

PART 1: OVERVIEW

The economic and fiscal outlook for Australia remains sound. The Australian economy is expected to grow modestly in 2006-07, despite the severe drought adversely affecting the farm sector and related industries. Strong fiscal outcomes are forecast and projected across the forward estimates.

An underlying cash surplus of \$11.8 billion is forecast for 2006-07, marginally stronger than the 2006-07 Budget forecast.

Estimated taxation receipts in 2006-07 are broadly unchanged from the 2006-07 Budget. A lower than expected receipts outcome in 2005-06, lower realised capital gains from investors and the effects of lower oil prices and higher deductible costs on petroleum resource rent tax have, together, broadly offset the effects of stronger employment growth and higher expected company profits.

Cash payments in 2006-07 are estimated to fall, largely reflecting slippage in some defence acquisition projects and lower payments across a range of income support programmes. These reductions are partially offset by policy measures announced since the Budget, including drought relief to support affected regions, new and expanded drug listings on the Pharmaceutical Benefits Scheme and payments to healthcare providers to ensure veterans continue to access free health care.

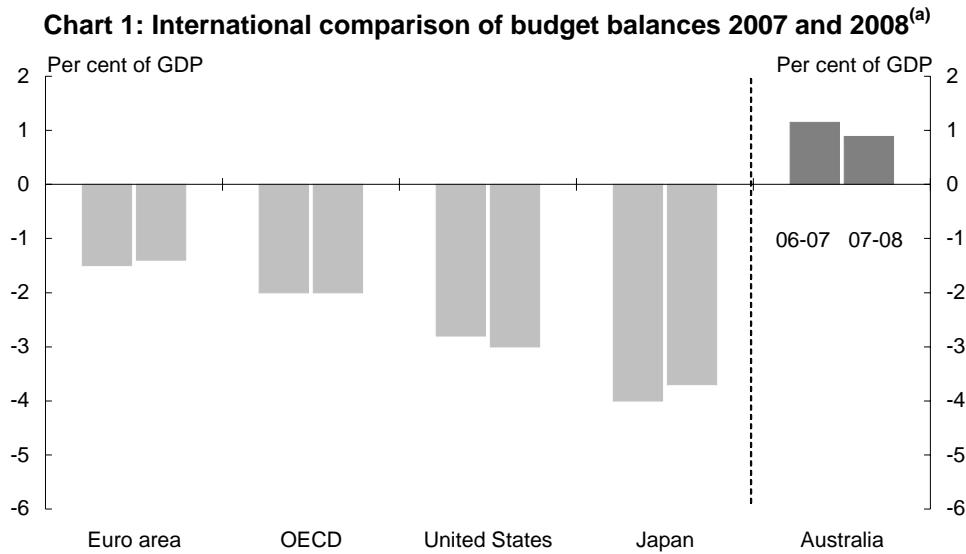
Table 1 presents the fiscal and underlying cash balances for 2006-07 and the forward years.

Table 1: Summary of budget aggregates

	Estimates			
	2006-07		2007-08	
	Budget	MYEFO	Budget	MYEFO
Underlying cash balance (\$b)(a)	10.8	11.8	10.6	9.7
Per cent of GDP	1.1	1.1	1.0	0.9
Fiscal balance (\$b)	10.3	10.4	9.9	9.9
Per cent of GDP	1.0	1.0	0.9	0.9
	Projections			
	2008-09		2009-10	
	Budget	MYEFO	Budget	MYEFO
Underlying cash balance (\$b)(a)	11.2	11.8	12.0	14.0
Per cent of GDP	1.0	1.0	1.0	1.2
Fiscal balance (\$b)	10.6	11.9	13.0	14.7
Per cent of GDP	1.0	1.0	1.1	1.2

(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 80, November 2006. 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 2006-07, higher than forecast at the 2006-07 Budget.

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 by 2½ per cent in 2006-07, significantly slower than the Budget forecast of 3¼ per cent. The downward revision to GDP growth largely reflects the severe drought being experienced across large parts of Australia. Farm GDP is now expected to fall by around 20 per cent in 2006-07, down from the 2 per cent increase anticipated at Budget. In 2007-08, GDP growth is forecast to accelerate to 3¾ per cent. Non-farm GDP is expected to grow by 3 per cent in 2006-07 and 3¼ per cent in 2007-08, while the farm sector is assumed to recover on the basis of a return to average seasonal conditions.

The outlook for the world economy remains positive, and is broadly unchanged from Budget. World GDP growth is expected to be 5¼ per cent in 2006, ¼ of a percentage point stronger than at Budget, before easing to 4¾ per cent in 2007. Ongoing above-average world growth is supporting a substantial increase in commodity prices, which is boosting Australian production and income growth.

The composition of Australian economic growth is expected to shift from business investment to exports through 2006-07 and 2007-08. Following four years of very

strong outcomes, business investment growth is expected to ease. The high level of investment and the resultant boost to resource sector productive capacity should support stronger non-rural commodity exports. Consumption growth is expected to remain moderate as the household sector continues to consolidate its financial position. This consolidation is being supported by solid income growth and further increases in net wealth. Dwelling investment is expected to undergo a modest recovery, after a mild slowdown.

Employment growth has been stronger than anticipated at Budget, contributing to the unemployment rate falling to 30-year lows. However, employment growth is expected to moderate in the period ahead, in line with around trend non-farm output growth. The easing in labour market conditions should see wage growth remain moderate.

Mostly reflecting sharp increases in fuel and fruit prices, inflation has been higher than anticipated at Budget. As these sharp increases unwind, inflation is expected to fall temporarily below 2 per cent in 2007. Underlying inflationary pressures are expected to ease gradually over the forecast period, with inflation settling in the middle of the target band by 2008.

The risks to the domestic economy are weighted to the downside, particularly if dry conditions persist and seasonal conditions do not return to average in 2007-08 as assumed. In addition, given the high level of household debt there remain downside risks around the speed and extent of the household sector's response to the recent tightening of monetary policy.

Prices for non-rural commodities are difficult to predict and if they were to remain high or increase further this would provide an additional boost to domestic income. However, there is a risk that if capital and labour do not move to the fast-growing sectors of the economy in response to the surge in commodity prices, output growth could be constrained and there may be further significant upward pressure on prices.

Table 2 presents the major economic parameters used in preparing the *Mid-Year Economic and Fiscal Outlook 2006-07*. The parameters for 2006-07 and 2007-08 are forecasts while those for 2008-09 and 2009-10 are projections. The projections of economic growth are based on analysis of underlying trends in employment and productivity. The projection assumption for productivity has been adjusted to reflect Australia's long-run average productivity growth rate of 1¾ per cent. As at Budget, key commodity prices are assumed to return to their long-run average level over the two projection years. This is broadly consistent with aggregate non-rural commodity prices retracing almost 60 per cent of their recent gain by the end of the projection period. For a discussion of this technical assumption see the 2006-07 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	
	2006-07	2007-08	2008-09	2009-10
Real GDP	2 1/2	3 3/4	3	3
Employment	2 1/4	1 1/4	1 1/4	1 1/4
Wage Price Index	4	4	4	4
CPI	3	2 1/2	2 1/2	2 1/2

(a) Year-average percentage change.