

PART 1: OVERVIEW

The economic and fiscal outlook for Australia remains strong. The Australian economy is expected to grow solidly in 2005-06, with the forecast for real economic growth unchanged since the 2005-06 Budget, notwithstanding the September quarter National Accounts. Strong fiscal outcomes are forecast and projected across the forward estimates.

An underlying cash surplus of \$11.5 billion is forecast for 2005-06, stronger than forecast at Budget, largely reflecting an increase in estimated cash receipts only partially offset by an increase in cash payments.

The increase in estimated cash receipts since the 2005-06 Budget reflects increased dividends principally special dividends from Telstra, prior year corporate profits affecting this year's company tax receipts, and strong employment growth affecting personal withholding receipts.

The increase in estimated cash payments largely reflects policy measures announced since Budget, including additional drought relief to support drought affected regions, improving access to communications infrastructure in rural and regional Australia, and a structural adjustment package for the Australian fishing industry to help secure fish stocks.

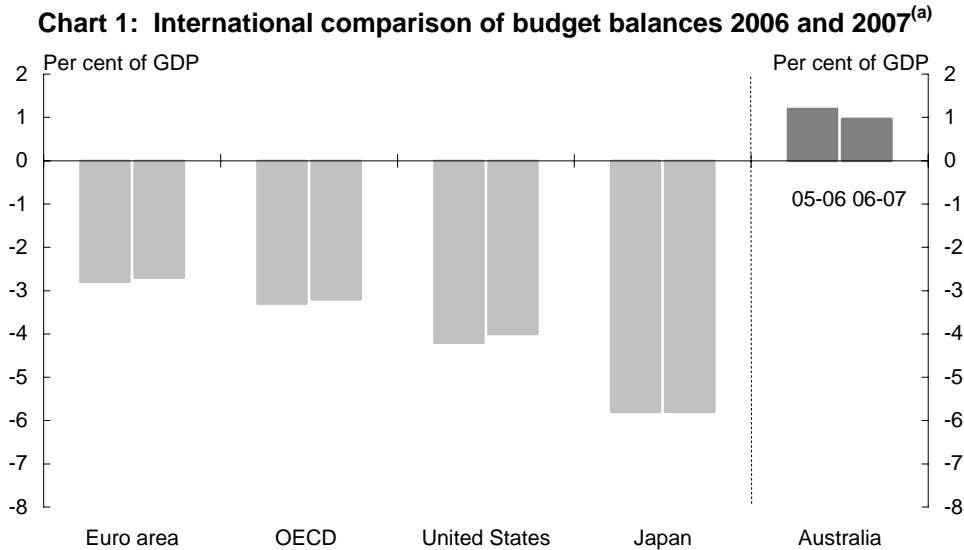
Table 1 presents the fiscal and underlying cash balances for 2005-06 and the forward years.

Table 1: Summary of budget aggregates

| | Estimates | | | |
|---|-------------|-------------|------------|-------------|
| | 2005-06 | | 2006-07 | |
| | Budget | MYEFO | Budget | MYEFO |
| Underlying cash balance (\$b)(a) | 8.9 | 11.5 | 7.9 | 9.7 |
| Per cent of GDP | 1.0 | 1.2 | 0.8 | 1.0 |
| Fiscal balance (\$b) | 7.4 | 10.4 | 7.5 | 9.7 |
| Per cent of GDP | 0.8 | 1.1 | 0.8 | 1.0 |
| | Projections | | | |
| | 2007-08 | | 2008-09 | |
| | Budget | MYEFO | Budget | MYEFO |
| Underlying cash balance (\$b)(a) | 8.5 | 10.1 | 9.3 | 10.7 |
| Per cent of GDP | 0.8 | 1.0 | 0.9 | 1.0 |
| Fiscal balance (\$b) | 8.0 | 11.0 | 9.0 | 11.8 |
| Per cent of GDP | 0.8 | 1.0 | 0.9 | 1.1 |

(a) Excludes expected Future Fund earnings.

The underlying cash surpluses projected for the future years emphasise Australia's sound fiscal outlook at a time when many of the major advanced economies are continuing to experience significant deficits.



(a) International data are for the total general government sector, sourced from OECD Economic Outlook 78, November 2005. Australian data is for the Australian Government general government sector.

In accrual terms, the fiscal balance is expected to record a \$10.4 billion surplus in 2005-06, higher than was forecast at the 2005-06 Budget. The fiscal balance is expected to remain in surplus over the forward estimates.

Further details on the accrual and cash budget estimates are provided in Part 3.

DOMESTIC AND INTERNATIONAL ECONOMIC OUTLOOK

The Australian economy is expected to grow solidly in 2005-06 and 2006-07, with GDP forecast to increase by 3 per cent in both years. While the forecast for GDP growth in 2005-06 is unchanged from that presented in the 2005-06 Budget, there have been some changes to the composition of growth. Business and dwelling investment are anticipated to be stronger than forecast at budget, while consumption and exports are expected to be weaker.

The outlook for the global economy remains favourable. The forecast for world growth has improved from Budget, with growth up $\frac{1}{4}$ of a percentage point in 2005 to $4\frac{1}{2}$ per cent, and $\frac{1}{2}$ of a percentage point higher in 2006 to $4\frac{1}{2}$ per cent. Major trading partner growth is expected to be $\frac{1}{2}$ of a percentage point higher in each year, reflecting stronger growth in China, Japan and India.

In Australia, consumption is expected to moderate over 2005-06 and 2006-07, from the very strong growth of recent years. While the increase in petrol prices during 2005 will have contributed to the slowing in consumption, the moderation predominantly reflects the plateau in house prices. Dwelling investment has also moderated, although the current dwelling cycle is likely to be very muted compared with past cycles. In

contrast, business investment remains strong and is expected to continue to grow strongly over the forecast period. Strong demand for commodities and high rates of capacity utilisation should support business investment.

Exports are expected to grow more quickly in 2005-06 and 2006-07 than in recent years. The downward revision to export growth from Budget in 2005-06 reflects the lingering effects of disappointing winter crops in 2004 and lower growth in oil production than anticipated. Non-rural commodities are expected to be the main driver of export growth.

While employment has grown rapidly over the past year, growth is expected to ease over 2005-06, although remain strong enough to maintain the unemployment rate around its current low levels. Inflation is expected to rise in 2005-06 ahead of what was forecast at Budget, reflecting increases in petrol prices. In line with moderating employment and wage growth and assumed stable oil prices, headline inflation should ease from near the top to around the middle of the target band in 2006-07. Underlying inflationary pressures are expected to remain contained during this period of high headline inflation.

The risks to the domestic economy are around developments in non-rural commodities including oil, and the ongoing adjustment in housing and consumption. High commodity prices and the associated boom in resources activity are providing substantial impetus to the Australian economy. While these influences are expected to begin to wane, they are likely to continue to support growth over the forecast period. It may be the case that prices of non-rural commodities remain higher than expected, stimulating stronger growth in incomes than is currently forecast. To date, growth in non-rural commodity export volumes has been weaker than anticipated. If this sluggishness were to persist, GDP growth may be lower than forecast.

Were oil prices to continue to rise, this would present an upside risk to inflation and a downside risk to growth. However, to date, both the global and domestic economies have adapted remarkably well to higher oil prices. As noted at Budget, the risk of a disorderly adjustment in the housing market has continued to abate. However, it is still possible that consumption growth declines more than anticipated reflecting the cessation of rapid growth in house prices.

Table 2 presents the major economic parameters used in preparing the *Mid-Year Economic and Fiscal Outlook 2005-06*. The parameters for 2005-06 and 2006-07 are forecasts while those for 2007-08 and 2008-09 are projections. The projections of economic growth are based on analysis of underlying trends in employment and productivity combined with certain technical assumptions. As at Budget, commodity prices are assumed to return to their long-run average level over the two projection years. For a discussion of changes to the projections of employment and wages from 2008-09 onwards and commodity price assumptions, see the 2005-06 Budget. The projections of inflation are consistent with the medium-term inflation target band.

Part 1: Overview

Table 2: Major economic parameters^(a)

| | Forecasts | | Projections | |
|------------------|-----------|---------|-------------|---------|
| | 2005-06 | 2006-07 | 2007-08 | 2008-09 |
| Real GDP | 3 | 3 | 3 1/2 | 3 1/4 |
| Employment | 2 | 1 | 1 1/2 | 1 1/4 |
| Wage Price Index | 4 1/4 | 4 | 3 3/4 | 4 |
| CPI | 3 | 2 1/2 | 2 1/2 | 2 1/2 |

(a) Year-average percentage change.