

# Australian commodities

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# Economic overview

## *Prospects for world economic growth, 2009 to 2014*

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- World economic growth is assumed to decline to 0.6 per cent in 2009 from an estimated 3.4 per cent in 2008, before recovering to 3 per cent in 2010. Over the medium term, world economic growth is assumed to strengthen to 4.3 per cent in 2011, before easing gradually to around 4 per cent a year toward 2014.
- Economic growth in China is assumed to moderate but remain relatively strong in the short term, averaging 6.7 per cent in 2009 and 8 per cent in 2010. Over the medium term, economic growth in China is assumed to average close to 9 per cent a year.
- Economic growth in Australia is assumed to be 1 per cent in 2008-09 and 0.75 per cent in 2009-10. Toward 2013-14, Australian economic growth is assumed to average around 3 per cent a year.

## The global economy

### *World economic growth has weakened sharply*

The global financial crisis which began in September 2008 has sharply weakened the world economic outlook for 2009. Following the insolvency of several investment banks and other financial institutions in the United States and Europe, financial conditions worldwide have tightened significantly, leading to substantial declines in stock market valuations and marked reductions in capital inflows to emerging economies.

In response to the financial crisis, the authorities in the United States, Western Europe and many other advanced and emerging economies have implemented substantial monetary and fiscal policy measures aimed at supporting economic activity, stabilising markets and bolstering consumer and business confidence. Notwithstanding these efforts, the world economic outlook has continued to weaken.

While the financial crisis originated in the OECD countries, the emerging economies have not decoupled from the current economic downturn. Moreover, recent trade and business indicators suggest a rapid weakening of activity in the emerging economies. Countries which have strong trade links with the United States and Western Europe have been particularly vulnerable to the spillover effects of sharply weaker economic activity in the OECD region.

In China, for example, economic growth slowed to a year-on-year rate of 6.8 per cent in late 2008, compared with an average growth rate of 9.9 per cent in the first three quarters of 2008 and 13 per cent in 2007. While the Chinese Government has implemented significant fiscal and monetary stimulus measures, it remains unclear at this stage whether these measures will be effective in stimulating growth in domestic demand.

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### World stock markets

	late July 2007	early September 2008		early February 2009	
	<i>before the onset of problems in the US subprime market index</i>	<i>before the onset of global financial crisis index</i>	<i>change between July 2007 and September 2008 %</i>	<i>index</i>	<i>change between February 2009 and July 2007 %</i>
<b>OECD</b>					
United States	13 191	11 373	-13.8	8 063	-38.9
Japan	14 601	12 338	-15.5	7 953	-45.5
Euro area	3 900	3 257	-16.5	2 276	-41.7
Australia	5 981	4 934	-17.5	3 469	-42.0
<b>East Asia</b>					
China	4 895	2 225	-54.5	2 196	-55.1
Korea, Rep. of	1 889	1 463	-22.5	1 179	-37.6
Chinese Taipei	9 310	6 421	-31.0	4 371	-53.0
<b>South East Asia</b>					
Indonesia	2 756	1 911	-30.7	1 323	-52.0
Malaysia	1 436	1 058	-26.3	883	-38.5
Philippines	3 241	2 696	-16.8	1 868	-42.4
Singapore	3 270	2 621	-19.8	1 709	-47.7
Thailand	884	657	-25.7	434	-50.9
India	18 115	14 567	-19.6	9 162	-49.4

Overall, world economic growth is estimated to have slowed markedly to an annual average of 3.4 per cent in 2008. This compares with growth of 5.2 per cent in 2007.

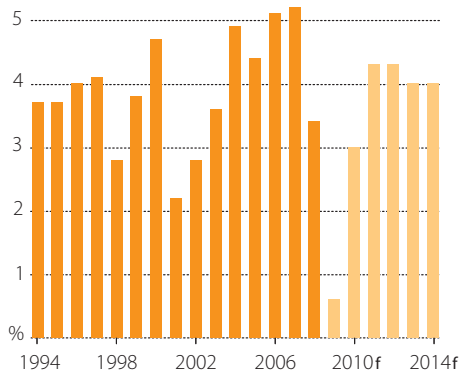
### *Growth in the global economy to decline markedly in 2009*

World economic growth is assumed to decline markedly in 2009. As a result of recent financial market volatility, economic activity in the OECD region is expected to contract. In the world's largest economy, the United States, credit conditions have tightened significantly, exacerbating the ongoing correction in the housing market. Despite the substantial fiscal stimulus implemented in mid-2008, economic indicators released recently suggest the recession in the US economy is deepening.

Economic activity in Western Europe has also been adversely affected by tighter credit conditions and downturns in the regional financial markets. Most regional economies are expected to go through a period of economic contraction in 2009, before a gradual recovery begins in early 2010.

Growth in the emerging economies is also expected to decelerate in the next few quarters, falling well below potential, before picking up gradually in late 2009. During this period, regional export growth is expected to slow markedly and increases in domestic demand are likely to be the main stimulus to overall economic activity.

World economic growth



Against this backdrop, global economic growth is assumed to decline to 0.6 per cent in 2009. Economic activity in the OECD region is assumed to contract by 1.8 per cent in 2009. In the emerging and developing economies, growth is assumed to be around 4.2 per cent in 2009, compared with an estimated 6.6 per cent in 2008.

*World economic growth assumed to recover in 2010*

The recovery in world economic performance is expected to begin in late 2009 – early 2010, with global economic growth assumed to increase to 3 per cent in 2010. Over the

Key macroeconomic assumptions

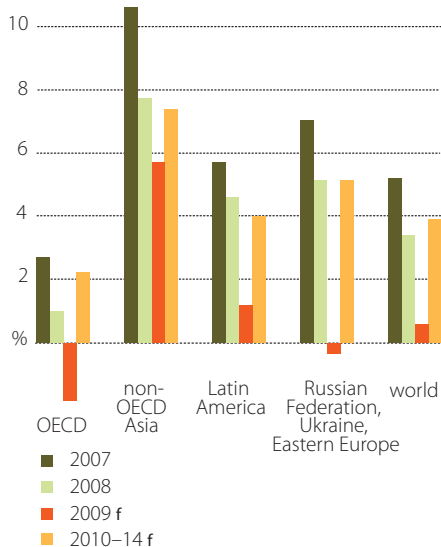
	unit	2007	2008	2009 a	2010 a	2011 a	2012 a	2013 a	2014 a
<b>Economic growth b</b>									
OECD	%	2.7	1.0	-1.8	1.2	2.7	2.5	2.4	2.3
United States	%	2.0	1.3	-1.5	1.8	3.2	3.0	2.8	2.8
Japan	%	2.4	-0.7	-2.5	0.6	2.0	1.8	1.6	1.5
Western Europe	%	2.6	0.7	-2.0	0.5	2.3	2.1	1.9	1.9
Germany	%	2.5	1.0	-2.5	0.3	2.5	2.3	2.0	1.9
France	%	2.2	0.7	-1.9	0.7	2.2	2.1	2.0	2.0
United Kingdom	%	3.0	0.7	-2.8	0.2	2.6	2.5	2.3	2.3
Italy	%	1.5	-1.0	-2.0	0.0	1.6	1.3	1.3	1.3
Korea, Rep. of	%	5.0	2.5	-1.0	2.5	5.0	4.7	4.5	4.5
New Zealand	%	3.2	0.4	-0.3	2.0	3.0	2.8	2.7	2.7
Developing countries	%	8.6	6.6	4.2	5.6	6.6	6.6	6.2	6.1
Non-OECD Asia	%	10.6	7.7	5.7	7.0	7.7	7.7	7.3	7.2
South East Asia c	%	6.3	5.2	2.7	4.4	6.0	5.7	5.5	5.5
China d	%	13.0	9.0	6.7	8.0	9.0	9.0	8.5	8.5
Chinese Taipei	%	5.7	2.3	0.0	3.6	5.0	5.2	5.0	4.5
India	%	9.3	7.3	5.5	7.0	8.5	8.5	8.0	8.0
Latin America	%	5.7	4.6	1.2	3.0	4.5	4.5	4.0	4.0
Middle East	%	6.4	6.1	3.9	4.7	6.0	6.0	5.7	5.7
Russian Federation	%	8.1	6.2	0.0	2.0	6.0	7.0	7.0	7.0
Ukraine	%	7.6	6.0	-2.0	2.5	5.5	6.0	6.0	6.0
Eastern Europe	%	5.4	3.2	1.0	3.0	5.0	5.0	4.5	4.5
World e	%	5.2	3.4	0.6	3.0	4.3	4.3	4.0	4.0
<b>Industrial production b</b>									
OECD	%	2.5	-2.0	-11.5	1.0	2.9	2.8	2.4	2.4
<b>Inflation b</b>									
United States	%	2.9	3.8	0.3	1.8	2.0	2.2	2.2	2.2
<b>Interest rates</b>									
US prime rate g	% pa	6.6	5.1	3.2	3.5	4.5	6.0	6.0	6.0
<b>US exchange rates h</b>									
Yen/US\$	Yen	118	104	100	104	110	112	114	115
Euro/US\$	Euro	0.73	0.68	0.75	0.70	0.70	0.70	0.70	0.70

a ABARE assumption. b Change from previous period. c Indonesia, Malaysia, the Philippines, Singapore, and Thailand. d Excludes Hong Kong. e Weighted using 2007 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.

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### Regional economic growth



medium term, global economic growth is assumed to strengthen further to 4.3 per cent in 2011, before easing gradually to an average of 4 per cent toward 2014.

An important assumption underlying the current outlook for world economic growth is that comprehensive stimulus packages introduced by many world economies, including the United States, Western Europe, China, India, the Republic of Korea and Australia, will work over time to stabilise financial market conditions and restore consumer and business confidence. Nevertheless, in the short term, financial markets are likely to remain under pressure. Consumers and businesses will also take time to regain confidence and gradually increase their spending and investment.

### *Risks to the world economic outlook*

There are substantial risks to the current world economic outlook. The principal downside risk stems from the insolvency of financial institutions in many OECD countries and the likely impact on OECD economic growth.

At the time of writing, financial market conditions worldwide remain volatile. A key element of uncertainty is the extent to which increased borrowing costs and higher lending risks will affect the banking sector's capacity and willingness to lend. Sharply tighter conditions in the credit markets have led to a significant reduction in lending not only to the riskier market segments, but also to more creditworthy borrowers in the corporate and household sectors. While such impacts have been more pronounced in the United States and Western Europe, where the exposure to credit market problems is higher, adverse effects could intensify in many other world economies. There is also a possibility that weaker world economic activity could increase losses in a range of asset holdings, leading to an even lower capital base in the global banking sector and thus prolonging or intensifying the current economic downturn.

Another downside risk relates to the spillover effects of economic contraction in the OECD region on the emerging economies. If economic slowdown in the emerging markets were sharper than currently assumed, world economic growth, and hence world commodity demand, would be significantly weaker.

In the emerging economies, principal concerns relate to their trade exposure to the OECD region, but domestic demand could also be adversely affected by worsening financial market conditions and declines in asset prices. Countries which have relied on easy access to foreign capital and sharply higher revenues from commodity exports to drive growth in domestic demand could be particularly at risk.

While significantly weaker world economic growth in 2009 represents the most likely outcome, there remain some upside risks to this outlook. For example, there remains the potential for domestic demand in some countries to perform better than currently assumed, for example in China, where the authorities have promptly introduced sizeable monetary and fiscal stimulus packages. A milder world economic downturn is also possible if the timing and pace of the expected economic recovery turns out to be earlier or stronger than currently anticipated.

### *Prospects for world commodity markets*

The sharp rise in commodity prices over the past five years was associated with a period of strong economic growth. Since mid-2008, concerns about slowing world economic growth and more favourable prospects for agricultural production as a result of improved seasonal conditions have led to a significant softening in many commodity prices. In the short term, volatility in commodity prices is likely to continue mainly as a result of increased uncertainty about world economic growth and hence world commodity demand.

Commodity price prospects are crucial to commodity producers and exporters. An important question facing commodity producers and exporters is what will be the impact of sharply weaker economic growth on world commodity markets? Furthermore, once the recovery in world economic growth begins, what will be the effect on world commodity demand and prices? Will world commodity prices return to the remarkably high levels achieved before the onset of the global financial crisis?

Under the assumption of favourable seasonal conditions, earnings from farm exports are not expected to be severely affected in the short term. Food consumption in the OECD economies is relatively insensitive to income changes. While considerable downward price pressure has emerged for some commodities such as wool, wine and dairy products, the demand for grains, beef and sheep meat appears to have been maintained. In addition to the global financial crisis, world prices for dairy products are also being affected by issues surrounding export subsidies in the European Union.

A sharp depreciation of the Australian exchange rate against the US dollar since mid-2008, if sustained, will also provide some support for commodity export earnings because most export contracts are denominated in US dollars. The Australian dollar was trading around US65c and TWI 54 in mid-February 2009, compared with a high of US98c and TWI 74 in mid-July 2008.

For mineral and energy commodities, the slowdown in world economic growth has placed significant downward pressure on world prices for mineral resources. Because commodity prices reflect forward looking expectations, prospects of sharply lower world economic growth have caused mineral and energy prices on world markets to decline rapidly. Without a significant improvement in the world economic outlook, a substantial strengthening in world mineral and energy prices appears unlikely in the short term.

### *Commodity demand prospects in China*

An important factor which can have a significant effect on world economic prospects and commodity prices on world markets is economic performance in China.

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China's importance in world commodity markets has increased significantly over the past decade. For many commodities, China's import demand has risen sharply, leading to a marked increase in its share of world trade.

Developments in China will play a key role in shaping world economic growth to 2014. In the short term, China is in a reasonable position to withstand the adverse effect of the global financial crisis. As of December 2008, China had US\$1.95 trillion of foreign exchange reserves. The country has also introduced significant fiscal and monetary stimulus packages aimed at supporting domestic demand.

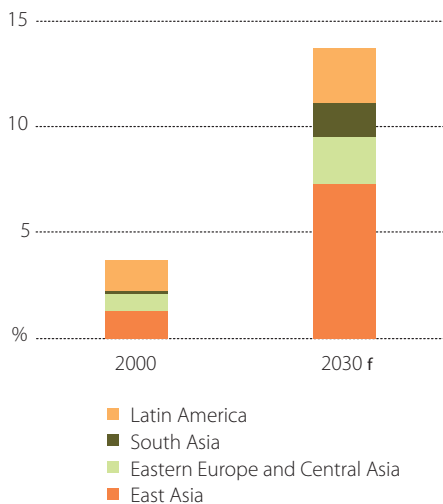
Over the medium to longer term, rapidly rising per person incomes in China are expected to lead to a significant increase in consumer demand. According to the World Bank, there were 56 million people (or around 4 per cent of the total population) in China belonging to the so-called 'global middle class' in 2000, with annual incomes of between US\$4000 and US\$17 000 (in purchasing power parity terms, 2000 dollars). The World Bank projects that China's middle class will increase to around 361 million people (or around 25 per cent of the total population) by 2030.

### Importance of China in world commodity markets

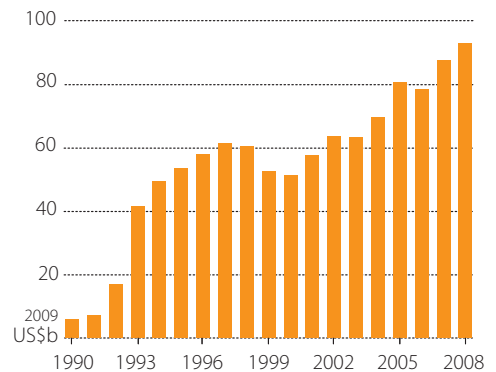
	three years ended 1997 share of world			three years ended 2007 share of world		
	production	consumption	imports	production	consumption	imports
	%	%	%	%	%	%
Cotton <b>a</b>	22.6	22.4	12.2	26.2	37.4	31.4
Dairy	1.7	1.7	0.3	5.0	5.1	1.1
Oilseeds <b>a</b>	15.9	16.2	3.3	13.9	22.0	37.9
Sugar <b>a</b>	6.2	7.0	1.5	8.0	8.9	2.3
Wool	11.1	17.1	19.1	18.5	18.5	39.0
Copper – concentrates	4.2	na	9.4	5.1	na	22.3
Copper – refined	8.8	7.6	1.2	17.5	23.5	14.6
Lead – concentrates	21.3	na	2.9	36.7	na	47.4
Oil <b>b</b>	4.3	5.1	1.4	4.3	8.4	3.4
Iron ore	13.2	18.3	10.3	18.1	40.0	42.4
Zinc – concentrates	15.5	na	-0.4	26.5	na	10.4
Zinc – refined	16.3	10.5	-9.5	30.0	29.6	1.1
	production	consumption	exports	production	consumption	exports
	%	%	%	%	%	%
Beef and veal	8.0	7.9	1.8	10.1	10.1	1.1
Wheat <b>a</b>	19.4	19.2	-4.7	17.3	16.6	1.6
Course grains <b>a</b>	15.1	14.3	1.5	15.5	15.2	1.6
Sheep meat <b>c</b>	14.5	19.1	0.0	29.0	na	0.2
Wine <b>d</b>	1.6	1.1	0.0	2.6	2.5	0.0
Aluminium <b>e</b>	8.8	10.1	-1.3	28.5	27.3	3.1
Gold	6.6	na	na	10.1	na	na
Lead – refined	11.5	7.9	11.7	33.3	28.1	19.4
Metallurgical coal	26.1	25.5	3.4	45.6	48.0	2.0
Thermal coal	37.0	43.0	8.3	42.9	50.2	8.9

**a** Based on crop years (2007 = 2007-08). **b** 2007 imports data not available. **c** 1995 and 2007 imports data not available, consumption includes goat meat. **d** Three years to 2007 based on 2005 data. **e** 1995 exports data not available. **na** Not available.

World middle income population percentage of world population



FDI flows to China



Selected Australian commodity exports to China

		3 years ended 1997-98	3 years ended 2007-08
Wheat	kt	850.3	162.7
Wine	kL	2 918.9	16 105.8
Cotton	kt	56.7	179.4
Sugar <sup>a</sup>	kt	251.4	126.4
Wool <sup>b</sup>	kt	177.6	333.2
Iron ore	Mt	26.7	142.1
Aluminium	kt	11.6	40.0
Copper -refined	kt	2.5	22.3
Copper - concentrates	kt	181.7	514.5
Gold	kg	1.0	387.8
Lead - refined	kt	5.3	0.4
Lead- concentrates	kt	43.4	162.3
Zinc - refined	kt	1.3	42.9
Zinc - concentrates	kt	93.7	482.4
Oil	ML	279.2	631.2
Metallurgical coal	Mt	0.2	2.0
Thermal coal	Mt	1.5	2.9
Commodity exports to China <sup>c</sup>	\$b	3.9	18.2

<sup>a</sup> 2007-08 data not available. <sup>b</sup> Greasy equivalent. <sup>c</sup> Agriculture, mineral and energy exports.

Despite possible disruptions to its short-term economic performance, continued strong industrialisation and urbanisation in China over the medium to longer term will put significant pressure on its domestic resources. As a result, China could become an even more important player in global markets, which would provide increased export opportunities for Australia's commodity industries.

Given its competitive labour costs, sizeable labour force and attractiveness for foreign direct investment, China has the potential to repeat its recent impressive economic performance in the medium term. On a purchasing power parity basis, China accounted for around 11 per cent of world income in 2008. If strong growth in foreign direct investment and productivity continues, it is not inconceivable China's share of world income could double toward 2030.

However, China's economic success is not guaranteed. China still requires significant structural reforms, especially in its financial sector, legal system and state-owned enterprises. If significant progress in the reform process can be achieved, China will be able to

## Economic overview

sustain high levels of economic growth in the medium to longer term. Otherwise, bottlenecks and capacity constraints will emerge and economic growth in China will inevitably slow.

## Economic prospects in Australia's major export markets

### *The United States*

As a result of the financial crisis, economic growth in the United States weakened sharply in the second half of 2008. Gross domestic product, in real terms, is estimated to have contracted at an annualised rate of 3.8 per cent in the December quarter 2008, following a decline of 0.5 per cent in the September quarter. The contraction in gross domestic product primarily reflected declines in exports, consumer spending and residential investment – the latter has been contracting since early 2006.

Consumer spending has been adversely affected by the declines in housing prices and stock market valuations, which have led to a sizeable reduction in household wealth. Labour market conditions have softened markedly in recent months, with job losses across all sectors of the economy. Since December 2007, the total number of job losses in the US economy reached around 3.6 million. The unemployment rate rose to 7.6 per cent in January 2009, compared with a low of 4.6 per cent in the same month two years earlier.

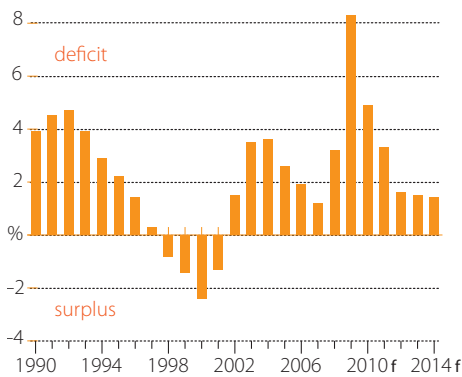
Higher unemployment and lower household wealth have resulted in consumer confidence falling to the lowest levels in decades. Looking forward, consumer spending is likely to remain subdued in the next few quarters. Because consumer spending accounts for around two-thirds of the US economic activity, its revival will be important for achieving a sustained recovery in economic growth.

To facilitate economic recovery, US authorities have implemented a number of stimulus measures, including large injections of liquidity into financial markets, significant reductions in the official interest rate and the introduction of various debt and deposit guarantees. In February 2009, the United States enacted legislation which outlines a fiscal stimulus package totalling US \$787 billion (or around 5 per cent of gross domestic product) spread over 2009 and 2010, in an attempt to provide further support to economic activity. The package includes tax cuts of more than US\$290 billion for individuals and businesses and higher government infrastructure spending.

Given the weak state of the US economy, the effectiveness of recent government policy initiatives in stabilising financial market conditions and restoring growth in consumer and business spending will be a major determinant of the US economic performance in the short term.

Recent declines in energy prices and weaker domestic economic activity have led to a significant decline in the inflation rate. The US consumer price index fell by 0.7 per cent in December 2008, the third consecutive monthly decline. Looking forward, inflation is expected to remain low in the coming quarters. Combined with weaker economic conditions, this suggests the US monetary policy is likely to remain accommodative. In mid-December 2008, the US Federal Reserve reduced the federal funds rate to a low of zero to 0.25 per cent.

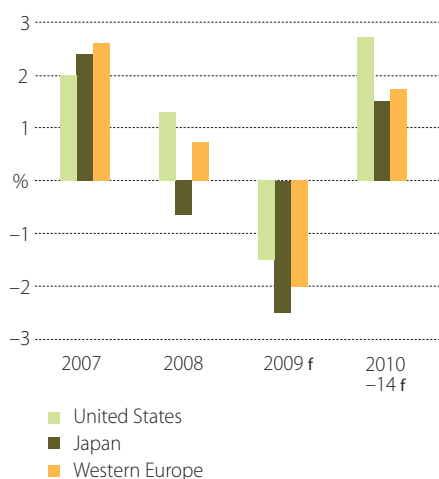
US budget deficit as a share of GDP



In preparing this set of commodity forecasts, economic activity in the United States is expected to remain subdued in the first half of 2009, before a gradual recovery begins in late 2009. For 2009 as a whole, the US economy is assumed to contract by 1.5 per cent. Economic growth is assumed to recover to around 1.8 per cent in 2010 and to gather pace to 3.2 per cent in 2011, before easing marginally to an annual average of 2.8 per cent toward 2014.

There are considerable downside risks surrounding the short-term outlook for the US economy. The main risk stems from the fact that the US financial markets remain under pressure and asset prices continue to fall, which has the potential to prolong the period of economic weakness. Another risk is the emergence of deflationary forces in the economy, which could lead to further reductions in business investment and employment. Reflecting these risk factors, there is a possibility that the US economic recovery could eventuate later and the pace of economic recovery could be weaker than currently assumed. There is also a potential risk that continuing large US trade deficits combined with weakening employment prospects could prompt a re-emergence of trade protectionism in that country.

OECD economic growth



While the most immediate challenge for the United States is to bring its economy back onto a growth path, the implementation of recent spending initiatives to stabilise financial and housing markets will result in fiscal deficit rising sharply over the short to medium term.

According to the US Congressional Budget Office projections, the federal budget deficit in 2009 will total US\$1.2 trillion, or 8.3 per cent of gross domestic product (excluding the fiscal stimulus package announced in February 2009). This compares with a deficit of US\$455 billion, or 3.2 per cent of gross domestic product, in 2008. The deficit is currently projected to decline to around 1.5 per cent of gross domestic product by 2014.

Non-OECD Asia

The global financial crisis has adversely affected economic activity in non-OECD Asia (excluding Japan and the Republic of Korea). In particular, rapidly falling global demand has led to a reduction in exports, which is an important driver of economic growth in the region.

## Economic overview

Because exports account for a relatively large share of many Asian economies, declining export growth has adversely affected regional industrial production, business investment and labour markets. In Malaysia and the Republic of Korea, for example, manufacturing activity has fallen markedly since late 2008.

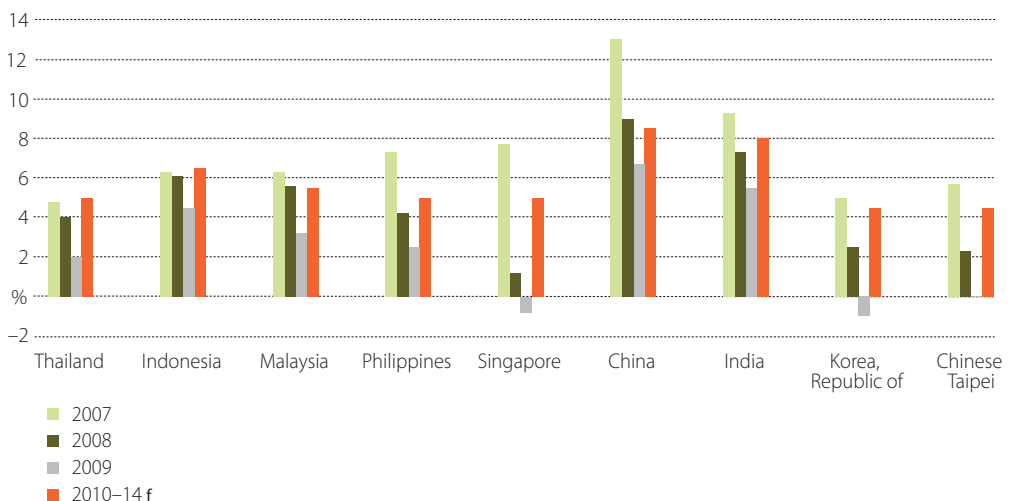
Concerns about the weakening OECD economic outlook and its impact on emerging Asia, together with the uncertainty over the global financial market situation, have also led to a sharp decline in capital inflows to the Asian region. Portfolio investment in some regional economies such as India, Malaysia, the Philippines and Thailand declined in 2008. Since the onset of the global financial crisis, foreign direct investment to some regional economies, including Singapore and Thailand, has also slowed.

In contrast to the situation in many OECD economies, banking sectors in most Asian countries appear to have been less affected by the fallout from the global financial crisis. While many banks in the Asian region have relatively limited exposure to the subprime and related assets, their structure and balance sheets have also improved since the Asian financial crisis.

In an attempt to support regional economic activity, central banks in many Asian economies, including India, the Republic of Korea, Chinese Taipei and South East Asian countries, have lowered their official interest rates. A number of regional economies such as the Republic of Korea and Chinese Taipei have also implemented substantial fiscal stimulus measures.

Looking forward, regional economic growth is expected to remain weak in the next few quarters. Toward late 2009, regional economic growth is assumed to begin recovering, supported by the expected strengthening in OECD economic activity by that time. Economic growth in non-OECD Asia is assumed to average 5.7 per cent in 2009, before recovering to 7 per cent in 2010. This compares with an estimated growth of 7.7 per cent in 2008. Over the medium term, economic growth in non-OECD Asia is assumed to strengthen to 7.7 per cent in 2011, before moderating gradually to an annual average of 7.2 per cent by 2014.

### Economic growth in Asia



Given the reliance of regional economies on exports, the primary downside risk to the regional outlook is a prolonged period of weakness in the OECD economies. Another downside risk relates to the rise in capital borrowing costs as a result of higher economic uncertainty. This means there could be increased difficulty in financing new investment and sustaining existing projects, which has the potential to lead to a significant decline in capital investment.

The global financial crisis underscores the need for emerging Asian economies to continue structural reforms in their financial sectors and to further strengthen their regulatory frameworks. The adverse effect of the global financial crisis on exports and overall economic growth also suggests that Asian economies would benefit from a more balanced growth strategy with a greater reliance on domestic demand. More balanced growth would also help to mitigate global trade and current account imbalances.

### *China*

Economic activity in China slowed considerably over the past year. For 2008 as a whole, China's economic growth slowed to 9 per cent, following a recently revised growth rate of 13 per cent in 2007.

Partial indicators released recently suggest growth in exports, industrial production and foreign direct investment has declined in late 2008. There are also indications that labour market conditions have softened, particularly in export-oriented industries. In contrast, consumer spending appears to have held up reasonably well, with retail sales expanding at an average annual rate of 21.9 per cent in the first eleven months of 2008, compared with an average growth of 16.3 per cent over the same period in 2007.

In November 2008, the Chinese Government announced a fiscal stimulus package of 4 trillion yuan (around 15 per cent of its gross domestic product) in an effort to support domestic demand. The fiscal stimulus will significantly increase government spending on infrastructure and other public sector investment projects.

After reaching an annual rate of 8.7 per cent in February 2008, inflation in China has eased to 1 per cent in January 2009. Easing inflationary pressures have provided room for a more expansionary monetary policy. Since September 2008, the Bank of China has reduced its benchmark interest rate by 216 basis points to be 5.31 per cent in mid-February 2009.

The expansionary policies adopted by the Chinese Government are expected to provide some support to domestic demand in the short term. In preparing this set of commodity forecasts, economic growth in China is assumed to average 6.7 per cent in 2009, before recovering to 8 per cent in 2010. As activity in the OECD economies rebounds, economic growth in China is expected to return to levels closer to its longer term potential. Over the medium term, economic growth in China is assumed to increase to 9 per cent in 2011, before easing gradually to an annual rate of 8.5 per cent by 2014.

There are considerable risks surrounding the economic outlook for China. The main downside risk relates to a more severe effect of the weaker international environment on domestic demand than currently assumed. There is a possibility that consumer confidence could weaken significantly, undermining growth in consumer demand.

## Economic overview

On the upside, China appears to be more resilient to external shocks than other Asian economies mainly because of its large balance of payments surplus. As a result, recent stimulus measures could have a bigger effect on domestic demand than currently anticipated. The decline in mineral and energy prices on world markets would also help to further reduce inflationary pressures in China.

Over the medium term, there are a number of issues which have the potential to affect economic growth in China. One major challenge is the need for China to rebalance its sources of economic growth away from exports and toward domestic consumption. As its importance in world trade rises, it will be difficult for China to maintain rapid export growth, particularly given increased tensions on market access issues between China and other major world economies.

### *India*

Reflecting the disruptions from the global financial crisis, economic growth in India has also weakened, from a year-on-year rate of 8.8 per cent in the March quarter 2008 to 7.6 per cent in the September quarter. Recent indicators suggest economic growth in India may have slowed further in the past few months. While activity in the construction and services sectors appears to have remained relatively buoyant, growth in exports has fallen. As a result, growth in industrial production has also weakened.

In an effort to support economic growth, the Indian Government announced a fiscal stimulus package of 200 billion rupee (US\$4 billion) in December 2008, which includes additional government spending, cuts to export taxes, a reduction in value added tax and other measures to support medium and small enterprises. In January 2009, the government announced a second stimulus package, which aims to provide more capital support to the financial sector. In addition, the Reserve Bank of India reduced its benchmark interest rate from a high of 9 per cent in October 2008 to 5.5 per cent in January 2009.

Looking forward, lower global demand is likely to place downward pressure on India's export performance. However, recent stimulus measures are expected to support the domestic demand, particularly consumer spending. Consumer spending accounts for around 60 per cent of the Indian economy.

Against this backdrop, economic growth in India is assumed to average 5.5 per cent in 2009, before recovering to 7 per cent in 2010. As growth in private consumption and investment rebounds, the Indian economy is expected to expand at around 8.5 per cent in 2011, before easing to an annual rate of 8 per cent by 2014.

Pursuit of countercyclical policy measures, especially higher government spending, has highlighted an important issue faced by the Indian economy, that of sustained large fiscal deficits. Increasing fiscal deficits and public sector debt have the potential to adversely affect the government's ability to finance spending on infrastructure, education and basic services over the medium term. Inadequate physical infrastructure, particularly in the transport and electricity sectors, has been a major constraint on India's economic growth in recent years.

### *Japan*

Economic activity in Japan has weakened markedly since mid-2008, with real gross domestic product declining at an annualised rate of 12.7 per cent in the December quarter 2008, after contracting by 2.3 per cent in the September quarter and 3.6 per cent in the March quarter. Falling exports and business spending, together with declining private consumption, have been the main contributors to the economic contraction in Japan. For 2008 as a whole, Japan's economy contracted by 0.7 per cent.

Partial indicators released recently suggest that economic contraction in Japan continues. Exports, the main driver of the country's economic growth, have been declining rapidly, turning the country's trade surplus into a deficit in recent months. Industrial production has also fallen markedly as a result of weaker external demand.

Recent consumer and business surveys indicate a sharp weakening in sentiment. For example, the Bank of Japan's latest Tankan report suggests that business investment is being scaled back as a result of the weaker corporate profit outlook. Falling incomes and rising unemployment have also placed downward pressure on household spending.

Looking forward, sharply weaker world economic growth will continue dampening export performance. Domestic demand is likely to remain subdued as corporate profits deteriorate and unemployment rises. In December 2008, the Japanese Government announced its intention to introduce a 10 trillion yen (US\$111 billion) fiscal stimulus package to support domestic demand. In the same month, the Bank of Japan lowered its official interest rate to 0.1 per cent and introduced measures to inject liquidity into the economy.

Japan's economy is assumed to contract by 2.5 per cent in 2009, before a modest expansion of 0.6 per cent in 2010. Over the medium term, economic growth in Japan is expected to recover to an average rate of around 1.8 per cent a year.

One major challenge faced by the Japanese Government is to achieve balance between the short-term need for fiscal stimulus and the longer term requirement of fiscal consolidation. Japan has the largest fiscal deficit (as a share of gross domestic product) among the OECD economies, with public sector debt forecast to reach around 174 per cent of gross domestic product by the end of 2009, excluding any further fiscal stimulus packages that may be implemented.

In the presence of an aging and declining population, the outlook for economic growth in Japan over the medium to longer term will also depend on the progress of structural reforms, particularly in the non-traded sector. Higher productivity growth will be required for Japan to maintain sustained economic growth over the longer term.

### *Western Europe*

Reflecting the adverse effect of the global financial crisis, real gross domestic product in the euro area contracted by 1.5 per cent in the December quarter 2008, after falling by 0.2 per cent in both of the previous two quarters. Weaker exports, household consumption and business investment spending are likely to have been the main contributors to the economic contraction in recent months.

## Economic overview

Recent economic indicators suggest the contraction in the region is likely to continue. A progressive rise in unemployment is expected to further weaken private consumption expenditure, while investment is also likely to fall further. Reflecting slowing external demand, the export sector is unlikely to provide support to general economic activity in the coming months.

In an attempt to provide a boost to the economic growth, the European Central Bank reduced its benchmark interest rate from a peak of 5.25 per cent in July 2008 to 3 per cent in January 2009. In December 2008, the European Council endorsed the European Economic Recovery Plan, which includes a stimulus of 200 billion euro (around 1.5 per cent of gross domestic product in the euro area) to support regional economic activity.

Looking forward, economic growth in Western Europe is assumed to contract by 2 per cent in 2009. A gradual recovery in regional economic activity is assumed to begin in early 2010, with economic growth averaging 0.5 per cent in that year.

Given the current weakness in the European banking sector, there are significant downside risks surrounding the economic outlook for the region. Private consumption and business spending could remain weak for an extended period under tight lending conditions in the banking sector and credit markets. The global financial crisis has also exacerbated the housing market downturns in several regional economies, especially in Ireland, Spain, France and the United Kingdom.

Over the medium term, economic growth in Western Europe is assumed to strengthen to 2.3 per cent in 2011, before moderating gradually to an annual rate of 1.9 per cent by 2014. Regional economies face a number of structural challenges to achieve sustained economic growth over the medium to longer term. These challenges include the need to address the issues of an aging population, more effective regional economic integration and improving productivity growth, which has been lagging behind that in most other OECD economies.

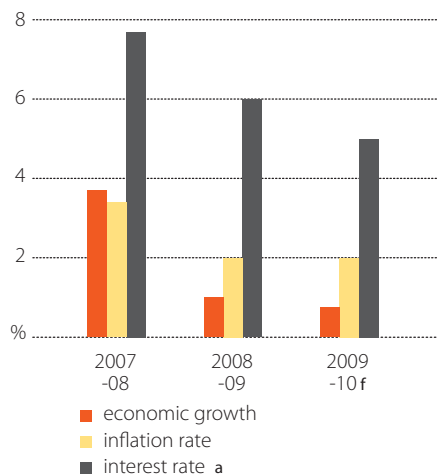
## Economic prospects in Australia

After a period of strong expansion, economic growth in Australia moderated in mid to late 2008. In seasonally adjusted terms, real gross domestic product increased by 0.1 per cent in the September quarter 2008, compared with growth of 0.4 per cent in the June quarter. Agriculture, forestry and fishing contributed 0.3 percentage points to economic growth in the September quarter 2008, while real gross domestic product in the non-farm sector contracted by 0.2 per cent.

The economic slowdown in the non-farm sector was largely driven by weaker household consumption. While private business investment made a positive contribution to economic growth in the September quarter 2008, its growth rate slowed compared with the previous two quarters.

Looking forward, economic activity in Australia is likely to weaken in the coming quarters. Sharply lower global demand appears to have dampened business confidence, with potentially adverse implications for capital investment plans. An expected softening in labour

Australian economic indicators



a Large business weighted average variable rate on credit outstanding.

market conditions could also lead to weaker growth in consumer spending.

In early February 2009, the Australian Government announced a \$42 billion Nation Building and Jobs Plan which aims to strengthen growth and employment in the economy. The plan complements the government's \$10.4 billion Economic Security Strategy, which was introduced in October 2008.

The plan is expected to deliver a fiscal stimulus package of around 2 per cent of Australia's gross domestic product in 2009. Over the next two years, the plan is expected to help support and sustain up to 90 000 jobs. The economic effect of the plan is that gross domestic product growth is expected to be around 0.5 per cent higher in 2008-09 and around 0.75 per cent to 1 per cent higher in 2009-10 than it otherwise would have been.

To provide further support to domestic demand, the Reserve Bank of Australia lowered the official interest rate to 3.25 per cent in early February 2009, a 400 percentage point reduction since September 2008. The substantial fiscal and monetary policy responses are likely to offset, at least partially, the adverse effect of the global downturn on the Australian economy.

Economic growth in Australia is assumed to average around 1 per cent in 2008-09 and 0.75 per cent in 2009-10. Over the medium term, the Australian economy is assumed to grow at a rate of around 3 per cent a year. The assumptions about economic activity and inflation in Australia do not incorporate any effects from the Australian Government's Carbon Pollution Reduction Scheme.

Key macroeconomic assumptions for Australia

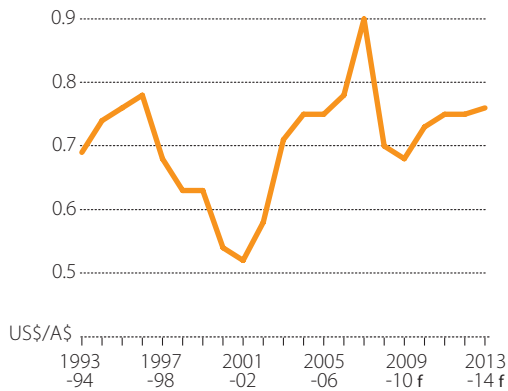
	unit	2006-07	2007-08	2008-09 a	2009-10 a	2010-11 a	2011-12 a	2012-13 a	2013-14 a
Economic growth b	%	3.2	3.7	1.0	0.8	3.0	3.0	3.0	3.0
Inflation b	%	2.9	3.4	2.0	2.0	2.5	2.5	2.5	2.5
Interest rates c	%pa	6.9	7.7	6.0	5.0	6.0	6.5	6.5	6.5
Nominal exchange rates d									
- US\$/A\$	US\$	0.78	0.90	0.70	0.68	0.73	0.75	0.75	0.76
Trade weighted index for A\$ e	index	65.0	70.0	56.0	55.0	58.0	60.0	61.0	61.0

a ABARE assumption. b Change from previous period. c Large business weighted average variable rate on credit outstanding. d Average of daily rates. e Base: May 1970 = 100.

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

## Economic overview

### US–Australian exchange rate



### Inflation

Inflationary pressures in Australia moderated in late 2008. The consumer price index rose year-on-year by 3.7 per cent in the December quarter 2008, after an increase of 5 per cent in the September quarter 2008. Contributing most to the slower inflation rate in the December quarter were automotive fuel (–18.2 per cent), motor vehicles (–2.4 per cent), deposit and loan facilities (–1.9 per cent) and pharmaceuticals (–4.7 per cent).

Other price indexes released recently suggest that inflationary pressures are likely to ease further in the short term. For example, the producer price index for final commodities increased by 1.3 per cent in the December quarter 2008, compared with a rise of 2 per cent in the September quarter. While the domestic component declined by 0.5 per cent, there was an increase of 14.8 per cent in the import component. Compared with the same quarter a year earlier, the producer price index increased by 6.4 per cent in the December quarter 2008.

Australia's inflation rate is assumed to average 2 per cent in both 2008-09 and 2009-10. Toward 2013-14, annual inflation in Australia is assumed to average around 2.5 per cent.

### Australian exchange rate

The Australian dollar has depreciated significantly both against the US dollar and on a trade weighted basis since the onset of the global financial crisis in the second half of 2008. The Australian dollar was trading around US65c and TWI 54 in mid-February 2009. This compares with a high of around US98c and TWI 74 in mid-July 2008. In the first eight months of 2008-09, the Australian dollar averaged around US76c and TWI 61.

Concerns about the adverse effect of sharply weaker world economic growth on commodity demand and prices have been a key factor contributing to the depreciation of the Australian dollar.

Movements in the Australian exchange rate have also been significantly influenced by changes in financial market sentiment, leading to volatility in the value of the Australian dollar. For example, the recent significant decline in the Australian dollar reflects a marked change in the financial market sentiment toward treating the US dollar as a safe haven. Despite the sharply weaker economic outlook for the United States, the US dollar has risen against most other major international currencies. The US dollar was trading around 0.79 euro and 0.70 pound sterling in mid-February 2009, compared with 0.63 euro and 0.50 pound sterling in mid-July 2008. Against the Japanese yen, the US dollar was trading around ¥92 in mid-February 2009, compared with ¥105 in mid-July 2008.

Looking forward, the Australian dollar is expected to remain relatively weak in the short term. In preparing this set of commodity forecasts, the Australian dollar is assumed to average US70c and TWI 56 in 2008-09 and US68c and TWI 55 in 2009-10. This compares with an average of US90c and TWI 70 in 2007-08.

A lower Australian dollar, if sustained, will provide some support for Australian export earnings, although it can also place upward pressure on the cost of imports. Given considerable uncertainty surrounding the short-term outlook for the Australian dollar, it will be important for primary producers and exporters to manage the risks associated with fluctuations in the Australian exchange rate.

Over the medium term, the Australian exchange rate is assumed to appreciate gradually. From an historical perspective, the value of the Australian dollar has been associated with changes in Australia's terms of trade and hence movements in commodity prices on world markets.

Under the assumption that world economic growth, and hence world commodity demand, recovers to levels that are more consistent with its longer term potential by 2011 and beyond, the value of the Australian dollar is assumed to increase to an average of US73c and TWI 58 in 2010-11. Toward the end of the outlook period, the Australian dollar is assumed to appreciate further both against the US dollar and on a trade weighted basis. By 2013-14, the Australian dollar is assumed to average around US76c and TWI 61.

## Outlook for Australia's commodity sector

### Commodity export prices

The index of unit export returns for Australian commodities, in aggregate, is forecast to fall by nearly 23 per cent in 2009-10, following an estimated rise of 33 per cent in 2008-09. While world prices for many commodities are forecast to decline, an assumed depreciation of the Australian dollar is expected to provide some support for export prices in Australian dollar terms.

### Australia's commodity sector unit export returns outlook

	unit	2006 -07	2007 -08	2008 -09 s	2009 -10 f	2010 -11 f	2011 -12 f	2012 -13 f	2013 -14 f
Farm	index	87.9	97.3	100.0	95.2	94.5	94.3	94.7	95.8
- real	index	92.7	99.3	100.0	93.4	90.4	88.0	86.2	85.1
Mineral resources	index	68.2	71.8	100.0	74.3	71.5	72.7	73.8	75.5
- real	index	71.9	73.3	100.0	72.9	68.5	67.8	67.3	67.1
Energy minerals	index	53.2	60.6	100.0	65.3	64.6	67.8	73.3	77.1
- real	index	56.1	61.8	100.0	64.1	61.8	63.3	66.7	68.5
Metals and other minerals	index	82.9	82.9	100.0	83.0	78.2	77.4	74.7	74.4
- real	index	87.4	84.6	100.0	81.4	74.9	72.3	68.0	66.1
<b>Total commodities</b>	index	70.9	75.3	100.0	77.5	75.0	75.9	77.0	78.6
- real	index	74.8	76.8	100.0	76.0	71.7	70.9	70.1	69.8

a Base: 2008-09 = 100. s ABARE estimate. f ABARE forecast.

Sources: Australian Bureau of Statistics; ABARE.

## Commodity outlook

For farm commodities, the index of unit export returns is forecast to decline by 5 per cent in 2009-10, after rising by around 3 per cent in 2008-09.

Unit export returns for Australian mineral and energy commodities are forecast to fall by around 26 per cent in 2009-10, following an estimated rise of 39 per cent in 2008-09. Unit returns for energy exports are forecast to decline by 35 per cent in 2009-10, compared with an increase of more than 65 per cent in 2008-09. Unit export returns for metals and other minerals are forecast to decrease by 17 per cent in 2009-10, after rising by around 21 per cent in 2008-09.

Unit returns for Australian commodity exports are projected to ease in real terms over the remainder of the outlook period. Largely reflecting expected lower export prices for mineral and energy commodities (in 2008-09 dollars), the index of unit export returns in real terms in 2013-14 is projected to be around 30 per cent below its estimated value in 2008-09.

### *Commodity export earnings*

The value of Australian commodity exports is forecast to be around \$162 billion in 2009-10, a fall of 17 per cent from an estimated \$196 billion in 2008-09. After declining to around \$159 billion in 2009-10 in real terms, the value of Australian commodity exports is projected to gradually rise over the remainder of the outlook period to 2013-14. Although Australian commodity exports are projected to increase to around \$175 billion in 2013-14 (in 2008-09 dollars), this is still 10 per cent lower than their estimated value in 2008-09. By 2013-14, Australian commodity exports are projected to be worth around \$175 billion (in 2008-09 dollars), 10 per cent lower than their estimated value in 2008-09.

Under the assumption of favourable seasonal conditions, export earnings for farm commodities are forecast to be around \$32.1 billion in 2009-10, a rise of 4 per cent from an estimated \$30.8 billion in 2008-09. Agricultural commodities for which export earnings are forecast to be higher in 2009-10 include wheat, barley, canola, lupins, peas, rice, raw cotton, sugar and lamb. For forest and fisheries products, export earnings are forecast to be around \$4 billion in 2009-10, an increase of 5 per cent from their estimated value in 2008-09.

Over the medium term, the value of Australian farm exports is expected to rise in real terms. Australian farm exports are projected to be worth close to \$34 billion (in 2008-09 dollars) in 2013-14, around 9 per cent higher than their estimated value in 2008-09.

Export earnings for Australian mineral and energy commodities are forecast to be around \$126 billion in 2009-10, compared with an estimated \$161 billion in 2008-09. For energy commodities, export earnings are forecast to fall by around 34 per cent to \$51 billion in 2009-10, largely driven by sharply lower forecast prices for oil and coal. For metals and other minerals, export earnings are forecast to decline by 11 per cent to \$75 billion in 2009-10. Despite a forecast rise in export volumes, an expected significant fall in prices for Australian iron ore is projected to account for the majority of this decline.

Under the assumption that world economic growth, and hence world commodity demand, recovers to levels that are more consistent with its longer term potential by 2010-11 and beyond, export earnings for Australian mineral and energy commodities (in 2008-09 dollars)

are projected to rise gradually over the remainder of the outlook period. By 2013-14, mineral and energy commodity exports are projected to be around \$138 billion, 15 per cent lower than their exceptionally high value estimated for 2008-09. For metals and other minerals, export earnings in 2013-14 are projected to be around \$73 billion, while export earnings for energy commodities in 2013-14 are projected to be worth \$64 billion.

### Medium-term outlook for Australia's commodity sector

	unit	2006 -07	2007 -08	2008 -09 s	2009 -10 f	2010 -11 f	2011 -12 f	2012 -13 f	2013 -14 f
<b>Commodity exports</b>									
Exchange rate	US\$/A\$	0.78	0.90	0.70	0.68	0.73	0.75	0.75	0.76
<b>Value of exports</b>									
Farm	A\$m	27 782	27 538	30 758	32 113	33 594	34 827	36 209	37 826
- real a	A\$m	29 303	28 091	30 758	31 503	32 152	32 520	32 985	33 618
Crops	A\$m	12 968	13 035	15 787	17 905	19 230	20 000	20 858	21 947
- real a	A\$m	13 678	13 297	15 787	17 565	18 405	18 675	19 001	19 505
Livestock	A\$m	14 815	14 503	14 971	14 208	14 364	14 827	15 351	15 879
- real a	A\$m	15 626	14 795	14 971	13 938	13 748	13 845	13 984	14 113
Forest and fisheries products	A\$m	3 849	3 813	3 858	4 040	3 999	4 077	4 333	4 512
- real a	A\$m	4 060	3 890	3 858	3 964	3 827	3 807	3 947	4 010
Mineral resources	A\$m	105 653	116 238	161 090	125 574	128 644	138 666	144 681	154 920
- real a	A\$m	111 437	118 575	161 090	123 190	123 124	129 479	131 801	137 686
Energy minerals	A\$m	39 427	45 591	77 262	50 847	53 408	59 664	65 482	72 316
- real a	A\$m	41 585	46 508	77 262	49 882	51 116	55 711	59 653	64 271
Metals and other minerals	A\$m	66 226	70 647	83 827	74 726	75 237	79 002	79 199	82 604
- real a	A\$m	69 851	72 067	83 827	73 308	72 008	73 768	72 148	73 415
Total commodities	A\$m	137 284	147 589	195 705	161 727	166 237	177 570	185 224	197 258
- real a	A\$m	144 800	150 556	195 705	158 657	159 104	165 806	168 733	175 314
<b>Farm sector</b>									
Farmers' terms of trade a	index	103.6	102.8	100.0	101.4	97.1	95.3	94.0	93.1
Gross value of farm prodn b	A\$m	36 248	43 595	44 939	45 147	45 607	46 894	48 522	49 991
- real a	A\$m	38 232	44 471	44 939	44 290	43 650	43 787	44 203	44 430
Crops	A\$m	17 995	23 678	25 154	25 941	26 459	27 052	27 921	28 755
- real a	A\$m	18 980	24 154	25 154	25 448	25 323	25 259	25 435	25 556
Livestock	A\$m	18 253	19 916	19 784	19 206	19 148	19 843	20 601	21 236
- real a	A\$m	19 252	20 317	19 784	18 841	18 326	18 528	18 767	18 874
Net value of farm production	A\$m	4 835	6 635	8 995	9 971	8 174	7 373	7 240	7 190
- real a	A\$m	5 099	6 769	8 995	9 782	7 824	6 884	6 595	6 390
Volume of farm production a	index	85.7	93.0	100.0	100.8	103.1	104.6	106.5	108.1
- crops	index	70.7	86.1	100.0	101.8	105.5	107.0	109.0	110.7
- livestock	index	104.6	101.3	100.0	99.6	100.2	101.6	103.5	105.1
<b>Minerals and energy sector</b>									
Volume of mine production a	index	99.8	99.2	100.0	103.0	108.3	113.0	115.2	119.7
- energy	index	97.4	95.7	100.0	100.1	105.1	109.8	111.2	115.3
- metals and other minerals	index	102.8	103.1	100.0	106.7	112.4	117.2	120.2	125.2
Gross value of mine prodn	A\$m	101 427	111 589	154 646	120 551	123 498	133 119	138 894	148 723
- real a	A\$m	106 979	113 832	154 646	118 262	118 199	124 300	126 529	132 178

a In 2008-09 Australian dollars. b For a definition of the gross value of farm production see table 21. s ABARE estimate. f ABARE forecast.

Note: ABARE revised the method for calculating farm price and production indexes in October 1999. The indexes for the different groups of commodities are calculated on a chained weight basis using Fishers' ideal index with a reference year of 1997-98 = 100.

Sources: Australian Bureau of Statistics; ABARE.

# Commodity outlook

## Major Australian commodity exports

World prices are in US\$ for all commodities except wool, beef, veal and wine, which are in \$A

