing of economic activity in China is assumed to continue over the short term, economic growth in that country, in year average terms, is expected to be maintained at levels that are consistent with its medium term

World economic growth



Key world macroeconomic assumptions

	Unit	2003	2004	2005 a	2006 a	2007 a	2008 a	2009 a	2010 a
Economic growth b									
OECD	%	2.0	3.2	2.3	2.3	2.4	2.4	2.4	2.4
United States	%	3.1	4.4	3.3	3.0	3.3	3.3	3.3	3.3
Japan	%	2.5	2.6	1.3	1.3	1.0	1.0	1.0	1.0
Western Europe	%	0.6	2.0	1.6	1.8	1.8	1.8	1.6	1.6
Germany	%	-0.1	1.7	1.0	1.3	1.5	1.5	1.3	1.3
France	%	0.2	2.3	1.8	2.0	2.0	1.8	1.8	1.8
United Kingdom	%	2.3	3.2	2.5	2.5	2.5	2.5	2.3	2.3
Italy	%	0.3	1.2	1.2	1.5	1.3	1.3	1.3	1.3
Korea, Rep. Of	%	3.1	4.6	3.8	4.2	4.5	4.0	4.0	4.0
New Zealand	%	3.4	4.8	2.5	2.8	3.0	3.0	3.0	3.0
Developing countries	%	5.7	6.5	5.5	5.4	5.3	5.2	5.2	5.1
Non-OECD Asia	%	7.2	7.6	6.5	6.3	6.5	6.2	6.3	6.0
South East Asia c	%	4.7	6.2	4.9	4.9	4.7	4.6	4.5	4.5
China d	%	9.1	9.5	8.0	7.8	8.5	8.0	8.0	7.5
Chinese Taipei	%	3.2	5.9	4.5	4.0	4.0	3.8	3.8	3.8
India	%	8.2	6.0	6.2	6.2	5.5	5.5	6.0	6.0
Latin America	%	1.7	4.5	3.5	3.5	3.0	3.0	3.0	3.0
Middle East	%	5.4	4.5	4.0	4.0	3.5	3.5	3.5	3.5
Russian Federation	%	7.3	7.0	5.5	5.5	5.0	5.0	4.0	4.0
Ukraine	%	9.3	5.5	4.5	4.5	4.0	4.0	4.0	4.0
Eastern Europe	%	4.5	4.5	4.5	4.5	4.0	4.0	4.0	4.0
World e	%	3.7	4.6	3.7	3.6	3.7	3.6	3.5	3.5
Industrial production b									
OECD	%	0.7	3.7	2.5	2.3	2.3	2.4	2.4	2.4
Inflation b									
United States	%	2.3	2.5	2.5	2.0	2.0	2.0	2.0	2.0
Interest rates									
US prime rate g	% pa	4.1	4.3	5.5	6.5	6.5	7.0	7.0	7.0
US exchange rates h									
Yen/US\$	Yen	115	108	107	110	113	115	115	115
Euro/US\$	Euro	0.88	0.80	0.81	0.87	0.96	0.97	0.98	1.00

a ABARE assumption. b Change from previous period. c Indonesia, Malaysia, the Philippines, Singapore, and Thailand. d Excludes Hong Kong. e Weighted using 2004 purchasing power parity (PPP) valuation of country gross domestic product by the IMF. g Commercial bank lending rates to prime borrowers in the United States. h Average of daily rates.

Sources: Australian Bureau of Statistics; International Monetary Fund; Organisation for Economic Cooperation and Development; Reserve Bank of Australia; ABARE.

potential of around 7–8 per cent (a soft landing scenario).

In other parts of the world, economic performance is expected to remain relatively robust in 2005. Latin America and the Middle East experienced economic upturns in 2004, supported by higher commodity prices on world markets. In 2005, economic growth is assumed to ease in these regions. In other emerging markets, including the Russian Federation, the Ukraine and eastern Europe, the economic recovery is expected to continue in the short term.

Medium term economic growth to be marginally slower

In preparing this set of commodity forecasts, world economic growth is assumed to be around 3.7 per cent in 2005 and 3.6 per cent in 2006. Over the medium term (to 2010), world economic growth is assumed to ease marginally to an annual rate of 3.5 per cent. The assumed average growth in the world economy over the medium term is marginally lower than the annual average achieved over the five years ended 2004 (3.6 per cent).

Risks to world economic performance

While world economic growth is assumed to be around 3.7 per cent in 2005 and 3.6 per cent in 2006, there are a number of risks that have the potential to weaken world economic performance.

– movements in US dollars

One factor that can significantly influence the outlook for world economic growth is movements in the US dollar. After strengthening against other major floating international currencies (including the Japanese yen, the euro, the Canadian dollar, the Australian dollar, the Swiss franc and the Swedish krona) in early 2004, the US dollar depreciated by around 12 per cent between May and December 2004. Compared with the high achieved in early 2002, the US dollar was around 30 per cent lower against other major floating international currencies in early 2005.

The US dollar was trading around ¥105 and 0.78 euro in mid-February 2005, compared with

¥114 and 0.84 euro in May 2004 and ¥133 and 1.16 euro in February 2002.

In contrast, the depreciation of the US dollar against managed international exchange rates (including many Asian currencies) has been substantially less. In the cases of China and Malaysia, their currencies are pegged to the US dollar.

Despite the marked decline in the value of the US dollar over the past two years, there remains a significant probability that it could depreciate further in 2005. While a significant decline in the value of the US dollar can be expected to help correct the US trade and current account imbalances, the gain for the US export and import competing industries would be a loss for the economies of its trading partners.

A significant decline in the value of the US dollar could pose a threat to world economic prospects. If the US dollar were to decline sharply, such a development would place significant upward pressures on international floating currencies, and downside risks to the export, and hence economic, performance of those countries. It would also generate significant pressures for a revaluation of pegged and managed exchange rates, especially those of the Asian economies.

A sharp depreciation of the US dollar could also adversely affect US economic performance. International investors could lose confidence in the US dollar, leading to a significant reduction in capital inflows, or even capital outflows, in that economy. Under this scenario, interest rates in the United States would increase significantly, adversely affecting its economic performance. A weakening of economic growth in the United States would pose a threat to economic prospects elsewhere in the world.

– and China's currency

Besides the risks associated with movements in the US dollar, there is speculation that China could revalue, or even float, its currency in the short term. China's government has announced its intention to gradually allow its currency to be more sensitive to market forces. While there has been a commitment from China's government to adopting a more flexible exchange rate regime, the timing remains uncertain. An

important precondition for the change will be macroeconomic stability. It would be unlikely for China's government to undertake market based exchange rate reforms without first achieving a 'soft landing' of its economy.

There have been international pressures for a revaluation of China's currency. In the United States, for example, manufacturers and labor groups have been complaining that China's fixed exchange rate gives Chinese companies an unfair advantage. In a recent report released by the pro-labor Economic Policy Institute, commissioned by the US-China Economic and Security Commission (a US congressional appointed panel), trade with China was claimed to have resulted in a loss of nearly 1.5 million jobs in the United States between 1989 and 2003. The report argues that China's fixed exchange rate is a major reason for the growing US trade deficit with China, reaching \$US124 billion in 2003. Calls for China to revalue its currency have also been raised in other countries, including Japan and many in the euro area.

Besides the uncertainties associated with movements in international currencies, another major risk to the world economic outlook remains to be movements in world oil prices. While world oil prices have eased from its recent high in late 2004, there is a distinct probability that significant volatility could continue (for the impacts of high oil prices on world economic growth, see Penm 2004).

Economic prospects in the United States

Following weak to modest economic growth in 2002 and 2003, economic activity in the United States strengthened significantly in 2004. The US economy is estimated to have grown by around 4.4 per cent in 2004, compared with growth of 3.1 per cent in 2003 and 2.4 per cent in 2002.

Partial indicators released in early 2005 have provided signals of continued growth in the US economy, albeit at a modest rate. Activity in the retail sector remains robust, with retail sales (in volume terms) increasing year on year by 5.9 per cent in December 2004. Industrial production increased year on year by 4.4 per cent in the same month, leading to an average increase of 4.1 per cent in 2004. The supply managers' index of manufacturing activity released in recent months points to continued growth in the short term.

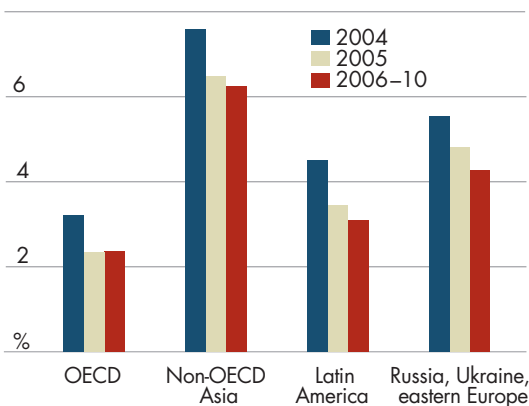
In response to strong economic growth, the job market has shown signs of improvement, albeit at a slow pace. The unemployment rate declined from a high of 6.4 per cent in mid-2003 to 5.2 per cent in January 2004.

Given the economic improvement, the Federal Reserve has been tightening monetary policy in order to avoid a significant increase in inflationary pressures. The federal funds rate was at 2.5 per cent in mid-February, compared with 1.0 per cent a year ago. The US interest rates are likely to be raised further during 2005, reducing the stimulus effects on the economy.

Fiscal stimulus will be wound back gradually. One-off tax rebates for consumers in 2004 are unlikely to be repeated in 2005. The budget deficit in 2004 was around US\$422 billion, or about 3.6 per cent of gross domestic product. According to the projection issued by the White House in late January, the budget deficit will be around 3.5 per cent of gross domestic product in 2005, if Congress approves an additional spending of US\$80 billion for military actions in Iraq and Afghanistan.

Reflecting the effects of reduced monetary stimulus, economic growth in the United States is assumed to ease to 3.3 per cent in 2005 and 3.0 per cent in 2006.

Regional economic growth



Medium term outlook for the US economy

Over the medium term, growth in the US economy is assumed to strengthen to 3.3 per cent a year toward 2010. The assumed economic growth toward 2010 is higher than the 2.8 per cent averaged over the five years ended 2004, but lower than the average of 3.8 per cent achieved in the second half of the 1990s.

There have been considerable concerns about a significant increase in the trade imbalance in the United States. Despite the recent depreciation of the US dollar, the trade deficit, seasonally adjusted, increased to US\$56.4 billion in December 2004, 28 per cent higher than for the same month a year earlier. For 2004 as a whole, the trade deficit was around US\$618 billion, a rise of 24 per cent on 2003.

The bilateral trade deficit of the United States with China was around US\$14.3 billion in December 2004, the largest the United States exhibits with any single trading partner. For 2004 as a whole, the bilateral trade deficit with China totaled US\$162 billion, compared with a deficit of \$124 billion in 2003.

One factor that has contributed to the widening trade imbalance is the increase in monetary and fiscal stimulus in the economy. A gradual return to the neutral stance of monetary policy and a successful reduction of fiscal deficit would provide support for increased savings in the economy, contributing to a lowering of the trade imbalance over the medium term.

On the other hand, if the large fiscal deficit were to persist into the medium term, its effect on the trade and current accounts would continue. In this scenario, there would be significant downward pressure on the US dollar, upward pressure on domestic interest rates and a crowding out of private investment, leading to weaker growth in economic activity.

The prospects for economic growth over the medium term will also depend on continued technological innovation and growth in productivity. Growth in US productivity is estimated to have increased from around 1.5 per cent a year between 1974 and 1995 to 3.1 per cent a year between 1995 and 2004 (Jorgenson, Ho and Stirob 2004). The production and use of informa-

tion technology was found to have accounted for a large share of the gains in productivity growth. Jorgenson et al. (2004) projected that growth in US productivity will average around 2.6 per cent a year over the next decade. Continued productivity growth will provide support for sustained economic growth.

On the other hand, if technological progress and productivity growth slow significantly over the medium term, then the annual average rate of economic growth that will be achieved toward 2010 could be markedly lower than currently assumed.

Economic performance in China

An important issue in the outlook for world economic growth in 2005 is whether China's economy will successfully achieve a soft landing. There has been increased confidence in financial markets about the prospects for China's economic performance. Nevertheless, considerable uncertainty remains in the economic outlook.

Economic growth in China has eased gradually since mid-2004. In year average terms, growth in China's economy remained strong at around 9.5 per cent in 2004, compared with 9.1 per cent in 2003. Economic easing in China is assumed to continue in the short term, with growth averaging around 8.0 per cent in 2005 and 7.8 per cent in 2006.

The importance of China in the world economy has increased significantly over the past decade. China has a large economy relative to other high growth emerging markets, including India, Brazil and the Russian Federation. Measured by purchasing power parity, for example, China's economy is about twice the size of India's and about four to five times larger than those of Brazil and the Russian Federation. Compared with India, China's exports of goods and services are about six times higher. China's economy is also more open than India's, with lower average tariffs on manufactured products and significantly higher inflows of foreign direct investment.

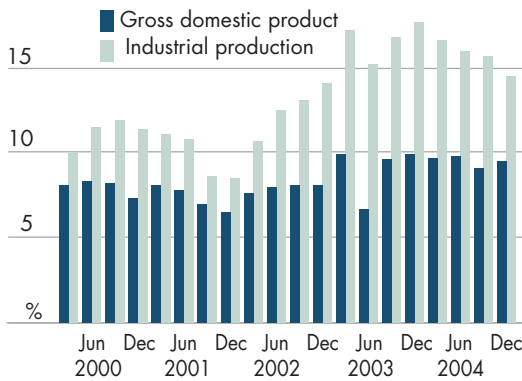
As discussed above, an important issue in the economic outlook is whether China will adopt

a more flexible exchange rate regime in the short term. International speculators have been pouring ‘hot money’ into China of the hope of a sizable revaluation of China’s currency.

From China’s perspective, a sizable revaluation against the US dollar would lead to a significant loss of the value of its foreign exchange reserves (measured at around US\$440 billion). For example, a 10 per cent revaluation means that China’s foreign exchange reserves would immediately lose about \$US44 billion in value. There are also concerns that a more flexible exchange rate regime could lead to instability in China’s banking system, a reduction in export competitiveness and an increase in the risk of higher unemployment.

Economic performance in China

Quarterly, ended December 2004, year on year growth



If China were to reform its exchange rate regime in the short term, the reform process would likely be gradual. One financial market suggestion has been that China would be more likely to first widen the trading band of its currency or peg its currency to a basket of international currencies, rather than just to the US dollar.

As to the size of the revaluation (should it happen), a wide range of opinions exists among market commentators. China’s currency has been pegged to around 8.28 yuan to the US dollar since 1996. Based on China’s significant economic performance, including high

economic growth and substantial inflows of foreign direct investment, it would appear that China’s economy could withstand a relatively significant appreciation of the currency. As mentioned earlier, the US dollar has depreciated by around 30 per cent against other major international floating currencies since early 2002. As China’s currency is pegged to the US dollar, it has depreciated against those international currencies by the same extent.

Despite strong economic growth in China, concerns over the possible impacts on China’s banking system and unemployment could restrict, at least initially, the extent of the revaluation, if it were to happen.

Over the medium term, economic growth in China will be dependent on the progress of economic reform. Despite strong economic performance, there are still significant reforms required in China’s economy, especially in the banking sector and state owned enterprises. In early January 2004, China’s government transferred around a tenth of its foreign exchange reserves (US\$45 billion) into two of the four state owned banks — China Construction Bank and Bank of China. Nonperforming loans in China’s banking sector are officially estimated at around US\$216 billion at the end of 2004 (private sector estimates are significantly higher). Progress on restructuring the banking sector will be an important determinant of macroeconomic stability in China over the next few years.

Toward 2010, economic performance in China is assumed to remain relatively strong. Economic growth in China is assumed to strengthen to 8.5 per cent in 2007, before easing gradually to 7.5 per cent in 2010.

Economic activity in Japan and the Republic of Korea

Japan

Japan’s economy experienced a decade of stagnation after the bubble economy burst in the early 1990s. During the past ten years, Japan has shown signs of economic recovery on several occasions (usually spurred by a signifi-

cant increase in exports), only to fall back into sluggish economic activity due mainly to weak consumer spending.

Between mid-2003 and early 2004, Japan once again exhibited economic recovery. Improved export performance was again the main contributor to economic growth in this period.

Since mid-2004, signs have emerged that economic growth in Japan is easing. There are considerable concerns about the effect on export, and hence economic, performance of the recent appreciation of the Japanese yen against the currencies of its two largest trading partners, the United States and China. The outlook for domestic demand, especially private consumption spending, remains uncertain as deflation continues.

Japan recently introduced a chain linked system of measuring economic activity that has led to a significant revision to previous estimates of gross domestic product. For example, economic growth in the June quarter 2004 was previously reported to be 1.1 per cent (annualised). This compares with a revised contraction of 0.6 per cent under the new system.

Looking forward, the rebound in export growth that began in early 2003 could moderate in response to an easing of world economic growth. The weakness of the nonmanufacturing sectors is likely to persist. On average, economic growth in Japan is assumed to be 1.3 per cent in both 2005 and 2006, compared with estimated growth of around 2.6 per cent in 2004.

Over the past decade, Japan has implemented significant fiscal and monetary stimulus to support economic growth. Official interest rates have been reduced to close to zero. Japan has the largest fiscal imbalance (as a percentage of gross domestic product) of the developed countries. Fiscal policy in Japan continues to face formidable challenges. Not only are there questions about the extent of continued support to economic activity but also what is the balance to be struck between short term requirements and medium term consolidation.

The extent to which Japan is able to return to sustained economic growth over the medium term will depend on there being significant reforms to its economic structure. This is especially the case when account is given to the presence of an aging and declining population and low productivity growth in the non-traded sector.

Japan's working age population has been declining since 1998 and the total population is projected to decline from 2006. Over the medium term, Japan's source of economic growth relies on productivity growth, which is dependent on the progress of economic restructuring.

In manufacturing, firms appear to be making progress with restructuring, with a number of large Japanese enterprises among the most productive in the world. However, the lack of competition has discouraged and slowed reforms in businesses oriented to the domestic market. Most industries in the nontraded sector

OECD productivity growth 1992–2002

	United States	Japan	Germany	EU	OECD
	%	%	%	%	%
Economic growth	3.2	1.1	1.4	2.0	2.6
Population growth	1.2	0.2	0.1	0.2	0.5
Employment growth	1.4	-0.1	0.1	0.6	1.4
Labor productivity growth in					
– total manufacturing	3.9	2.4	2.4	na	na
– construction	0.2	-3.0	0.0	na	na
– wholesale and retail trade, restaurants and hotels	3.8	0.9	-0.6	na	na

na Not available.

Source: OECD (2004)

have recorded lower productivity growth than in other OECD countries (OECD 2004). Facing an aging and declining population, Japan requires substantial economic restructuring of the non traded sector. Slow progress in structural reform will result in weakness in economic performance and further pressure on the fiscal position.

Reflecting an aging and declining population and the need for significant economic restructuring, economic growth in Japan is assumed to average around 1.0 per cent a year out to 2010.

Republic of Korea

Economic growth in Korea is estimated to have been around 4.6 per cent in 2004, compared with 3.1 per cent in 2003. Contributing most to the economic growth in 2004 was a significant increase in exports. Despite the export boom, the economy did not quite reach the government's growth target of 5 per cent because of sluggish private consumption spending and investment expenditure.

Looking forward, partial indicators released recently indicate that domestic demand is unlikely to strengthen significantly in the next few months. For example, wholesale and retail trade fell year on year by 3.7 per cent in November 2004, while private investment spending fell sharply over the same period. More importantly, strong export performance could moderate gradually in response to easing economic growth in Korea's major export markets including the United States and Japan.

In spite of a modest growth outlook, a number of risks, including higher oil prices, a weaker US dollar, political scandals and ongoing labor unrest could further weaken economic performance in the short term.

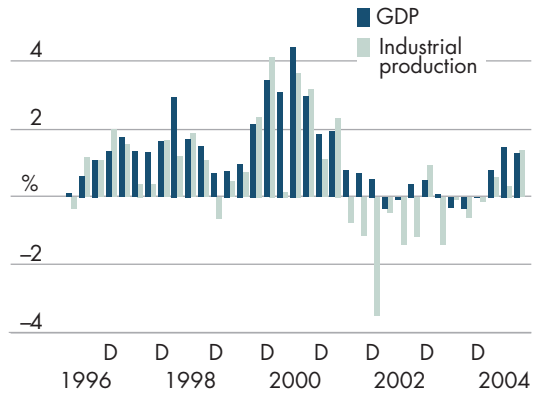
Economic growth in Korea is assumed to fall to around 3.8 per cent in 2005, before strengthening to 4.2 per cent in 2006. Toward 2010, economic growth in Korea is assumed to ease to 4.0 per cent a year.

Outlook for western Europe

Following slow growth in 2002 and 2003, economic activity in western Europe improved in 2004, with growth estimated to have averaged

Economic performance in Germany

Quarterly, ended September 2004, year on year growth



month. Despite a stronger euro against the US dollar and most of the Asian currencies, the trade surplus (in euro terms) increased by close to 20 per cent in 2004.

Export performance has been the main contributor to economic growth in recent years. Nevertheless, there remain considerable concerns about the outlook for Germany's export performance in 2005, especially in the light of slower world economic growth and the continued strength in the euro.

Germany's economy is estimated to have grown by 1.7 per cent in 2004. A part of this improved growth resulted from a higher number of public holidays falling on weekends in 2004, leading to an increase in the number of working days. After adjusting for this effect, real gross domestic product is estimated to have increased by 1.1 per cent in 2004. Economic growth in Germany is assumed to be 1.0 per cent in 2005, before increasing slightly to 1.3 per cent in 2006.

There are significant structural problems that need to be overcome in the German economy. The most sensitive areas include significantly large social welfare spending, a relatively large budget deficit and rigidities in the labor market. In January 2005, the European Union accepted Germany's proposal (supported by France and Italy) to abandon an automatic disciplinary procedure for member countries that exceed the deficit limit set by the Stability and Growth Pact.

Germany's budget deficits have exceeded the limit of 3 per cent of gross domestic product since 2002. While this action by the European Union may have provided some relief for Germany (and France) in terms of breaching the deficit limit, fiscal consolidation remains a major issue.

In France, economic growth has also weakened over the past few years, but remained stronger relative to some other major regional economies, including Germany and Italy. Partial indicators released recently suggest that this trend is likely to continue in the short term. Industrial production increased year on year by 2.1 per cent in November 2004 and retail trade (in volume terms) rose by an annual rate of

3.5 per cent in the same month. A major challenge in the short term is to stimulate growth in consumer spending to support economic activity. The unemployment rate was at 9.9 per cent in December 2004, unchanged from the same month a year earlier.

Economic growth in France is assumed to be 1.8 per cent in 2005, before increasing marginally to 2.0 per cent in 2006. This compares with growth of around 2.3 per cent in 2004.

For western Europe as a whole, economic growth is assumed to be around 1.6 per cent in 2005, before strengthening marginally to 1.8 per cent in 2006.

The relatively weak growth performance in western Europe over the past few years indicates the need to increase productivity growth through structural reform. The areas requiring substantial efforts include restructuring labor markets and reforming healthcare and pension systems. For example, while health care services in western Europe are generally better than in other parts of the world, the cost of maintaining such services has been growing significantly. There is also an urgent need for the new EU member countries to reform their health care systems to improve efficiency. With an aging population, the pressures on health care and pension spending are likely to increase.

Structural reform and further economic integration will be important for growth prospects in the region. If successful, productivity growth, and hence the potential rate of economic growth, would increase in the region. Otherwise, economic underperformance will continue.

Economic growth in east and south east Asia

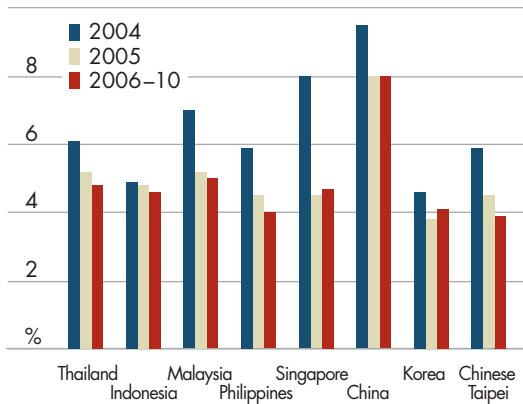
Supported by strong export performance, many of the east and south east Asian economies achieved strong economic growth in 2004. For example, economic growth in non-OECD Asia (excluding Japan and the Republic of Korea) is estimated to have averaged 7.6 per cent in 2004, compared with growth of 7.2 per cent in 2003.

Looking forward, export performance in the region could ease as economic growth moderates in the United States, China and Japan. Nevertheless, economic growth in the region is likely to

remain relatively robust, as domestic demand is expected to strengthen. For non-OECD Asia as a whole, economic growth is assumed to be 6.5 per cent in 2005 and 6.3 per cent in 2006. Toward 2010, economic growth in the region is assumed to average slightly over 6.0 per cent a year.

In Chinese Taipei, the economy is estimated to have grown by 5.9 per cent in 2004, compared with 3.2 per cent in 2003. Partial indicators released recently suggest that economic growth is continuing, with industrial production increasing year on year by 5.4 per cent in November 2004. Despite stronger economic activity, inflationary pressures have been relatively low with consumer prices increasing by 1.6 per cent during 2004. Economic growth in

Economic growth in Asia



Chinese Taipei is assumed to be 4.5 per cent in 2005, before easing gradually to around 3.8 per cent a year over the medium term.

In Malaysia, the manufacturing sector has benefited from increased export demand and a competitive exchange rate (the value of Malaysia's ringgit is pegged to the US dollar). Industrial production increased year on year by close to 10 per cent in November 2004. The trade surplus was around US\$21 billion in the first eleven months of 2004. Economic growth in Malaysia is assumed to be 5.2 per cent in 2005, before easing slightly to 5.0 per cent a year toward 2010.

For south east Asia as a whole, economic growth is assumed to be 4.9 per cent in 2005, before easing gradually to around 4.5 per cent a year over the medium term.

Despite the relatively positive economic outlook, there are several downside risks that could significantly weaken economic performance in the region. In broad terms, if there were a significant easing of strong economic growth in the United States or China, there would be adverse flow on effects to the regional economies.

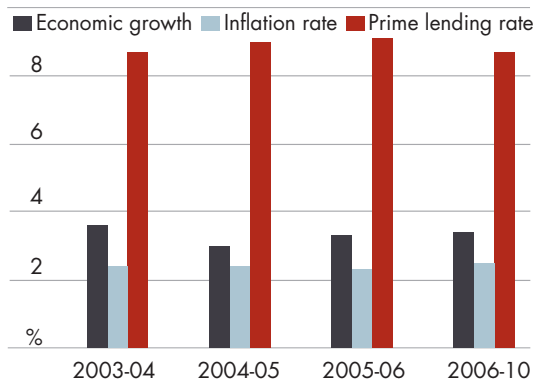
Another downside risk to regional economic performance relates to higher oil prices, which have led to considerable inflationary pressures in the region. In local currency terms, world oil prices in 2004 increased by around 40 per cent from the average of 2002 and 2003.

Economic prospects in Australia

The outlook for the Australian economy remains positive, with a significant increase in economic activity in the second half of 2004. Real gross domestic product, seasonally adjusted, increased year on year by 3.0 per cent in the September quarter, following a rise of 4.5 per cent in the June quarter. The farm economy increased year on year by 14 per cent in the September quarter, contributing significantly to growth in general economic activity.

Assuming average seasonal conditions, farm production, in volume terms, is forecast to

Australian economic indicators



Key macroeconomic assumptions for Australia

		2002	2003	2004	2005	2006	2007	2008	2009
	Unit	-03	-04	-05 a	-06 a	-07 a	-08 a	-09 a	-10 a
Economic growth bc	%	3.1	3.6	3.0	3.3	3.5	3.5	3.3	3.3
Inflation b	%	3.1	2.4	2.4	2.3	2.5	2.5	2.5	2.5
Interest rates c	% pa	8.4	8.7	9.0	9.1	8.7	8.7	8.7	8.7
Nominal exchange rates d									
– US\$/A\$	US\$	0.58	0.71	0.75	0.72	0.68	0.67	0.66	0.65
Trade weighted index for A\$ e	index	53.0	61.4	63.0	61.0	59.0	58.0	57.0	56.0

a ABARE assumption. b Change from previous period. c Prime lending rate to large businesses. d Average of daily rates. e Base: May 1970 = 100.

Sources: Australian Bureau of Statistics; Reserve Bank of Australia; ABARE.

increase by 2.7 per cent in 2005-06, following a forecast decline of 2.4 per cent in 2004-05. Crop production, in volume terms, is forecast to increase by 3.1 per cent in 2005-06, following an expected decline of 6.0 per cent in 2004-05. After a forecast increase of 2.0 per cent in 2004-05, the volume of livestock production is forecast to increase by 2.2 per cent in 2005-06.

Australia's trade account, seasonally adjusted, recorded a deficit of around \$6.4 billion in the September quarter 2004, compared with a deficit of \$5.5 billion in the June quarter. The current account deficit, seasonally adjusted, was around \$13.7 billion, or equivalent to around 6.5 per cent of gross domestic product, in the September quarter 2004. This compares with a deficit of \$11.9 billion, or around 6.1 per cent of gross domestic product, in the same quarter a year earlier.

Looking forward, economic growth in Australia is expected to remain robust. While growth in consumer spending could ease in 2005-06, business investment expenditure is expected to increase. Economic growth in Australia is assumed to be 3.0 per cent in 2004-05, before increasing to 3.3 per cent in 2005-06. Over the medium term, the Australian economy is assumed to grow at an average rate of around 3.3 per cent a year.

Inflation to remain under 3 per cent

Australia's inflationary pressures increased in late 2004, with the consumer price index rising year on year by 2.6 per cent in the December quarter, compared with a rise of 2.3 per cent

in the September quarter. Contributing most to the increase in the December quarter were rises in automotive fuel, fruit and domestic holiday travel and accommodation. Partially offsetting these increases were falls in the cost of pharmaceuticals and women outerwear.

Looking forward, other price indexes released recently suggest that modest inflationary pressures are likely to continue in the remainder of 2004-05. For example, the producer price index for final commodities increased year on year by 4.3 per cent in the December quarter 2004, compared with a rise of 3.2 per cent in the September quarter. While the import component declined year on year by 2.2 per cent, this was more than offset by an increase of 5.5 per cent in the domestic component in the quarter.

Australia's inflation rate is assumed to be 2.4 per cent in 2004-05 and 2.3 per cent in 2005-06. Over the medium term, annual inflation in Australia is assumed to be around 2.5 per cent.

Australian exchange rate

Short term direction of the Australian dollar

The Australian dollar has exhibited considerable volatility both on a trade weighted basis and against the US dollar over the past year or so.

During the first half of 2004, the Australian dollar depreciated markedly against major international currencies. The value of the Australian dollar declined from US80c, ¥84 and 0.62 euro in mid-February to US68c, ¥74 and 0.56 euro in mid-June. On a trade weighted basis, the Aus-

lian dollar depreciated from around TWI 66 to TWI 59 over the same period.

The Australian dollar was relatively stable between July and October 2004, before appreciating markedly during late 2004 and early 2005. The Australian dollar was trading around TWI 63, US77c, ¥80 and 0.59 euro in mid-February. In the first eight months of 2004-05, the Australian dollar is estimated to average around TWI 62, US74c, ¥79 and 0.58 euro. This compares with TWI 61, US71c, ¥79 and 0.60 euro in 2003-04.

The recent appreciation of the Australian dollar reflects, in part, some significant economic developments. One factor that has contributed markedly to the recent appreciation of the Australian dollar is the weakness in the US dollar against other international currencies. As discussed above, the US dollar has weakened significantly both on a trade weighted basis and against international floating exchange rates.

The other factor that has provided support for a higher value of the Australian dollar is movements in Australia's terms of trade, especially a significant increase in commodity prices on world markets. Australia's terms of trade increased year on year by around 11 per cent in the September quarter 2004, compared with a rise of 7 per cent in 2003-04 as a whole.

In the short term, movements in the Australian exchange rate are likely to continue to be influenced by the factors mentioned above. The

value of the Australian dollar, especially against the US dollar, will be affected by the strength of the US dollar. Currently, there are considerable concerns in financial markets that the large trade and current account deficits in the United States will continue to place downward pressure on the US dollar.

From a historical perspective, the value of the Australian dollar has been significantly associated with changes in Australia's terms of trade and hence movements in commodity prices on world markets. In response to the outlook for an easing of world economic growth, prices of some Australian commodities on world markets (in US dollar terms) are forecast to average lower in the short term. This could place downward pressure on the Australian dollar, especially in the latter part of 2005.

Interest rate differentials between Australia and the major world economies are also expected to affect the Australian dollar. The main factor affecting Australian interest rates will be the outlook for economic growth and inflation. Given modest inflationary pressures and robust economic growth in Australia, Australia's prime lending rates are assumed not to increase significantly. In year average terms, prime lending rates are assumed to average 9.0 per cent in 2004-05 and 9.1 per cent in 2005-06, compared with 8.7 per cent in 2003-04.

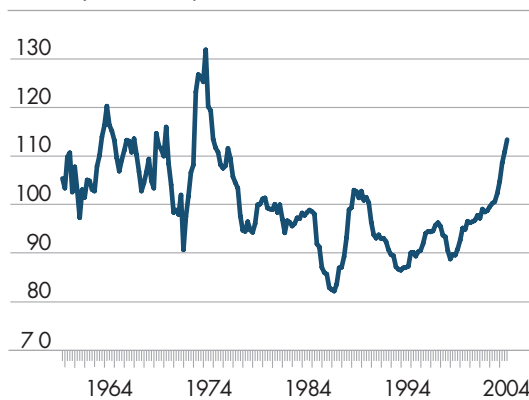
In contrast, US interest rates are expected to increase in the remainder of 2005, leading to a narrowing of the interest rate differential between Australia and the United States. The US prime lending rates are assumed to average around 5.5 per cent in 2005 and 6.5 per cent in 2006, compared with 4.3 per cent in 2004. Higher interest rates in the United States are expected to provide support for a higher value of the US dollar against international floating exchange rates.

Taking the above into account, the Australian dollar is assumed to average around US75c and TWI 63 in 2004-05 and US72c and TWI 61 in 2005-06.

There is considerable uncertainty about the outlook for the Australian dollar. This is because movements in the Australian dollar could be significantly influenced by changes in sentiment

Australian terms of trade

Quarterly, ended September 2004



in financial markets, leading to strong volatility in the Australian exchange rate.

For example, over the past financial year, the Australian dollar fluctuated from a low of US64c and TWI 57 in September 2003 to a high of US80c and TWI 66 in February 2004. Since the floating of the Australian dollar in December 1983, the Australian currency has had an average fluctuation range of around US10 cents a year. Managing the risks associated with fluctuations in Australia's exchange rate remains important for primary producers and exporters.

Australian dollar assumptions over the medium term

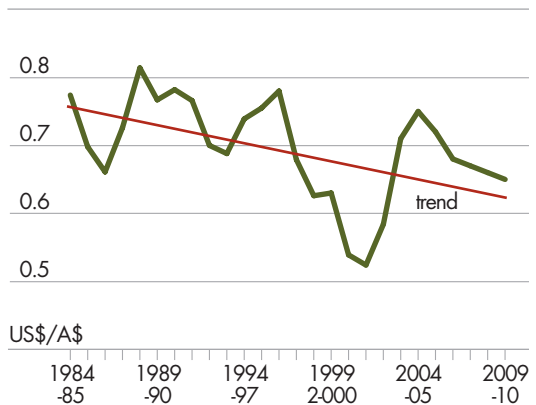
Over the medium term, it is reasonable to assume that movements in the Australian exchange rate will continue to be influenced by Australia's terms of trade, interest rate differentials and economic performance relative to the major world economies.

Toward 2009-10, Australia's real prime lending rates are assumed to average around 6.2 per cent, similar to that averaged in the five years ended 2003-04. The differential with real lending rates in the United States is assumed to narrow from currently around 4.0 percentage points to around 1.0 percentage point by 2009-10. Consistent with the assumption of moderating world economic growth, Australia's terms of trade are projected to ease gradually from the current high to a level that is more consistent with the historical trend.

Toward the end of the outlook period, the Australian dollar is assumed to depreciate both against the US dollar and on a trade weighted basis. By 2009-10, the Australian dollar is assumed to average around US65c and TWI 56.

The assumed movements in the Australian exchange rate toward 2009-10 are also based on underlying assumptions that, in Australia, the economic reform process will be uninterrupted; relatively high productivity growth will

Australian exchange rate against US dollar



be achieved; and sound economic management will continue. If the Australian economy fails to match the performance of other world economies, a sharply lower Australian dollar than currently assumed could eventuate. On the other hand, if Australia significantly outperforms other world economies in terms of economic management and performance, then a stronger Australian exchange rate than currently assumed would, of course, be consistent with that scenario.

References

- Jorgenson, D., Ho, M.S. and Stirob, S. 2004, 'Will the US productivity resurgence continue?', *Current Issues in Economics and Finance*, Federal Reserve Bank of New York, vol. 10, no. 13, December 2004.
- Penm, J. 2004, 'Economic overview: impacts of high oil prices', *Australian Commodities*, vol. 11 no. 4, 519-28.
- OECD (Organisation for Economic Cooperation and Development) 2004, *Product Market Competition and Economic Performance in Japan*, Economics Department Working Paper, no. 387, Paris.