

# STATEMENT 3: ECONOMIC OUTLOOK

This statement presents the economic forecasts that underlie the budget estimates.

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## STATEMENT 3: ECONOMIC OUTLOOK

The stronger world economy will provide a renewed source of growth for domestic economic activity in 2004-05, leaving Australia well-placed to build on the current economic expansion. Solid economic growth is forecast for 2004-05, with higher export growth largely offsetting lower growth in domestic demand (as measured by gross national expenditure). Employment growth is forecast to remain solid, holding the unemployment rate near 23-year lows, while inflation is forecast to fall to below the bottom of the 2 to 3 per cent target band reflecting moderate growth in labour costs and the higher exchange rate.

### OVERVIEW

In 2003-04, **economic growth** in Australia is forecast to be  $3\frac{3}{4}$  per cent, unchanged from the forecasts presented in the *Mid-Year Economic and Fiscal Outlook 2003-04*. Gross national expenditure (GNE) is forecast to grow by 6 per cent for a second consecutive year, with household consumption being boosted by increasing wealth from higher house prices and investment growth driven by increasing construction activity in both the residential and non-residential sectors. Farm production is forecast to grow strongly in 2003-04, contributing  $\frac{1}{2}$  of a percentage point to gross domestic product (GDP) growth. Strong consumption growth helped the economy to ride out the challenges presented by the severe drought, a patchy world economy, Severe Acute Respiratory Syndrome (SARS) and continuing international security concerns, which saw net exports make a large detraction from GDP growth in 2003-04.

In 2004-05, economic growth is forecast to be  $3\frac{1}{2}$  per cent, with growth in GNE easing to a more sustainable  $3\frac{3}{4}$  per cent, partly offset by a smaller detraction from net exports. Employment is forecast to grow by  $1\frac{3}{4}$  per cent in 2004-05, which should be sufficient to maintain the unemployment rate at around  $5\frac{3}{4}$  per cent. Inflation is forecast to decline to around  $1\frac{3}{4}$  per cent through the year to the June quarter 2005, influenced by low prices for imported consumables and moderate labour cost pressures. The current account deficit is expected to narrow to 5 per cent of GDP in 2004-05, primarily reflecting an improvement in Australia's terms of trade.

Growth in all of the major components of GNE is forecast to slow in 2004-05. A decline in the construction of medium-density buildings is forecast to contribute to a contraction in dwelling investment activity. Construction of detached housing is also forecast to fall in 2004-05, while investment in alterations and additions is forecast to grow by less than in 2003-04. Growth in household consumption and business investment is forecast to ease towards trend rates in 2004-05, following very strong growth in recent years.

Net exports are forecast to detract  $\frac{1}{2}$  of a percentage point from economic growth in 2004-05, as imports continue to grow a little more quickly than exports in response to

the still solid levels of domestic spending. Nevertheless, and despite the appreciation of the currency over the past two years, 2004-05 should see a significant improvement in export growth compared with the previous two years. The stronger world economy will provide support for exports of non-rural commodities, manufactures and services. The large grain harvest in 2003-04 has contributed to a build up of farm stocks, which will provide continuing support to rural exports into 2004-05, although the prospect of continuing dry conditions in parts of rural Australia is a risk to the outlook for activity in aggregate.

The recovery in the **world economy** has strengthened significantly since last year's Budget. World growth was strong in the second half of calendar 2003, supported by expansionary monetary and fiscal policy. The durability of the world economic recovery has been aided by the broadening of growth, with strong growth in the United States (US) and East Asia, a firming recovery in Japan and modest growth in Europe.

World economic growth is expected to be brisk throughout 2004, resulting in above trend growth for the year as a whole. Monetary and fiscal policy will likely remain broadly expansionary across a wide group of economies. Despite higher oil and commodity prices, world inflationary pressures are generally low.

In the domestic economy, the very strong growth in **household consumption** expenditure over the past year was supported by robust growth in real after-tax incomes, rapid increases in wealth, and continuing high consumer confidence. These factors, in addition to the Government's Budget initiatives, will continue to support consumption growth in the near term. However, an assumed slower pace of wealth accumulation flowing from a flattening in dwelling prices and slightly lower employment growth are expected to see consumption growth moderate to around 4¼ per cent in 2004-05.

After three years of strong growth, **dwelling investment** is forecast to fall by 3 per cent in 2004-05, with the slowing in activity expected to begin around mid-2004. While the dwelling sector has maintained momentum through 2003-04, the long-anticipated slowdown has begun in some markets, although its extent remains uncertain. Oversupply is most pronounced in pockets of the medium-density sector, particularly for apartments near major city centres. Falls in prices are widely expected and lower construction activity is forecast in this component of the housing sector through 2004-05 and beyond. A more modest downturn is forecast for detached housing, reflecting the relatively more robust conditions in that sector. Partly offsetting the declines in new building activity, renovation work is forecast to continue to grow, but at a slower pace than in recent years.

Growth in **business investment** has been exceptionally strong in recent years, despite the uncertain world environment, but is expected to slow toward trend rates in 2004-05. Business investment conditions remain favourable, with strong profit growth in sectors exposed to the domestic economy, low interest rates, and corporate balance

sheets in a generally sound position. Business surveys point to high levels of both business confidence and capacity utilisation.

In line with these positive fundamentals, and supported by lower prices for imported capital goods, new machinery and equipment investment is forecast to grow by 8 per cent in 2004-05. New non-dwelling construction is forecast to grow by 6 per cent in 2004-05 after very strong growth over the past two years. The lower growth forecasts reflect increasing commercial vacancy rates and a slowing in commencements of major new infrastructure projects. However, construction activity is forecast to remain at very high levels as a share of GDP as work on existing projects continues.

While private final demand growth is expected to ease from 6½ per cent in 2003-04 to 4 per cent in 2004-05, growth in **public final demand** is expected to increase from 2¾ per cent to 3½ per cent. Over the past two years, public finances have been supported by strong economic growth, while State government revenues have benefited particularly from activity in the housing market. Economic growth will continue to support the forecast increase in public demand through 2004-05.

**Export** growth is expected to increase to 8 per cent in 2004-05, reflecting improved conditions in the rural sector and the more positive outlook for the world economy. Increased production capacity in Australia for non-rural commodities is also expected to boost export growth, but the appreciation of the Australian dollar over the past two years will remain a constraint on export growth more generally. **Import** growth is forecast to moderate to 9 per cent in 2004-05, in line with the expected easing in GNE growth. Taken together, the trade forecasts imply that the external sector will detract ½ of a percentage point from economic growth in 2004-05, a significantly smaller deduction than was recorded over the past two years.

The **terms of trade** are forecast to increase strongly in 2004-05, driven by increased prices for a number of Australia's non-rural commodity exports, and further declines in many import prices, particularly for information and communication technology (ICT) goods. This improvement in the terms of trade underpins a forecast narrowing of the current account deficit to 5 per cent of GDP in 2004-05.

**Employment** growth is forecast to ease slightly to 1½ per cent through the year to the June quarter 2005, reflecting the slight moderation in forecast economic growth for 2004-05. Employment growth at this rate would be sufficient to hold the unemployment rate near 23-year lows of around 5¾ per cent through 2004-05.

The **inflation** outlook remains benign, underpinned by moderate growth in labour costs and the substantial appreciation of the Australian dollar over the past two years. Inflation is forecast to gradually decline to around 1¾ per cent through the year to June 2005, as the effect of the drought on food prices diminishes, the rate of increase in project home prices moderates and the lagged effects of the exchange rate appreciation continued to feed through to retail prices. In addition, tradables prices will benefit

from tariff reductions on motor vehicles and textiles, clothing and footwear from 1 January 2005.

The key **risk** to the economic outlook relates to developments in the housing sector, particularly the future path of house prices and the associated wealth effects on consumption. Dwelling investment is forecast to moderate over 2004-05 and the rate of increase in nominal house prices is expected to flatten in aggregate, with some market segments seeing price falls. The assumed slowing in house price growth is forecast to lead to a slowing in household wealth accumulation and consumption growth. However, there is a risk of a more widespread fall in house prices that, if realised, would amplify the slowing in wealth and consumption growth, and have broader implications for aggregate economic activity.

Medium-density apartments, particularly in areas near major city centres, have clearly seen significant over-building in recent years, public warnings of the dangers notwithstanding. A more dramatic fall in prices – even if contained to particular market segments or geographic areas – would introduce additional risk to the outlook.

That said, the dwelling sector has consistently surprised on the upside, and a further boost to aggregate activity from dwelling construction cannot be ruled out.

Increasing levels of household debt also present a potential risk. Household debt-to-income ratios have increased over the past decade, partly in response to low interest rates, moderate rates of inflation and financial market innovation. While there is no evidence that current levels of debt are proving onerous for households in aggregate, higher levels of debt have increased the vulnerability of households to adverse shocks, particularly shocks that might be associated with a deterioration in labour market conditions.

The forecasts are predicated on an assumption that average seasonal conditions will prevail in 2004-05. A continuation of very dry conditions in the south-east, or lower than average seasonal rainfall across broader areas of Australia over the coming year, presents a risk to the prospects for a full recovery in the farm sector and poses a downside risk to the forecasts for farm production and exports in 2004-05.

The risk to the domestic outlook from developments in the world economy appears to have abated significantly since the 2003-04 Budget, with strong growth in the US and East Asia, a firming recovery in Japan and modest growth in Europe. Uncertainties remain, however, about the evolution of the world economic recovery. The recovery has surprised with its strength, suggesting some upside risk to world growth, although questions remain about the unwinding of imbalances in saving and investment flows, and the impact of high and volatile oil prices.

**Table 1: Domestic economy forecasts<sup>(a)</sup>**

|   | Outcomes(b)                | Estimates                  | Forecasts                  |                                  |
|---|----------------------------|----------------------------|----------------------------|----------------------------------|
|   | 2002-03<br>year<br>average | 2003-04<br>year<br>average | 2004-05<br>year<br>average | Four<br>quarters to<br>June 2005 |
| <b>Panel A - Demand and output(c)</b>             |                            |                            |                            |                                  |
| Household consumption                             | 4.1                        | 5 1/2                      | 4 1/4                      | 4                                |
| Private investment                                |                            |                            |                            |                                  |
| Dwellings   | 15.5                       | 6                          | -3                         | -5                               |
| Total business investment(d)                      | 16.8                       | 11                         | 7                          | 5                                |
| Non-dwelling construction(d)                      | 31.9                       | 16                         | 6                          | -1                               |
| Machinery and equipment(d)                        | 16.4                       | 10                         | 8                          | 8                                |
| Intangible fixed assets                           | 5.7                        | 4                          | 7                          | 8                                |
| Private final demand(d)                           | 6.7                        | 6 1/2                      | 4                          | 3 1/4                            |
| Public final demand(d)                            | 4.3                        | 2 3/4                      | 3 1/2                      | 3 3/4                            |
| Total final demand                                | 6.2                        | 5 3/4                      | 4                          | 3 1/2                            |
| Change in inventories(e)                          |                            |                            |                            |                                  |
| Private non-farm                                  | 0.1                        | - 1/4                      | 0                          | 0                                |
| Farm and public authorities(f)                    | -0.1                       | 1/2                        | - 1/4                      | 1/4                              |
| Gross national expenditure                        | 6.2                        | 6                          | 3 3/4                      | 3 1/2                            |
| Exports of goods and services                     | -0.5                       | 2                          | 8                          | 6                                |
| Imports of goods and services                     | 13.5                       | 12                         | 9                          | 7                                |
| Net exports(e)                                    | -3.0                       | -2 1/4                     | - 1/2                      | - 1/2                            |
| Gross domestic product                            | 2.9                        | 3 3/4                      | 3 1/2                      | 3 1/4                            |
| Non-farm product                                  | 4.0                        | 3 1/4                      | 3 1/2                      | 3 1/4                            |
| Farm product                                      | -24.8                      | 20                         | 4                          | 2                                |
| <b>Panel B - Other selected economic measures</b> |                            |                            |                            |                                  |
| External accounts                                 |                            |                            |                            |                                  |
| Terms of trade                                    | 2.1                        | 6 1/2                      | 4 1/2                      | 2 3/4                            |
| Current account balance                           |                            |                            |                            |                                  |
| \$billion   | -41.4                      | -46                        | -43 1/2                    |                                  |
| Percentage of GDP                                 | -5.5                       | -5 3/4                     | -5                         |                                  |
| Labour market                                     |                            |                            |                            |                                  |
| Employment (labour force survey basis)            | 2.5                        | 1 3/4                      | 1 3/4                      | 1 1/2                            |
| Unemployment rate (per cent)(g)                   | 6.2                        | 5 3/4                      | 5 3/4                      | 5 3/4                            |
| Participation rate (per cent)(g)                  | 63.7                       | 63 1/2                     | 63 1/2                     | 63 1/2                           |
| Prices and wages                                  |                            |                            |                            |                                  |
| Consumer Price Index                              | 3.1                        | 2 1/4                      | 2                          | 1 3/4                            |
| Gross non-farm product deflator                   | 2.6                        | 4                          | 2 1/2                      | 1 3/4                            |
| Wage Cost Index                                   | 3.5                        | 3 3/4                      | 3 3/4                      | 3 3/4                            |

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

(b) Calculated using original data.

(c) Chain volume measures.

(d) Excluding transfers of second-hand assets from the public sector to the private sector.

(e) Percentage point contribution to growth in GDP.

(f) For presentational purposes, forecast changes in inventories held by privatised marketing authorities are included with the inventories of the farm sector and public marketing authorities.

(g) The estimate in the final column is the forecast rate in the June quarter 2005.

Source: Australian Bureau of Statistics (ABS) Cat. No. 5206.0, 5302.0, 6202.0, 6345.0, 6401.0, unpublished ABS data and Treasury.

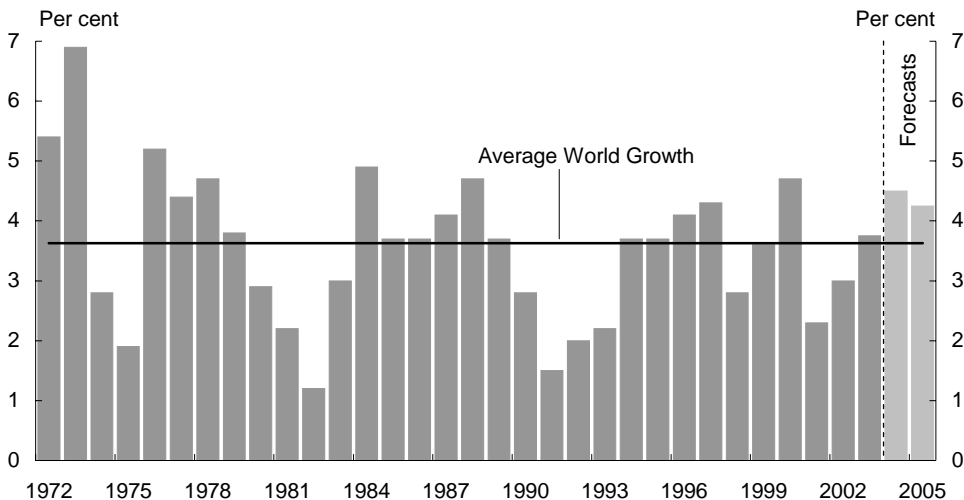
## THE OUTLOOK FOR THE INTERNATIONAL ECONOMY

The world economy grew strongly in the second half of 2003, supported by expansionary monetary and fiscal policies. The durability of the economic recovery has been aided by the broadening of growth, with strong growth in the US and East Asia, a firming recovery in Japan, and modest growth in Europe.

World economic growth is expected to be brisk throughout 2004, resulting in above trend growth for the year as a whole. Monetary and fiscal policies are likely to remain broadly expansionary across a wide group of economies. As the world recovery proceeds, policy stimulus is likely to be reduced with economic growth expected to ease accordingly in 2005. Despite a rise in oil and commodity prices, inflationary pressures are generally low reflecting continued excess capacity, with competitive pricing in domestic and world markets.

The world economy grew by 3.9 per cent in 2003 in year-average terms. World GDP is expected to grow by 4½ per cent in 2004, easing to 4¼ per cent in 2005. Growth in Australia's major trading partners is expected to be 4¾ per cent in 2004, before easing back to 4 per cent in 2005.

**Chart 1: World GDP growth<sup>(a)</sup>**



(a) World GDP growth rates are calculated using GDP weights based on purchasing power parity. Source: National statistical publications, International Monetary Fund (IMF) and Treasury.

The risks around the near-term outlook are balanced. An upside risk to the outlook is that the momentum building across large parts of the world economy could generate a more vigorous recovery than is currently envisaged. There were a number of upside surprises to growth over the latter half of 2003 and it could be the case that analysts have been slow to adjust their expectations as the world economy has recovered.

Further, there is a substantial amount of policy stimulus in the pipeline that has the potential to stimulate growth more than anticipated.

Weighing against upside risks are downside risks emanating from geopolitical tensions, current account and fiscal imbalances, and high and volatile oil prices. Recent increases in oil prices reflect strong demand, particularly from China and the rest of East Asia. Increases in oil prices also reflect geopolitical tensions in the Middle East, a desire by the Organization of the Petroleum Exporting Countries (OPEC) to cut production, oil supply disruptions in Venezuela, and low private sector oil stocks, particularly in the US. For some countries, such as those in the euro area, the rise in oil prices has been offset by currency appreciation against the US dollar. However, high oil prices still pose a risk to world growth, with the current drivers of world demand, the US and East Asia, being the regions most negatively affected by higher US dollar oil prices.

The path of adjustment of current account and fiscal imbalances is a key risk to the medium-term outlook. Policy settings in the US and parts of East Asia are highly expansionary and unbalanced world growth has led to large global imbalances. The orderly depreciation of the US dollar and strengthening of domestic demand in East Asia should assist in partly correcting external imbalances. However, this partial adjustment needs to be set against the strong likelihood of imbalances persisting, with ongoing weakness in the euro area and structural impediments to growth in both the euro area and Japan. While the near-term risk of a disorderly adjustment process may have diminished somewhat, risks remain with the possibility of a sharp adjustment to the US dollar and US interest rates if foreign official capital inflows into the US were to be reduced. That said, it is likely that major Asian central banks have provided short-term support to global activity through their purchase of US Government bonds as part of their exchange rate management policies, though there are medium-term costs to these policies that will need to be addressed.

As the world recovery proceeds, interest rates around the world will rise from historical lows as monetary policy becomes less stimulatory. There is also the likelihood that unsustainable fiscal positions will contribute to an increase in global interest rates. Such a scenario would affect not only those countries in which fiscal positions need to be addressed, such as the US, but also emerging market and developing countries. This latter group is at risk of experiencing higher levels of interest rates, and higher spreads against US interest rates, as the recent reduction in risk premia are re-evaluated. An increase in global interest rates could have a large impact on the balance sheets of both the public and private sectors in emerging market and developing countries.

Lack of progress on multilateral trade negotiations and the recent increase in protectionist sentiment in some countries and regions also present a risk to longer-term growth prospects through constraints to increased trade and economic integration. Improving economic conditions, with favourable implications for labour markets in industrialised countries, may act as a countervailing influence. However,

the potential for world and domestic imbalances to exacerbate concerns is likely to persist.

**Table 2: International GDP growth forecasts<sup>(a)(b)</sup>**

|                        | 2000   | 2001   | 2002   | 2003   | 2004     | 2005     |
|------------------------|--------|--------|--------|--------|----------|----------|
|                        | Actual | Actual | Actual | Actual | Forecast | Forecast |
| World                  | 4.7    | 2.4    | 3.0    | 3.9    | 4 1/2    | 4 1/4    |
| Total OECD             | 3.9    | 1.0    | 1.7    | 2.2    | 3 1/2    | 3        |
| United States          | 3.7    | 0.5    | 2.2    | 3.1    | 4 3/4    | 3 3/4    |
| Japan                  | 2.8    | 0.4    | -0.3   | 2.7    | 3        | 2        |
| Euro area              | 3.5    | 1.6    | 0.9    | 0.4    | 1 3/4    | 2 1/4    |
| Major Trading Partners | 5.3    | 1.6    | 2.9    | 3.4    | 4 3/4    | 4        |
| Non-Japan East Asia(c) | 7.8    | 2.2    | 5.0    | 4.3    | 6 3/4    | 5 1/2    |

(a) Percentage change on previous year.

(b) Growth rates for world and the euro area are calculated using GDP weights based on purchasing power parity, while growth rates for major trading partners and non-Japan East Asia are calculated using export trade weights.

(c) Non-Japan East Asia comprises Korea, Singapore, Taiwan, Hong Kong, China, Indonesia, Malaysia, Thailand and the Philippines.

Source: National statistical publications, IMF and Treasury.

The US economy grew strongly over the second half of 2003 and into 2004. Growth broadened to include a strengthening recovery in business investment and exports, with continued support from consumption. The rebound in business investment over the second half of 2003 was predominantly driven by investment in equipment and software, especially ICT goods. Consumption, particularly of durable goods, was supported by strong growth in disposable incomes, wealth, and a high level of mortgage refinancing triggered by low interest rates. Disposable incomes were boosted by tax rebates, while increases in wealth reflected rising house prices and stronger stock markets.

The near-term outlook for the US economy is for continued strong growth, although not at the rapid pace of late 2003. Investment is expected to be the key driver of growth with productivity, profitability and business confidence all remaining strong. The low cost of capital and the need to replace existing capital equipment should provide further support to investment over 2004. Until recently there were concerns about weak employment growth. These concerns have been reduced somewhat with the release of recent data, which showed a strong rise in employment in the first quarter of 2004.

Despite recent increases in oil and commodity prices, US inflation remains low owing to continued excess capacity in the labour market, strong domestic competitive pressures and little imported inflation. As the recovery continues, monetary policy settings are likely to become less accommodative, as is already reflected in market interest rates. Reflecting these policy settings, US economic growth is expected to remain strong in 2005, but ease gradually as monetary and fiscal stimuli are reduced.

The US current account deficit remains around record high levels, while the size and likely persistence of the fiscal deficit continues to raise concerns about the medium-term outlook for US and world growth. The depreciation of the US dollar will assist in reducing the current account deficit, but in the near term the US current account will likely remain financed by foreign official capital inflows, which heightens US and global vulnerability to shocks and policy changes. A significant strengthening of domestic demand in the rest of the world, combined with a rebalancing of saving and investment within the US, is required before imbalances are likely to be substantially reduced.

The Japanese economy improved markedly over 2003, growing more strongly than expected in the second half of the year. Although concerns about the quality of national accounts data persist, GDP is estimated to have grown by 2.7 per cent in 2003. Growth was driven primarily by exports and business investment, which in turn were driven by external demand and healthier corporate balance sheets. Importantly for the sustainability of the recovery in Japan, consumption also began to contribute to growth.

The 'quantitative easing' monetary policy strategy adopted by the Bank of Japan appears to be having an impact with deflation and deflation expectations easing somewhat. Together with an increase in both consumer and business confidence and growth in disposable incomes, there are positive signs that domestic demand will strengthen in 2004. Improved corporate sector profitability and stronger share prices should support business investment.

Despite the more positive outlook for the Japanese economy, there remain significant structural weaknesses that continue to hamper economic growth. Partly reflecting these concerns and the likely impact of the appreciation of the yen, economic growth is expected to slow in 2005. Looking beyond this, Japan faces significant demographic challenges from a rapidly ageing population. The pressure this will place on the fiscal position is exacerbated by the high levels of government debt. With the Japanese workforce declining, GDP growth will need to come from productivity growth, underlining the urgency of action needed to address structural impediments to growth.

Economies in non-Japan East Asia grew strongly in the second half of 2003. The impact of the SARS epidemic was short but sharp, while avian flu had very little impact on economic growth. The rebound in US growth, particularly the strength of investment in ICT, coupled with very strong growth in China, contributed significantly to export growth across the rest of East Asia. Domestic demand is showing signs of strengthening in the more industrialised East Asian economies, while the developing economies of the region are also growing briskly.

China expanded rapidly in 2003, growing at its highest annual rate since 1996 (Box 1). Output growth was driven by strong investment, particularly in construction and automobiles. Trade has expanded significantly, with vigorous growth in both exports

and imports. Rapid money supply and credit growth have raised concerns about the economy overheating and triggered a tightening of policy. A key uncertainty is how effective such tightening will be in reducing strong investment growth and containing inflationary pressures, particularly in the context of its managed exchange rate regime.

The euro area recovery has been hesitant with growth stalling in early 2003, before picking up modestly in late 2003. The improvement in growth was driven by external demand rather than an expansion in domestic demand. The weakness in domestic demand is reflected in the continued low level of consumer confidence. While economic indicators remain mixed, on balance they suggest a continued modest recovery with weakness remaining centred on Germany, which accounts for nearly a third of the output of the single currency zone.

Domestic demand in the euro area remained anaemic despite large fiscal deficits and tax cuts in both Germany and France. In 2004, six euro area countries are expected to breach the 3 per cent of GDP fiscal deficit limit prescribed by the Stability and Growth Pact. Concerns remain about the willingness of euro area governments to tackle their cyclical and persistent structural problems. The pending demographic challenges increase the need for progress on structural reform, particularly while labour movement restrictions from the ten accession countries exist. Europe's capacity to manage macroeconomic policy will be further tested if the accession countries prematurely adopt the euro.

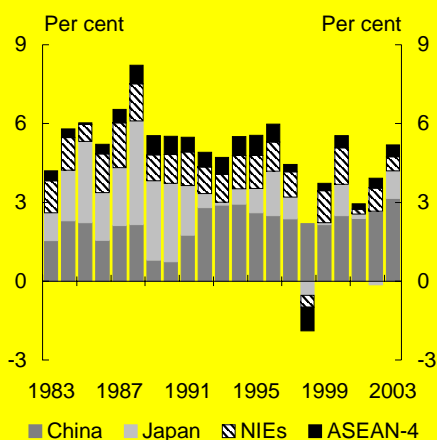
The United Kingdom (UK) grew more strongly than the euro area in 2003 and growth prospects remain significantly better in 2004. Growth in the UK is likely to be underpinned by continued solid consumption growth supported by growth in real disposable incomes and a record low level of unemployment, together with increases in both house prices and financial wealth.

In the near term, the world economic outlook is positive with upside and downside risks broadly balanced. The medium-term outlook presents more challenges, with the adjustment of large current account and fiscal imbalances and significant policy reforms required in many industrialised countries. There are also risks surrounding the related unwinding of the substantial policy stimulus currently in place.

**Box 1: China as a driver of regional growth**

China's economy has grown by a remarkable 9.7 per cent per year on average over the past twenty years. In more recent years China has made an increasingly important contribution to regional growth (Chart A). China's development as a major regional trading partner has been driven by the opening up of its large markets, its low production cost advantage and East Asian economies seeking out new opportunities. Since mid-2003, the region has exported more to China than to Japan.

**Chart A: Contributions to East Asian growth**



Source: IMF and Treasury estimates. Newly Industrialised Economies (NIEs) are Korea, Taiwan, Hong Kong and Singapore. ASEAN-4 are Indonesia, Malaysia, Thailand and the Philippines.

China's emergence is also reinforcing East Asia's already strong links with developed economies, particularly the US. China's exports to the US have risen to around 21 per cent of its total exports in 2003, with a considerable portion of these exports including components and semi-finished manufactures from elsewhere in the region.

Despite the considerable momentum in China's economy there are a number of challenges that need to be addressed to ensure the continuation of strong and stable growth.

One challenge is to address possible overheating of the economy. While consumer price inflation has been trending up, it has primarily been driven by food prices, with the prices of many other goods falling. Further, while inflation is likely to edge higher and become more widespread due to producer price pressure, a number of competing factors, such as productivity growth and a large surplus of rural labour, should work together to keep inflation under control.

A greater challenge is to address possible overinvestment. Investment as a share of GDP is now well above its previous peak in 1993, with strong investment in steel, cement, aluminium, property and automobiles. Rapid investment has pushed up commodity prices and placed pressure on infrastructure. There is a risk that capital is being allocated inefficiently and directed towards projects that will prove unprofitable, placing further pressure on China's financial system.

China's policymakers have used a range of measures to rein in money supply and credit growth, including raising banks' required reserve ratios and discouraging loan growth to certain industries. The degree to which these measures are successful will have a large bearing on China's near-term growth path and, by implication, the world economy.

## THE OUTLOOK FOR THE DOMESTIC ECONOMY

### Key assumptions

The forecasts for the domestic economy are underpinned by several key technical assumptions. The exchange rate is assumed to remain around the average level of recent months (a trade weighted index of around 63). Interest rates are assumed to remain around current levels. World oil prices (West Texas Intermediate) are assumed to fall gradually to around \$US32 per barrel by June 2005, broadly in line with market expectations. The farm sector forecasts are based on an assumption of average seasonal conditions in 2004-05.

Deviations from these assumptions can have a material effect on the forecasts. For example, if the exchange rate fell below its assumed level in 2004-05, then it is likely that economic activity and inflation would be higher than forecast, while higher oil prices would likely lead to lower economic activity and higher inflation than forecast.

### Demand and output

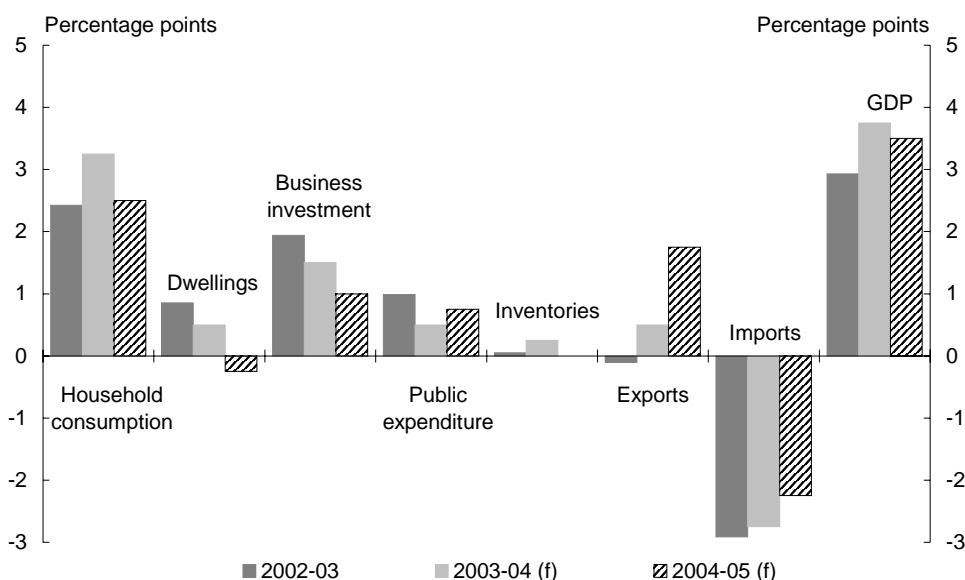
The capacity of the Australian economy to adapt to, and ride out, economic shocks has been reinforced by ongoing economic reforms and prudent macroeconomic policies. Indeed, sustained product and labour market reforms have likely enhanced the effectiveness of macroeconomic policy, while stable macro performance has given firms, employees and consumers the confidence to better pursue opportunities provided by structural reform. That Australia has continued to grow strongly in recent years, despite the challenges presented by drought, an international economic downturn and increasing world security and health concerns, is testament to the increased flexibility and resilience of the economy.

The Australian economy is forecast to grow by 3½ per cent in 2004-05 in year-average terms, slightly below the 3¾ per cent forecast for 2003-04. Growth in non-farm GDP is forecast to pick-up slightly to 3½ per cent in 2004-05, while farm GDP is expected to continue to recover from the drought, increasing by around 4 per cent. Employment growth is forecast to remain solid in 2004-05, with the unemployment rate holding at around 5¾ per cent. Inflation is forecast to fall to around or a little below the bottom of the target band. The current account deficit is forecast to fall to 5 per cent of GDP, primarily reflecting an increase in the terms of trade. Over the past few years, strong domestic growth and weak international demand, combined with a falling supply of rural exports, led to a deterioration in Australia's net export position. As the recovery in the world economy gains strength in 2004-05 and rural production continues to recover, the factors weighing on net exports will abate, leading to a forecast smaller net export deduction from GDP growth.

As a result, the next year should see a rebalancing of economic growth from domestic to external drivers (Chart 2). Slower growth in consumption and business investment and a decline in dwelling investment are forecast to offset an acceleration in public

demand growth, leading to a moderation in GNE growth from 6 per cent in 2003-04 to 3¾ per cent in 2004-05. Export growth is forecast to accelerate for the reasons outlined above, while lower growth in domestic spending should lead to a moderation in import growth. Overall, net exports are forecast to detract ½ of a percentage point from economic growth, a substantial improvement from the large detractions seen in recent years.

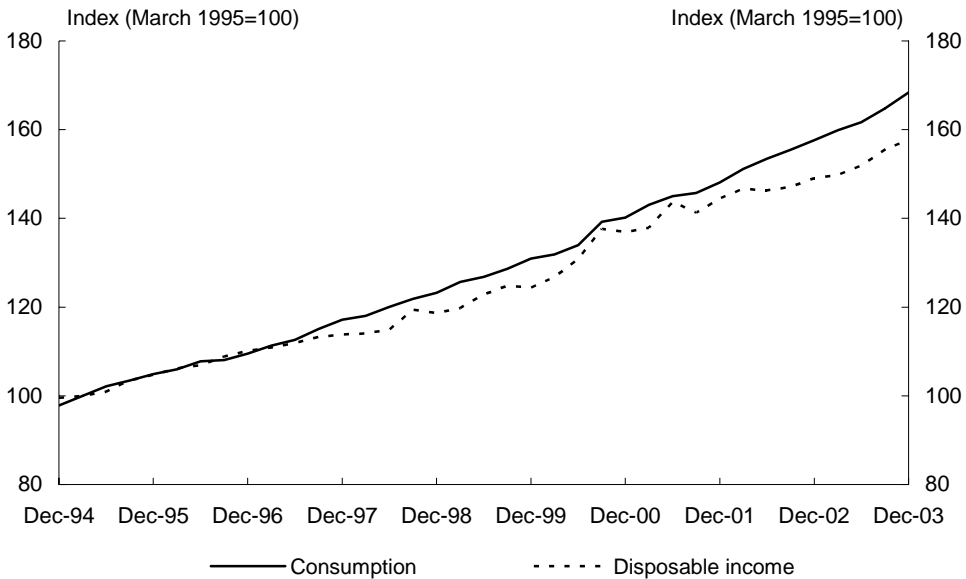
**Chart 2: Contributions to GDP growth<sup>(a)</sup>**



(a) Adjusted for second-hand asset sales.  
Source: ABS Cat. No. 5206.0 and Treasury.

### Household consumption

Consumption growth has run ahead of income growth for several years (Chart 3), leading to falls in the household saving ratio. Increases in wealth have been an important driver of this stronger consumption growth, with increases in equity prices boosting wealth through the mid to late 1990s and substantial increases in house prices doing the same over the past two years. Access to wealth is also being made easier with the more widespread use by households of mortgage redraw facilities.

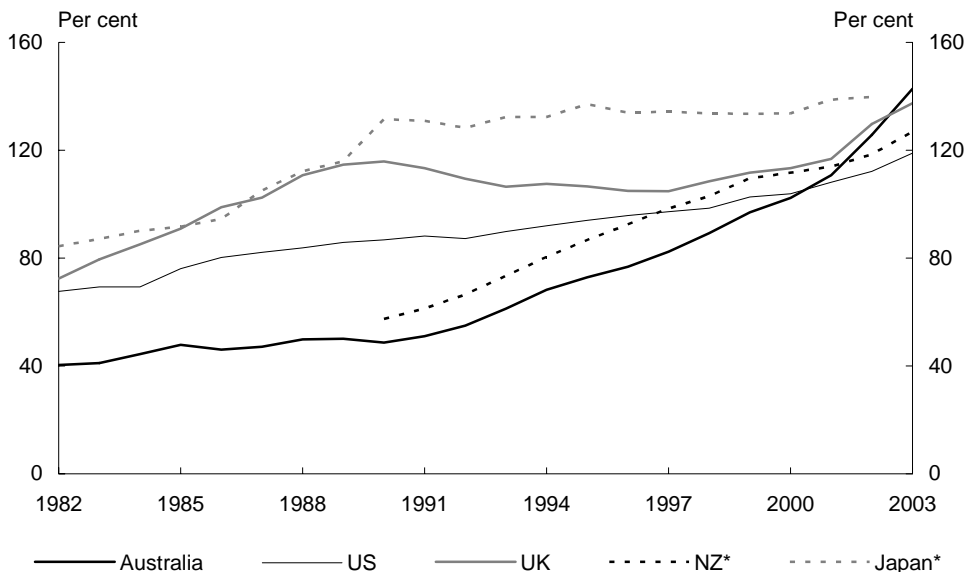
**Chart 3: Household consumption and disposable income**

Source: ABS Cat. No. 5206.0.

Developments in the housing sector will be an important determinant of consumption growth over 2004-05. The rate of increase in nominal house prices is expected to flatten in 2004-05, resulting in a significant decrease in the pace of wealth accumulation. This is forecast to reduce consumption growth from the strong rates recorded in 2003-04. However, a more widespread fall in house prices could lead to a sharper than forecast slowing in consumption growth.

The increasing use of mortgage redraw facilities and higher levels of new borrowing for consumption and investment purposes have seen households taking on an increasing level of debt in recent years. This is reflected in Australia's household debt to income ratio, which is now slightly above that prevailing in other similar developed countries (Chart 4). Higher levels of debt have led to a rise in the debt servicing ratio, suggesting that households are now more vulnerable to adverse shocks, particularly those associated with a deterioration in labour market conditions. That said, there is little evidence to suggest that current levels of debt are proving onerous for households in aggregate. The increase in debt has been largely matched by an increase in assets, meaning that households' gearing ratios have remained broadly unchanged. Evidence from the survey of Household Income and Labour Dynamics in Australia (HILDA) indicates that the households with the largest increases in debt are those most able to afford them – that is, high income households.

**Chart 4: Household debt to income ratio**



\* Includes unincorporated enterprises.

Source: ABS Cat. No. 5206.0, 5232.0, Reserve Bank of Australia (RBA) and Treasury.

The pace of consumption growth (Chart 5) is forecast to ease in 2004-05 to 4¼ per cent, below the pace of household disposable income growth.

Recent labour market outcomes have supported consumption growth, with employment increasing solidly over 2003 and the unemployment rate holding near 23-year lows in early 2004. A stronger labour market, combined with moderate growth in wages and the 2003-04 income tax cuts, saw household disposable income growing at a very fast pace in the second half of 2003. Real incomes have also been supported by low consumer price inflation, especially through falling prices for many imported consumables.

Improved profits from unincorporated businesses, particularly those operating in the retail, construction and farm sectors have also boosted household incomes. However, while farm production has increased following the drought, a higher exchange rate and relatively weak prices for agricultural commodities have prevented farmers' incomes from recovering to their pre-drought levels.

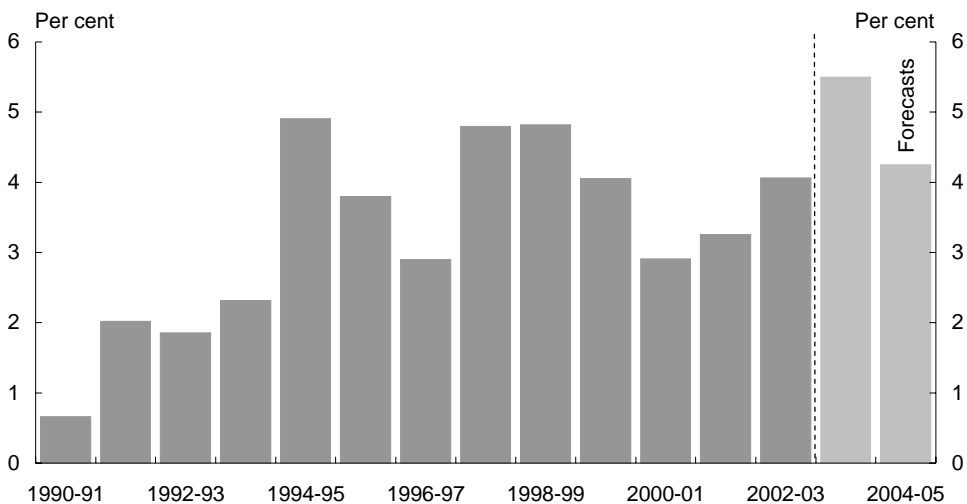
These strong fundamentals have been reflected in surveyed measures of consumer confidence. The Westpac-Melbourne Institute Consumer Sentiment Index has remained at historically high levels, with the interest rate rises of November and December 2003 doing little to dent buoyant confidence levels.

Consumption growth will be supported by solid growth in real household income in 2004-05, underpinned by low consumer price inflation, moderate wages growth and the Government's Budget initiatives. However, the anticipated downturn in dwelling

investment should lead to slower growth in the consumption of housing-related durables, following strong growth over the past three years.

A further factor affecting consumption growth over 2004-05 is the path of oil prices. Oil prices have remained high over the past year, reflecting higher energy demand from East Asia, political and security uncertainties in a number of oil-exporting countries and increased discipline on the part of OPEC countries. The higher exchange rate over 2003 dampened the effects of higher US dollar oil prices for Australia. There is a risk, however, that oil prices could increase further or the Australian dollar could fall, causing households to reduce discretionary expenditure to offset an increase in petrol prices.

**Chart 5: Growth in household consumption**



Source: ABS Cat. No. 5206.0 and Treasury.

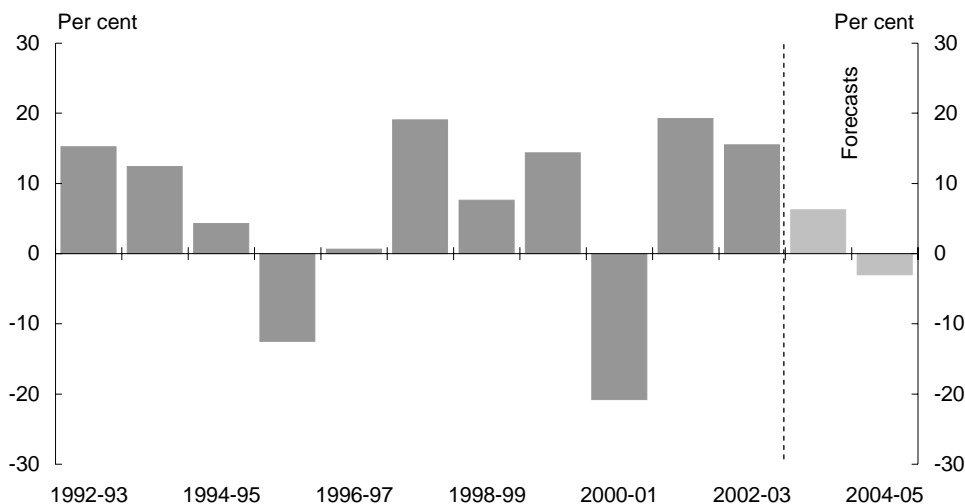
## Dwelling investment

Dwelling investment is forecast to fall by 3 per cent in 2004-05, following forecast growth of 6 per cent in 2003-04 (Chart 6). A decline in the construction of medium-density housing and a smaller fall in detached housing should dominate modest growth in alterations and additions in the year ahead. There remains considerable dwelling construction work in the pipeline, which should hold activity in the dwelling sector at high levels in the near term.

Conditions in the detached sector of the housing market have been more restrained than in the medium-density sector. Nevertheless, the lagged effects of higher interest rates and slightly weaker underlying demand are expected to lead to a modest fall in construction activity in 2004-05. Supporting the outlook for a slowing, private sector house approvals have fallen by 11 per cent since September 2003 and finance for new dwellings has also fallen in recent months.

In contrast to conditions in the detached sector, the medium-density sector is presenting much clearer evidence of oversupply, particularly for apartments near major city centres. As a result, a sharp decline in medium-density construction is expected in 2004-05, driven by falling demand by investors who are now facing higher vacancy rates, lower rental yields and increased borrowing costs following the interest rate increases in November and December 2003. In addition, apartment prices in a number of markets have begun falling, raising the prospect of much slower capital gains than in the past or capital losses for some recent investors. At the same time, alternative investments, such as equities, have begun to perform relatively more strongly, which influences the general attractiveness of investment in real estate. Partial indicators are consistent with this outlook, with medium-density approvals falling recently and new investor finance halving since its peak in December 2002.

**Chart 6: Growth in dwelling investment**



Source: ABS Cat. No. 5206.0 and Treasury.

The decline in medium-density construction is expected to be greatest in inner Melbourne and Sydney, where evidence of oversupply is the most pronounced. There is a risk that falling prices in the medium-density sector could prompt a more widespread fall in house prices. This entails a risk for the forecast growth of both consumption and housing investment (see the previous section for a discussion of the effects of changes in wealth on consumption growth).

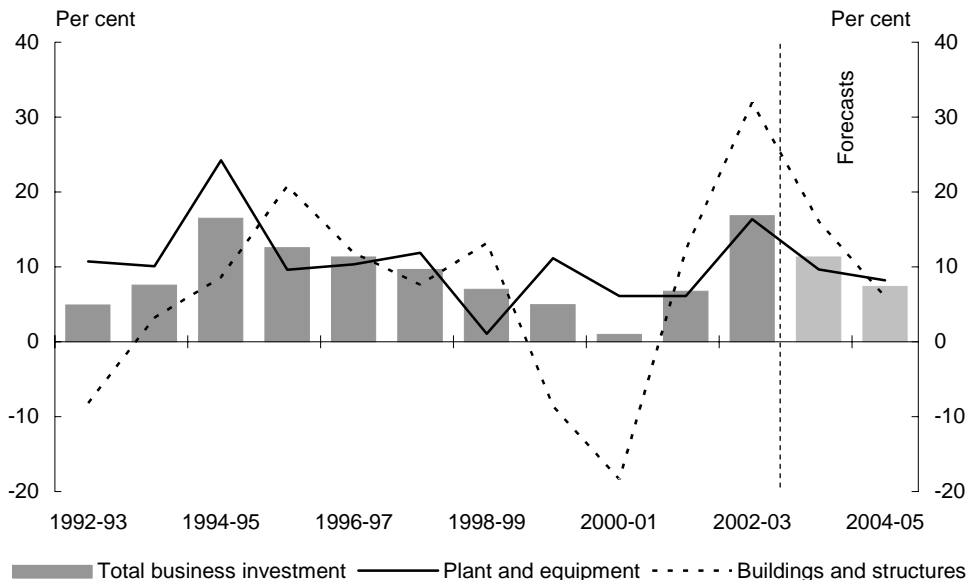
Alterations and additions remain a relatively cost effective option for owner-occupiers who desire a higher quality dwelling but want to avoid the stamp duties and transaction costs that apply to the purchase of a house or apartment. Investment in alterations and additions is forecast to grow in 2004-05, albeit at a slower pace than in 2003-04, providing some offset to the decline in new dwelling investment. The lower rate of growth in renovation work in 2004-05 reflects the effect of moderating growth in wealth and last year's interest rate rises. The expectation that increases in house

prices are likely to be more subdued in 2004-05 will also tend to restrain alterations and additions work by investors seeking capital gains from renovated properties.

## Business investment

New business investment is forecast to grow by 7 per cent in 2004-05, following 11 per cent growth in 2003-04 (Chart 7). The fundamental drivers of business investment remain very supportive and, partly as a consequence, business confidence remains at historically high levels. Profits have increased sharply over the past year, strengthening corporate balance sheets, particularly in sectors more exposed to the domestic economy. Interest rates remain at relatively low levels, capacity utilisation is high, domestic demand remains robust and international demand is strengthening.

**Chart 7: Growth in business investment<sup>(a)</sup>**



(a) Excluding net purchases of second-hand public sector assets by the private sector.  
Source: ABS Cat. No. 5206.0 and Treasury.

The risk identified in last year's Budget that businesses may scale back discretionary investment expenditure in response to heightened world uncertainty does not appear to have been a significant factor in 2003-04. Indeed, the strength of business investment in the face of world economic and security concerns highlights the confidence of businesses in the Australian economy, which has been complemented by the ongoing low cost of capital.

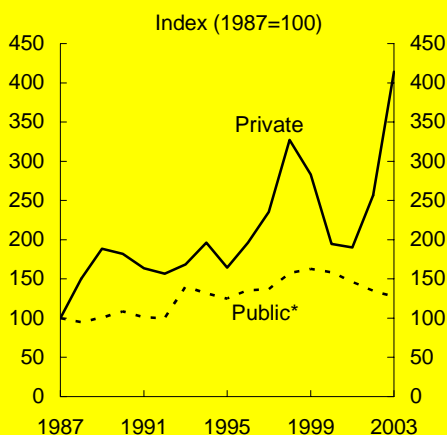
The mining sector has been an important driver of business investment over the past year as the continued emergence of China and strengthening growth in the international economy has boosted the demand for mineral-related commodities. This is expected to continue into 2004-05. Purchases of aircraft by Australia's major airlines

have also continued to support investment spending, although this has been at a lower rate than in 2002-03. The move towards private provision of public-access infrastructure is also boosting private investment for projects that would once have been undertaken by government (Box 2).

### Box 2: Infrastructure investment

Private engineering construction has increased sharply in recent years. In fact, new engineering construction by the private sector more than doubled in the three years to the December quarter 2003. A part of this increase reflects the building of public access infrastructure.

**Chart A: Road infrastructure construction**



\* Includes work done by the private sector for the public sector.

Source: ABS Cat. No. 8762.0 and Treasury.

In the past, most public access infrastructure was paid for by the public sector. However, this has been changing

in recent years as the private sector has become more involved in the provision and operation of infrastructure facilities. The growth in private engineering construction in recent years has been partly driven by this compositional change from public to private investment spending.

One example of this compositional change is in spending on road infrastructure, where private spending has grown strongly (Chart A). Private Public Partnerships (PPPs) are one vehicle by which private participation in infrastructure provision is increasing. Examples of PPPs include the Lane Cove Tunnel (valued at around \$1 billion), the Cross City Tunnel and Westlink M7 Motorway (valued together at over \$2 billion) and the Citylink project (valued at around \$2 billion).

While vehicles such as PPPs are an increasingly important component of business investment, important public policy issues around the appropriate management and allocation of risks in such projects remain.

Growth in machinery and equipment investment is expected to be 8 per cent in 2004-05. The latest survey of investment intentions indicated that firms' first estimates of nominal spending on machinery and equipment investment in 2004-05 were lower than their first estimates for 2003-04. However, early capital expenditure estimates provide only a broad indication of possible outcomes and, as the year unfolds, it is likely that firms will upgrade their investment intentions more strongly than in recent

years as the strength of the recovery in the world economy becomes more apparent. The significant fall in the price of imported machinery and equipment as a result of the appreciation of the exchange rate over the past two years will also support real business investment in 2004-05.

Non-dwelling construction is expected to grow by 6 per cent in 2004-05. The level of engineering construction is expected to remain very high over 2004-05, but growth should pull back from the exceptionally fast rate seen over the past two years. A large number of engineering construction projects remain in the pipeline or underway, including such high value projects as the Bayu Undan gas platform, the North West Shelf expansion, and the Western Sydney Orbital. However, a large part of the work on projects that are currently underway is expected to be completed in 2003-04 and a number of the high value investment projects on the horizon are not expected to see significant expenditure until after 2004-05, leading to a slowing in engineering construction growth over 2004-05.

New building construction is likely to see a moderate cyclical downturn after also experiencing very strong growth in recent years. The latest work-yet-to-be-done data from the Australian Bureau of Statistics suggest that activity in the sector may have peaked. The anticipated slowing in new building construction is also consistent with information from the latest *Delta Electricity Access Economics Investment Monitor*, which points to the absence of large projects scheduled to begin construction in 2004-05. Much of the forecast slowing in activity reflects excess capacity in the commercial office market.

## **Inventories**

In 2004-05, output is expected to broadly keep pace with sales, with inventories making no net contribution to GDP growth. Movements in farm and public authority stocks are forecast to detract  $\frac{1}{4}$  of a percentage point from GDP growth in 2004-05, following a contribution of around  $\frac{1}{2}$  of a percentage point in 2003-04. Stronger farm production in 2003-04 initially added to farm and marketing authority stocks, but some of this is likely to be exported in 2004-05.

## **Public final demand**

Public final demand<sup>1</sup> constitutes around 22 per cent of GDP. The final demand of the national public sector (including the final demand of the Australian Government) makes up around 8 per cent of GDP, while the remainder is from the State and local public sector.

Growth in public final demand is forecast to ease slightly, to  $2\frac{3}{4}$  per cent in 2003-04, from the above trend rate of growth observed in 2002-03, before picking up to

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1 Public final demand comprises the public sector's expenditure on goods and services. It does not include payments such as personal benefits and other transfers.

3½ per cent in 2004-05. A range of investment projects – particularly at the State and local government level – will continue to support solid growth in public spending in 2004-05.

Developments in the housing market present a particular uncertainty for public finances at the moment. Changes in housing construction activity, real estate turnover and house prices all have the capacity to affect taxation revenue, particularly for the States. As a consequence, public spending decisions could also be affected by developments in these areas.

## **Net exports and the current account**

### **Net exports**

Net exports are forecast to detract ½ of a percentage point from GDP growth in 2004-05. This is a significant expected improvement in the net export performance, following a detraction of more than 5 percentage points from GDP growth over the past two years.

Imports are forecast to increase by 9 per cent in 2004-05, below the 12 per cent growth forecast for 2003-04. Lower growth in imports is consistent with the forecast moderation in GNE growth. However, the appreciation of the exchange rate over the past two years, which has led to a fall in the prices of imported consumption and investment goods, will continue to support import demand over 2004-05.

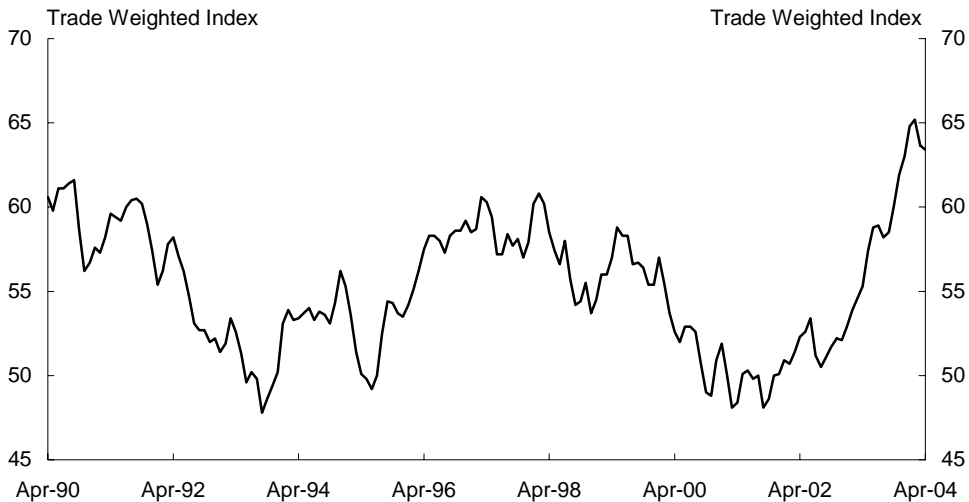
Exports are forecast to increase by 8 per cent in 2004-05, following only modest growth of 2 per cent in 2003-04. The recovery in exports is expected to be underpinned by the strengthening recovery in world demand, growth in farm production and a pick-up in tourist arrivals. The sharp appreciation of the nominal exchange rate over the past two years will remain a constraint on export growth in the near term (Chart 8). The real exchange rate has appreciated by even more than the nominal exchange rate, reflecting higher rates of inflation in Australia than in our trading partners.

Exports of non-rural commodities, which account for the largest share of Australia's exports, are forecast to grow strongly in 2004-05. This growth is expected to be driven by increased production capacity in Australia, especially for iron ore, coal, and liquefied natural gas, which has been ramped up in response to very strong world demand for bulk commodities, notably from China (Box 3). However, capacity constraints in domestic transport infrastructure, ports and international shipping may restrain export growth in some areas in the near term. The duration and strength of economic growth in the US, Japan and China will be an important determinant of the demand for Australia's non-rural commodity exports.

Rural exports are forecast to grow strongly in 2004-05, in line with the recovery in farm production in 2003-04 from the 2002-03 drought. Weather conditions remain a critical factor for farm production in 2004-05. Irrigated crops and livestock are yet to fully recover from the impact of the drought. In the case of livestock, a full recovery may

take some time. Dry conditions in parts of Australia to date in 2004, particularly in the south-east, remain a risk to farm production in the coming year. In the event that Australia was to experience prolonged drought conditions so quickly after the 2002 experience, this would likely have serious implications for aggregate activity and, in particular, for rural and regional Australia.

**Chart 8: Exchange rate**



Source: RBA.

Exports of elaborately transformed manufactures are forecast to pick up over the course of 2004-05, in line with the strengthening international economy. However, the forecast growth in manufactured exports is expected to be less than in previous recoveries, due to the loss of competitiveness of Australian goods in international markets related to the sharp appreciation of the real exchange rate over the last two years.

Services exports fell sharply in recent years, reflecting the effects on tourism of a weak world economy and heightened global security and health concerns. The SARS outbreak led to a particularly sharp downturn in Australia's inbound tourism. As the world economy continues to recover through 2004-05, services exports are forecast to increase strongly. Nevertheless, people are now more conscious of the potential security and health issues associated with overseas travel, and sentiment is likely to be more sensitive to perceived changes in security conditions.

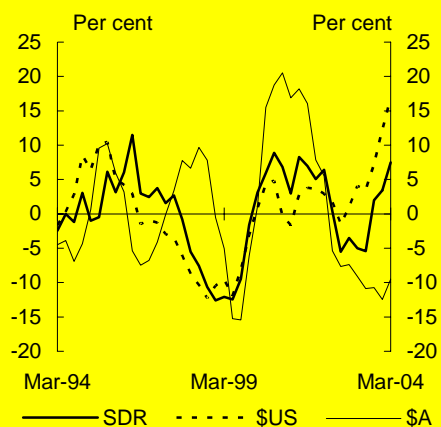
There has also been considerable focus recently on the perceived threat of 'off-shoring' – that is, the provision of services to the Australian market from other countries. However, Australia has traditionally exported and imported services – as with goods – and the transfer of, for example, call centre jobs offshore is no different than the purchase of, for example, legal services from a New York law firm (Box 4).

The critical thing to recognise is that dynamic, flexible economies see the constant creation and loss of jobs, and that maximising competitiveness and productivity are key elements in generating sustainable growth in jobs and living standards. These issues are discussed further in Statement 4.

**Box 3: Commodity prices**

China’s booming economy, as well as the recovery in the US and Japan, has pushed up world demand and prices for non-rural commodities. In particular, the rapid expansion of the Chinese economy – which grew by 9.1 per cent in 2003 – has required vast amounts of raw materials. This has contributed to a rise in non-rural commodity prices of almost 8 per cent through the year to the March quarter 2004 in currency neutral (Special Drawing Rights (SDR)) terms (Chart A).

**Chart A: Non-rural commodity prices**  
(Through the year)



Source: RBA.

Dramatic rises in the price of Australia’s bulk commodity exports, such as coal and iron ore, are expected as new contracts with China and Japan come into effect.

Although some of the recent price rises have been partially offset by the appreciation of the Australian dollar, Australian firms are well positioned to take advantage of highly favourable international conditions and the anticipated increases in demand and prices in the period ahead.

In the past two years, capital expenditure by the mining industry has increased dramatically in Australia, consistent with the high levels of profitability in the sector over that period. This expansion in mining capacity can also be seen in mining employment, which grew by 9.2 per cent through the year to the March quarter 2004 to be nearly a third higher than its low in June 2000.

It is expected that the increased capacity will allow non-rural commodities exports to grow by around 9 per cent in 2004-05.

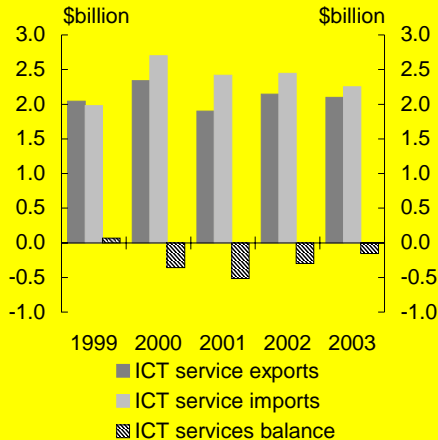
Further export growth may be expected beyond 2004-05. However, it is also expected that price growth will moderate as additional capacity comes on line – both in Australia and internationally. Furthermore, the continuation of the very high demand for non-rural commodities is subject to risks surrounding the sustainability of growth in China and other parts of the world.

#### Box 4: Recent trends in the trade of services

Australia's current account deficit (CAD) has widened over the past two years. This has largely reflected a widening of the trade deficit, with imports being supported by strong domestic demand and exports subjected to a series of supply and demand shocks (see Box 5).

One trade issue that has become more prominent in recent times is 'off-shoring' – that is, the provision of business services to the Australian market from other countries. The off-shoring of ICT services, such as call centres, has been a particular area of focus.

**Chart A: Trade in ICT services**



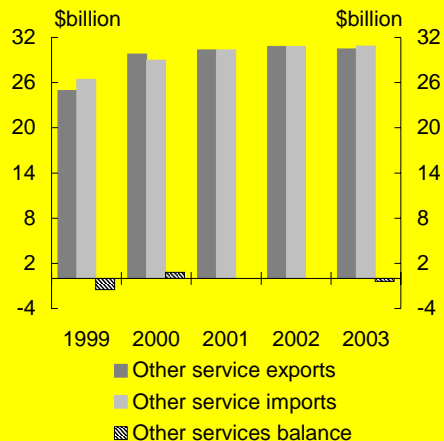
Source: ABS Cat. No. 5302.0.

Trade in ICT services constitutes under 10 per cent of Australia's total trade in services. While Australia runs a deficit in ICT services, the deficit is small and has declined over the past two years (Chart A).

Australia's trade in non-ICT services is also close to balanced and has remained relatively steady in recent years (Chart B).

As a result of this near-balance on the services account, the services deficit only accounted for 1 per cent of the CAD in 2003, despite services constituting around one-fifth of exports and imports. In contrast, the goods deficit accounted for around 50 per cent of the CAD.

**Chart B: Trade in non-ICT services**



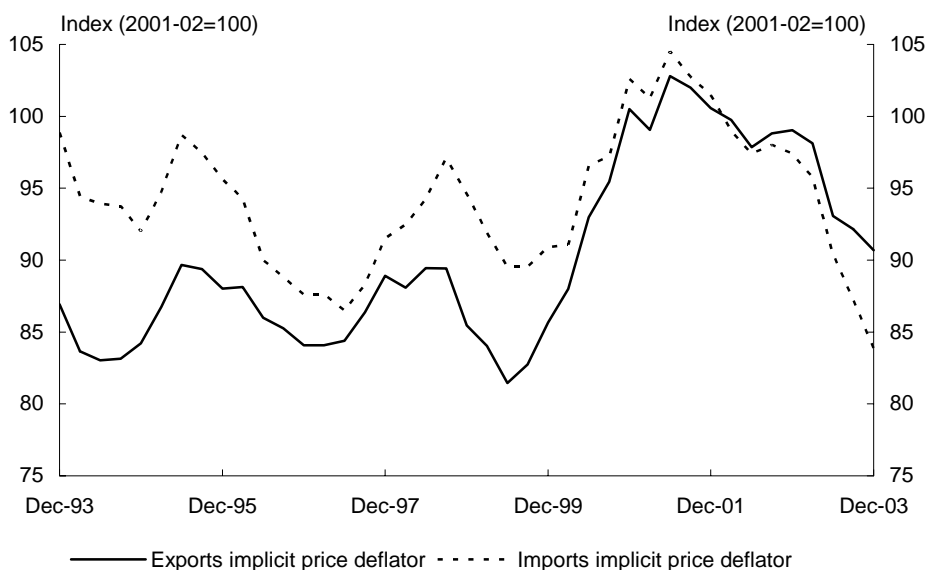
Source: ABS Cat. No. 5302.0.

It is important to recognise that service export industries are significant employers in the Australian economy. While some employment will be lost to off-shoring, the trade data suggest that Australia is also benefiting from employment creation in service export industries.

### The terms of trade

The terms of trade are forecast to increase by 4½ per cent in 2004-05, following growth of 6½ per cent in 2003-04. Export prices are forecast to strengthen through 2004-05, particularly for non-rural commodities. The growth in import prices is forecast to remain subdued. Export prices have fallen in recent years, but the fall in import prices has been much greater, providing a boost to the terms of trade (Chart 9).

**Chart 9: Export and import prices (AUD)**



Source: ABS Cat. No. 5302.0.

As the recovery in the world economy gathers strength, commodity prices are forecast to increase, with energy-intensive manufacturing countries, such as China, making a relatively greater contribution to world growth. Substantial price rises are expected for Australia’s bulk commodity exports, with many coal and iron ore contract prices rising significantly after the recent round of international negotiations.

Import prices are forecast to be subdued over 2004-05 following price falls over the past year, which were driven by the sharp rise in the Australian dollar. Technological progress is driving the prices of ICT goods lower on world markets. The increasing contribution of low-wage economies to the world production of manufactures and services is also helping to restrain growth in import prices.

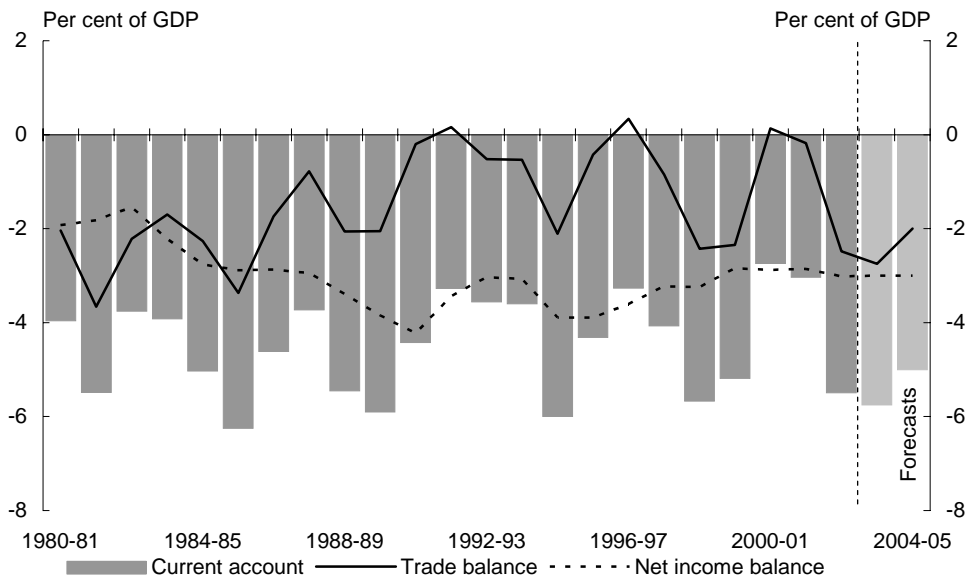
Strong growth in the terms of trade continues to provide an important buffer for Australian incomes, despite the relatively weak net export performance. This has contributed to the ability of the Australian economy to continue to grow through the period of downturn in the international economy.

## The current account

The current account deficit is expected to narrow to 5 per cent of GDP in 2004-05, from the 5¾ per cent forecast for 2003-04 (Chart 10). As noted in last year's Budget, the widening of the current account deficit over 2002-03 and 2003-04 reflected the impact of the desynchronised Australian and world economic cycles and the drought. As the world economy recovers, the growth rate of GNE moderates, and rural exports recover, the current account deficit is expected to fall (Box 5).

Very strong growth in the terms of trade over recent years has cushioned the current account deficit from the full impact of the deterioration in net exports. Anticipated growth in the terms of trade drives the forecast narrowing of the current account deficit in 2004-05.

**Chart 10: Current account balance**



Source: ABS Cat. No. 5302.0 and 5206.0 and Treasury.

The net income deficit is forecast to widen in 2004-05, in line with the accumulation of net foreign liabilities associated with recent current account deficits, although it should remain relatively stable as a proportion of GDP. The net income deficit remains sensitive to the path of world interest rates. As the world economy recovers, there is a risk that rising world interest rates might increase the servicing cost on Australia's net foreign debt.

**Box 5: The effects of desynchronised growth**

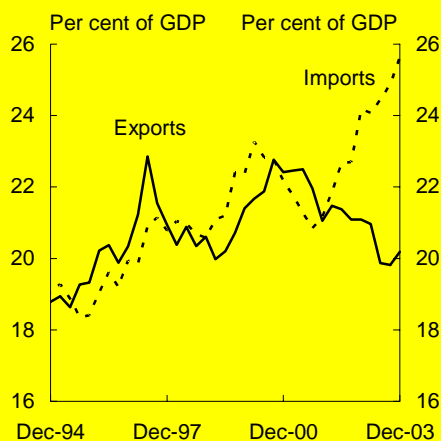
Import demand has been supported by strong growth in the domestic economy over the past two years. In contrast, Australia’s exports have been subject to a series of supply and demand shocks. The weak world economy, the impact of 11 September 2001, the SARS outbreak and the collapse of Ansett Airlines have all constrained demand for Australian exports. The supply of exports was also affected by the severe drought in 2002.

The desynchronisation of growth between the domestic and world economies led to imports increasing faster as a share of GDP than exports (Chart A). Overall, net exports detracted more than 5 percentage points from GDP growth in 2002-03 and 2003-04.

As a trading economy, exports make up a relatively larger share of Australia’s GDP than they do for some other developed countries. This makes the economy relatively more vulnerable to external shocks. Economic policy often has little or no ability to ameliorate the effects of these shocks when they occur. Therefore, it is important to focus beforehand on economic reforms that strengthen the economy and increase its flexibility to ride out shocks.

In recent years, reforms have been introduced to enhance competition in product markets and increase the flexibility of the labour market, the objectives of monetary and fiscal policy have been more clearly specified and the tax system has been overhauled. All of these reforms have contributed to making the economy stronger and more flexible. Nevertheless, it is important to continue to pursue economic reforms that facilitate trade and enhance Australia’s ability to withstand future shocks.

**Chart A: Exports and imports**



Source: ABS Cat. No. 5206.0.

**Labour market, wages and prices**

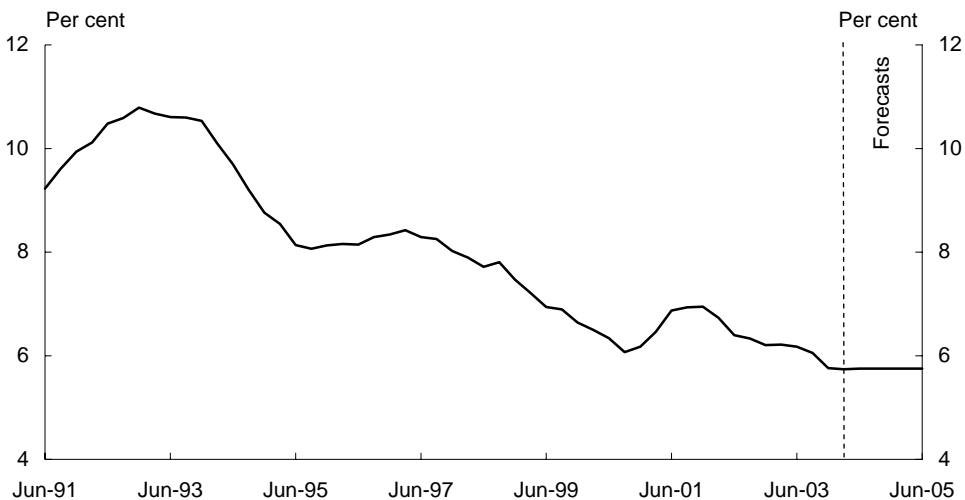
**Labour market**

Australia’s unemployment rate is forecast to remain at, or close to, 23-year lows over 2004-05. For a detailed discussion of low unemployment in Australia, see Statement 4.

Growth in labour costs is expected to remain moderate, supporting the outlook for solid employment growth. This outlook is consistent with leading measures of labour market conditions. Job vacancies data remain at solid levels, with the ANZ job advertisements series being around its highest level in 10 months in March 2004. Surveys of business hiring intentions also point to solid employment growth in the near term.

Employment growth is expected to fall slightly to 1½ per cent through the year to the June quarter 2005, in line with a forecast decrease in through-the-year non-farm GDP growth. The forecast rate of employment growth should be sufficient to maintain the unemployment rate at around 5¾ per cent over 2004-05 (Chart 11), assuming that the participation rate remains around current levels.

**Chart 11: Unemployment rate**



Source: ABS Cat. No. 6202.0 and Treasury.

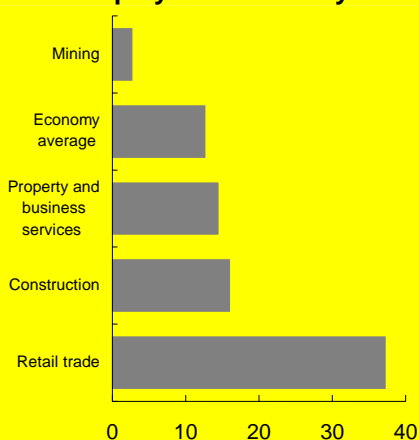
Over 2004-05, the composition of non-farm GDP growth is expected to be underpinned by growth in relatively capital intensive sectors of the economy, particularly mining. This presents a risk that employment growth might be slightly lower than would normally be the case for the forecast level of economic growth (see Box 6 for a discussion of the composition of employment growth).

Farm employment is expected to pick up through the forecast period, in line with the rebound in farm production. However, farm employment is likely to remain well below pre-drought levels until the livestock sector fully recovers over the next few years (see *Economic Roundup, Autumn 2004*, pages 25-42).

**Box 6: Employment intensity and industry drivers of GDP growth**

Industries in Australia differ markedly in terms of their labour intensity. For example, in 2003 the mining industry employed three workers per million dollars of gross value added (GVA) production, while the retail trade industry employed 37 workers per million dollars of GVA production (Chart A).

**Chart A: Selected industry employment intensity<sup>(a)</sup>**



(a) Persons per million dollars of GVA.  
Source: ABS Cat. No. 5206.0, 6105.0.

In recent years, GDP growth has been driven by solid growth in industries that are both relatively intensive users of labour resources and significant employers; in particular, construction, property and business services and retail trade.

A rebalancing between the industry drivers of GDP growth is expected to occur in 2004-05. Growth is expected to moderate in a number of industries which are relatively more employment intensive, such as construction. In contrast, growth is expected to pick up in a number of industries that are relatively more capital intensive, such as mining and agriculture.

Overall employment growth is expected to remain solid, but a little below the rates recorded in recent years. The relatively capital-intensive nature of the industry composition of the forecast growth suggests that employment growth is likely to be weaker than might otherwise be expected, given forecast output growth.

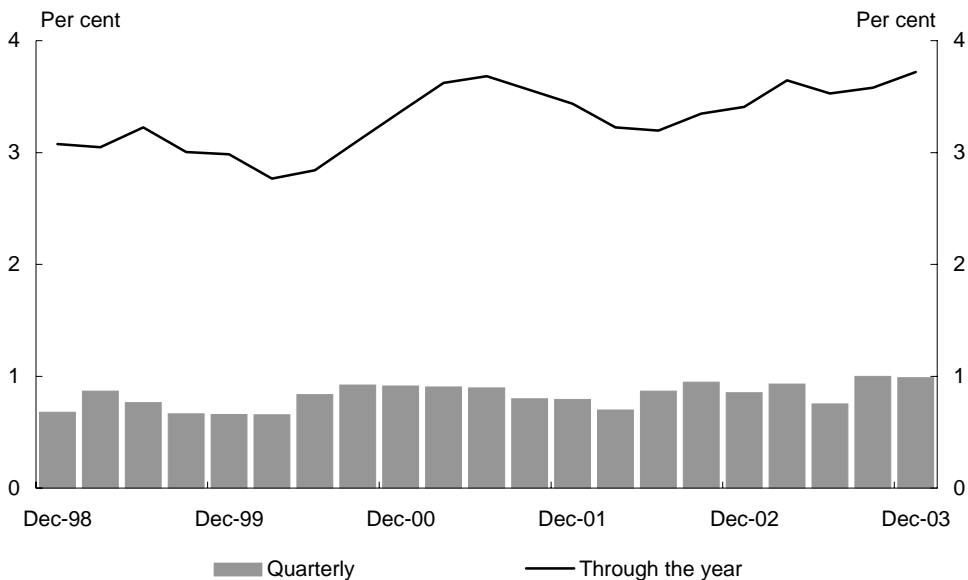
**Wages**

Growth in labour costs has remained moderate (Chart 12) despite the unemployment rate having fallen to near 23-year lows in recent months. Increased flexibility flowing from labour and product market reforms has helped to contain labour costs compared with previous episodes of low unemployment. Business liaison suggests that employers are having some success in finding productivity offsets to deal with localised wage pressures. The significant growth in part-time employment also provides an outlet for labour market pressures, with some part-time employees willing and able to take on more hours as the economy expands (see Statement 4 and *Economic Roundup, Autumn 2004*, pages 1-20 for a more detailed discussion of these issues).

There is some evidence of isolated labour market pressure, with business surveys indicating that some employers are finding it difficult to obtain skilled labour, most notably in the construction sector. Wage pressures have also been evident in parts of the public sector and these pressures are expected to continue into 2004-05. However, this has not translated into generalised wage pressure. The forecast convergence of employment growth to around that of the labour force is expected to reduce the risk that currently isolated wage pressures will spill over into more generalised wage demands.

Overall, wage pressures are expected to remain contained through 2004-05. Recent falls in the unemployment rate are forecast to lead to a slight firming in wage growth in the near term. However, the forecast moderation in non-farm GDP growth through the year to the June quarter 2005, and the associated slowing in employment growth, should see these pressures ease. The Wage Cost Index (WCI) is forecast to grow at 3¼ per cent in both 2003-04 and 2004-05.

**Chart 12: Wage Cost Index**



Source: ABS Cat. No. 6345.0.

## Prices

Inflation is forecast to slow to 1¾ per cent through the year to the June quarter 2005, down from around 2½ per cent through the year to the June quarter 2004, and below the medium-term inflation target band.

Growth in the headline Consumer Price Index – the inflation measure targeted by the Reserve Bank of Australia – has fallen substantially over the past year, from nearly 3½ per cent in early 2003 to 2 per cent through the year to the March quarter 2004. Lower growth in tradables prices, largely reflecting the substantial appreciation of the

Australian dollar over the past year, has been a major contributor to these lower inflation outcomes (Box 7). Partly offsetting this, non-tradables prices have been increasingly driven by strong contributions from project home prices and the prices of health and education services.

The inflation outlook remains benign, with the past appreciation of the Australian dollar expected to continue to exert downward pressure on tradables prices for some time. Oil prices are assumed to increase over the near term given recent developments in the world oil market and then fall gradually over 2004-05, consistent with the oil price futures curve. In addition, tradables inflation will benefit from tariff reductions on motor vehicles and textiles, clothing and footwear from 1 January 2005. Food prices are also expected to moderate as the effect of the drought diminishes.

Capacity constraints are expected to ease a little over 2004-05, in line with forecast lower through-the-year growth in non-farm GDP and recent strong business investment. An assumed moderation in the growth rate of project home prices is also expected to contribute to an easing in non-tradables inflation.

Movements in labour costs remain an important determinant of inflation. With the unemployment rate forecast to hold steady through 2004-05 and wage growth forecast to remain moderate, there is little evidence of a strong impetus to inflation pressures from this source. Nevertheless, given high levels of capacity utilisation, the possibility that current isolated skill shortages and wage demands could widen into more generalised wage pressures presents a risk to the inflation forecasts.

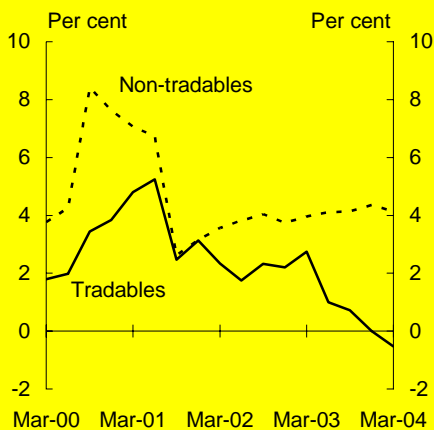
### Box 7: The outlook for inflation

Inflation has fallen steadily over the past year, to be 2 per cent through the year to the March quarter 2004. However, the prices of tradable and non-tradable goods have followed divergent paths in recent years (Chart A).

Inflation of tradable goods and services has been falling, and has been negative in recent quarters, reflecting strong competitive pressures in the world economy and the higher exchange rate.

The exchange rate will continue to restrain increases in the prices of tradables since it takes some time for the effect of an exchange rate movement to pass fully through to retail prices.

**Chart A: Inflation components**



Source: ABS Cat. No. 6401.0.

Inflation of non-tradables, on the other hand, has increased to more than 4 per cent, reflecting price increases for project homes and some services such as health and education.

The forecast moderation in housing construction activity is expected to take some pressure off project home prices. The recovery of farm production from the drought should also lead to lower inflation for food items, although continuing dry conditions in parts of Australia may slow this effect.

Taking these factors together, the outlook is for inflation to remain low over 2004-05, despite the divergence between tradable and non-tradable prices.

While inflation of non-tradables is expected to fall as housing activity slows, inflation of tradables is likely to increase once the pass-through of the higher exchange rate is complete.

