

PART 2: 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 (see Box 1). GDP growth is forecast to accelerate to 3¾ per cent in 2007-08. 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.

Prospects for world economic growth remain favourable. World GDP growth is forecast to be 5¼ per cent in 2006, ¼ of a percentage point higher than at Budget. In 2007 the world economy is expected to grow by 4¾ per cent, in line with the 2006-07 Budget outlook. The improved outlook for the world economy reflects stronger growth in the euro area and China.

Ongoing strong world economic growth and the continued high level of Australian business investment are expected to support a gradual shift in the composition of economic growth towards exports. Business investment as a share of GDP in 2005-06 was at its highest level for 32 years. As noted at Budget, this expansion in productive capacity is likely to result in strong non-rural commodity export volumes growth in 2006-07 and 2007-08.

Domestic incomes continue to be supported by high commodity prices, with the terms of trade reaching their highest level since the early 1950s. The surge in the terms of trade has seen domestic income grow substantially faster than GDP. Real gross domestic income increased by 5.0 per cent in 2005-06, well above the GDP growth rate of 2.9 per cent. Real gross domestic income is expected to again increase faster than real GDP in 2006-07, supported by continued commodity price growth.

The stimulus from commodity prices has been most pronounced in the resource-rich States of Western Australia and Queensland. Economic growth in both States has been substantially stronger than the rest of the economy. Gross State Product in both Western Australia and Queensland increased strongly in 2005-06, by 4.9 per cent, well above GDP growth of 2.9 per cent. This divergence in growth is expected to ease modestly over the forecast period.

Household consumption growth is expected to remain moderate in 2006-07 and 2007-08 as the household sector continues to consolidate its financial position. Following a period of rapidly increasing household debt, consumers have taken the opportunity in recent years to begin to rebuild their savings. This consolidation has been supported by strong household income growth, personal income tax cuts and increased support for families. Recent interest rate increases are expected to constrain consumption growth.

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Dwelling investment has shown signs of a modest recovery during 2006, following a mild downturn in the past two years. This recovery is expected to continue into 2007-08, largely driven by owner occupiers, with recent interest rate increases and modest rental yields expected to weigh more heavily on investors.

The performance of the labour market has been stronger than expected at Budget, with more rapid employment growth and the unemployment rate falling to a 30-year low of 4.6 per cent. Employment growth is expected to moderate over the forecast period, in line with around trend non-farm GDP growth. The unemployment rate is expected to be around 5 per cent in 2006-07 before rising slightly in 2007-08 – in part reflecting the impact of the Government's Welfare to Work reforms.

Inflation has been higher than anticipated at Budget, largely reflecting the jump in petrol prices in mid-2006 and the one-off effect of Tropical Cyclone Larry on fruit prices. Taken together these two effects have contributed half of the increase in inflation since the March quarter 2006. Inflation is expected to fall temporarily below 2 per cent when these factors unwind in 2007. Underlying inflationary pressures are also expected to moderate over the forecast horizon, with inflation expected to settle in the middle of the target band by 2008.

RISKS TO THE OUTLOOK

The risks around 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.

Australia continues to benefit from strong demand for our commodity exports. This surge in demand requires a large adjustment within the economy, with significant increases in the demand for labour and capital in the mining and related sectors. This adjustment will take time and so far has progressed smoothly. Wages and other input prices have increased to attract the required resources. To date, these sector-specific input cost increases have not spilled over into other sectors. However, there is a risk that if labour and capital do not move to the fast-growing sectors of the economy, output growth could be constrained and there may be more significant upwards pressure on prices.

Rising house prices in the early part of this decade contributed to rising household debt and increased the sensitivity of households to adverse labour market outcomes and interest rates. Moreover, while housing market conditions have improved in recent months, there remains considerable uncertainty around the pace and extent of household balance sheet consolidation. It is possible that consumption and dwelling investment growth will slow more than expected in response to recent higher interest rates and the expected easing in employment growth.

While high petrol prices have constrained consumption spending, the surge in other key commodity prices has significantly boosted investment and domestic incomes. The

surge in mining investment and exploration, in Australia and elsewhere, is expected to place downward pressure on commodity prices. Commodity prices are inherently difficult to predict, and if they were to remain high or increase further this would provide an additional boost to domestic income and production.

Forecasts for world growth have been revised up from Budget, although a number of downside risks remain. The potential for a larger-than-anticipated housing-led slowdown in output in the United States represents a significant downside risk to world activity. Whilst oil prices have moderated in recent months, they remain high and could retrace their recent falls. A disorderly adjustment of world saving and investment imbalances continues to be a risk to the global economy as such an outcome could substantially affect exchange rates and world growth.

INTERNATIONAL ECONOMIC OUTLOOK

At Budget, the world economy was expanding strongly, with the pattern of growth across countries becoming more broadly based. The world economy remained strong over the first half of 2006, with strong activity across most regions. More recently, growth outcomes have begun to diverge. In particular, the US economy has slowed, driven by a downturn in the housing market and the lagged effects of monetary policy tightening. Growth in the euro area and Japan remains strong, with business investment a key driver of domestic demand in these economies. China and India have continued to grow rapidly, and continued economic strength has been a feature in other regions such as Latin America, Central and Eastern Europe, and Africa.

Spare capacity has been steadily absorbed in a number of developed economies, which has led to emerging signs of inflationary pressure. Monetary policy has been tightened in all major advanced economies, including Japan. That said, long-term inflation expectations remain well contained, and have actually fallen recently amid expectations of a moderation in US demand.

The world economic growth forecast for 2006 has been revised to 5¼ per cent, ¼ of a percentage point higher than at Budget, while the 2007 forecast remains unchanged (Table 3). Major trading partner growth is expected to be 4¾ per cent in 2006, an upward revision from Budget of ¼ of a percentage point, while the 2007 forecast remains unchanged. These upward revisions are largely due to higher-than-expected growth in China and the euro area, which more than offset slight downward revisions to the outlook for the US and Japan.

Table 3: International GDP growth forecasts^{(a)(b)}

| | Actual | Forecasts | |
|------------------------|--------|-----------|-------|
| | 2005 | 2006 | 2007 |
| United States | 3.2 | 3 1/4 | 2 1/2 |
| Euro area | 1.4 | 2 3/4 | 2 |
| Japan | 1.9 | 2 | 2 |
| China | 10.2 | 10 1/2 | 10 |
| Other East Asia(c) | 4.9 | 5 1/2 | 5 |
| Major Trading Partners | 4.3 | 4 3/4 | 4 1/4 |
| Total OECD | 2.8 | 3 | 2 1/2 |
| World | 4.9 | 5 1/4 | 4 3/4 |

(a) Percentage change from preceding year.

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

(c) Other East Asia comprises the newly industrialised economies (NIEs), which constitutes Hong Kong, Korea, Singapore and Taiwan, and the Association of Southeast Asian Nations group of four (ASEAN4) which constitutes Indonesia, Malaysia, the Philippines and Thailand.

Source: National statistical publications, IMF and Treasury.

The outlook for the **United States** economy has deteriorated since Budget, with growth in the June and September quarters being weaker than anticipated. The US economy is expected to grow by 3¼ per cent in 2006, ¼ of a percentage point lower than at Budget, and 2½ per cent in 2007, ¾ of a percentage point lower than at Budget.

A contraction in residential investment is expected to continue to affect US growth into 2007. Moreover, the slowdown in the housing market is expected to result in a moderate slowing in consumption growth. However, overall domestic demand is expected to remain solid, reflecting high employment, firm wage growth and the recent moderation in oil prices. Business investment is expected to remain firm in 2007, with corporate profits currently strong and core capital goods orders remaining robust.

The likelihood of further increases in US interest rates appears to have diminished due to moderating output growth and inflation. However, the labour market remains tight and unit labour costs are rising, and there remains a risk that a continuation of the cyclical downturn in productivity could exacerbate inflation pressures.

In **Japan** the outlook for economic growth has been revised down since Budget. In part, this reflects weaker-than-expected growth in private consumption as a result of low incomes growth and one-off factors, such as unfavourable weather affecting clothing purchases. In addition, real GDP growth in 2005 has been revised down substantially, from 2.7 per cent to 1.9 per cent. Taking these effects together, the Japanese economy is expected to grow by 2 per cent in 2006, one percentage point lower than at Budget. GDP is expected to grow at a similar rate in 2007, with a modest pick-up in private consumption growth offsetting a moderation in the pace of business investment.

The Bank of Japan raised interest rates to 0.25 per cent in July, which was the first increase in almost six years. With recent core inflation outcomes being weaker than expected, further increases in interest rates are expected to occur very gradually.

Growth in the **Chinese** economy has exceeded expectations since Budget, largely due to a pick-up in investment growth in the first half of the year. The Chinese economy is forecast to grow by 10½ per cent in 2006 and 10 per cent in 2007, an upwards revision of ¾ of a percentage point from Budget in both years.

The pick-up in investment growth has led to renewed concerns about overheating and overinvestment, prompting the Chinese authorities to introduce further monetary and administrative tightening measures from April 2006. These measures have led to investment and GDP growth easing in the second half of 2006. GDP growth is expected to moderate slightly in 2007 but remain strong, with high rates of national saving, widespread urbanisation and the availability of a large pool of low-cost labour continuing to underpin the rapid pace of capital accumulation.

Growth in the rest of **East Asia** has evolved largely in line with expectations at Budget, with favourable world growth supporting robust demand for the region's exports and strong employment growth supporting consumption growth. However, growth prospects across the region are likely to diverge in 2007. The ASEAN4 economies are expected to continue growing strongly while growth in the NIEs is expected to moderate. A pick-up in domestic demand in the NIEs is likely to be insufficient to offset weaker demand for the region's exports particularly from the US.

Expectations for **euro area** growth in 2006 have improved markedly since Budget, with the 2006 forecast revised up by one percentage point, to 2¾ per cent, reflecting stronger-than-expected business investment. However, growth in 2007 is expected to moderate to around trend growth of 2 per cent, which predominantly reflects the fiscal consolidation packages that have been announced in Germany and Italy, as well as recent monetary policy tightening. The European Central Bank has raised official interest rates by a total of 150 basis points since December 2005.

There are a number of risks associated with the current outlook for the world economy with the balance of these risks tilted to the downside. These include: the potential for the US to slow more than expected; the possibility of higher oil prices; a re-appraisal of financial market risk; and a disorderly unwinding of world saving and investment imbalances.

An unexpectedly sharp slowdown in the US housing sector has emerged as a key risk to the US economy and the near-term world outlook. A sustained downturn in house prices could adversely affect consumption, depending on the extent to which households consolidate their balance sheets, which may precipitate a broader downturn in the US economy. Recent IMF estimates suggest that an unexpected one percentage point decline in US growth could lower world growth by around ½ of a percentage point.

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Oil prices are currently around 20 per cent below the August peak of US\$77 per barrel. Whilst the fall in prices is likely to provide some relief to consumers it may be short-lived. Supply-side concerns linger, and the spectre of further increases in prices remains a feature of the current market.

An increase in inflation expectations in mid-2006, and associated fears over the potential for more aggressive monetary policy tightening in advanced economies, sparked a sharp sell-off in financial markets. Financial markets have since recovered with recent months marked by a period of relatively low volatility. That said, the world financial system is not immune to adverse economic shocks, and in particular a shock which might lead to a reassessment of credit risk or expose weaknesses in risk management practices.

Whilst an orderly unwinding of world saving and investment imbalances remains the most likely path of adjustment over the medium term, the longer the imbalances continue, the greater is the potential for a sudden adjustment. Recent weakness in the US dollar may provide a tentative indication that the adjustment process is already under way. A disorderly adjustment would involve sudden changes in financial asset prices and exchange rates. A sudden adjustment of this sort could have serious implications for world economic activity.

DOMESTIC FORECASTS

The forecasts for the domestic economy are underpinned by several technical assumptions. The exchange rate is assumed to remain around the average level of recent months (a trade-weighted index of around 64 and a \$US exchange rate of around 77c). Interest rates are assumed to remain unchanged at their current levels. World oil prices (West Texas Intermediate) are assumed to be around \$US65 per barrel on average, in line with current market expectations. The farm sector forecasts are based on an assumed return to average seasonal conditions in 2007-08.

The Australian economy is forecast to grow by 2½ per cent in 2006-07 and 3¾ per cent in 2007-08. The key domestic economic forecasts are summarised in Table 4.

Table 4: Domestic economy forecasts^(a)

| | 2005-06 | 2006-07 | |
|---|--------------|------------------------|-----------------------|
| | Outcomes(b) | Forecasts | |
| | Year average | Budget Year average | MYEFO Year average |
| Panel A - Demand and output(c) | | | |
| Household consumption | 2.6 | 3 | 3 |
| Private investment | | | |
| Dwellings | -3.8 | -1 | 2 |
| Total business investment(d) | 16.0 | 8 | 1 |
| Non-dwelling construction(d) | 21.0 | 6 | 6 |
| Machinery and equipment(d) | 14.5 | 9 | -4 |
| Private final demand(d) | 4.3 | 3 3/4 | 2 1/2 |
| Public final demand(d) | 4.3 | 3 1/4 | 3 1/4 |
| Total final demand | 4.3 | 3 1/2 | 2 3/4 |
| Change in inventories(e) | | | |
| Private non-farm | -0.5 | 0 | 1/4 |
| Farm and public authorities(f) | 0.2 | - 1/4 | - 1/4 |
| Gross national expenditure | 4.0 | 3 1/2 | 2 1/2 |
| Exports of goods and services | 2.2 | 7 | 4 |
| Imports of goods and services | 7.3 | 7 | 5 |
| Net exports(e) | -1.1 | - 1/2 | - 1/2 |
| Gross domestic product | 2.9 | 3 1/4 | 2 1/2 |
| Non-farm product | 2.8 | 3 1/4 | 3 |
| Farm product | 4.5 | 2 | -21 |
| Panel B - Other selected economic measures | | | |
| External accounts | | | |
| Terms of trade | 10.9 | 0 | 5 |
| Current account balance | | | |
| \$billion | -53.6 | -62 1/2 | -51 1/4 |
| Percentage of GDP | -5.6 | -6 1/4 | -5 |
| Labour market | | | |
| Employment (labour force survey basis) | 2.2 | 1 | 2 1/4 |
| Unemployment rate (per cent) | 5.1 | 5 1/4 | 5 |
| Participation rate (per cent) | 64.5 | 64 1/4 | 64 3/4 |
| Prices and wages | | | |
| Consumer Price Index | 3.2 | 2 3/4 | 3 |
| Gross non-farm product deflator | 5.0 | 2 1/2 | 4 |
| Wage Price Index | 4.1 | 4 | 4 |

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

(b) Calculated using original data.

(c) Chain volume measure.

(d) Excludes second-hand asset sales from the public sector to the private sector.

(e) Percentage point contribution to growth in GDP.

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

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

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Household consumption is expected to grow by 3 per cent in 2006-07 and 3¼ per cent in 2007-08, slightly faster than the 2.6 per cent growth recorded in 2005-06. As at Budget, consumption growth is expected to remain a little below trend, reflecting ongoing consolidation in household balance sheets. Consumption growth is being supported by solid increases in household incomes reflecting strong employment growth, personal income tax cuts and more recently lower petrol prices. Household net wealth is expected to grow modestly, in part reflecting a return to moderate house price growth which will also support consumption. These factors are being partially offset by an increased household debt-servicing burden given the recent increases in interest rates.

Dwelling investment is expected to grow modestly in both 2006-07 and 2007-08, following mild declines in the preceding two years. Solid dwelling investment growth since Budget and the recent firm dwelling approval outcomes signal a modest recovery in the housing market. The recovery in dwelling investment is expected to be led by alterations and additions and purchases by owner-occupiers, as the recent interest rate increases and low rental yields are expected to continue discouraging investors.

Business investment growth is expected to slow significantly to 1 per cent in 2006-07 and remain moderate in 2007-08. This is weaker than expected at Budget and follows four years of robust growth. The Australian Bureau of Statistics' September 2006 *Survey of New Capital Expenditure and Expected Expenditure (CAPEX)* indicates that investment intentions for 2006-07 are weak across most industries. However, the investment environment remains favourable, particularly for the mining sector and new buildings and structures investment, with the cost of capital remaining low, corporate finances healthy and capacity utilisation around record highs.

Public final demand is expected to ease to 3¼ per cent in 2006-07. This follows two years of strong public investment growth at both the Commonwealth and State and Local levels.

Net exports are expected to subtract significantly less from GDP growth over the forecast period than they have in recent years, largely due to expected strong growth in non-rural commodity exports and moderate growth in imports.

Exports are expected to increase by 4 per cent in 2006-07 and by 6 per cent in 2007-08. The weaker outlook for export growth compared with Budget reflects a weaker outlook for rural and elaborately transformed manufactures (ETM) exports. The effect of weaker farm production on rural exports is expected to be partially offset by a run-down in grain inventories from their current high levels. Non-rural commodities exports are expected to grow strongly in 2006-07 and 2007-08, as production from newly completed projects increases. ETM and service exports are expected to record only modest growth in 2006-07, reflecting continued international competitive pressures and sustained higher air travel costs to Australia.

Imports growth is expected to remain around 5 per cent in 2006-07 and 6 per cent in 2007-08, reflecting solid growth in gross national expenditure.

The **terms of trade** have increased to their highest level since the early 1950s. This outcome is higher than expected at Budget, reflecting higher non-rural commodity prices. The terms of trade is expected to fall in 2007-08, reflecting falls in non-rural commodity prices and modest increases in import prices. Recent high commodity prices have encouraged substantial investment in mining capacity, both in Australia and around the world. As this increased capacity comes on line, it is expected to lead to a decline in commodity prices.

The **current account deficit** (CAD) is expected to narrow in 2006-07, in contrast to an expected widening at Budget. The higher terms of trade and slower import growth have contributed to the improved outlook for the CAD. High domestic profits combined with an increase in world interest rates and a higher stock of net foreign debt are expected to contribute to a widening of the net income deficit in 2006-07. As commodity prices partially unwind, the CAD is expected to widen modestly in 2007-08.

Recent **employment** outcomes have been substantially stronger than anticipated at Budget, with the unemployment rate falling to 4.6 per cent, a 30-year low. Employment is expected to increase by 2¼ per cent in 2006-07, before moderating to 1¼ per cent in 2007-08. The unemployment rate is expected to be around 5 per cent in 2006-07, lower than the Budget forecast of 5¼ per cent.

The participation rate has been higher than anticipated and is expected to rise further in 2007-08, largely reflecting the Government's Welfare to Work reforms. Participation requirements for Disability Support Pension and Parenting Payment recipients should lead to more people entering the labour force, boosting Australia's productive capacity. The unemployment rate is expected to increase in 2007-08 as the people entering the labour market as part of the Welfare to Work reforms take time to gain employment.

Wage growth is expected to remain contained. The Wage Price Index is expected to grow by 4 per cent in 2006-07 and 2007-08. Recently growth has moderated, although this in part reflects a change in the timing of award wage increases announced by the Fair Pay Commission. While wage growth has been strong in some sectors, particularly in mining and construction and to a lesser extent the public sector, these sector-specific pressures are not expected to spill over to more rapid aggregate wage increases.

Inflation has been higher than expected at Budget, largely reflecting the jump in petrol prices in mid-2006 and the one-off impact of Tropical Cyclone Larry on fruit prices, although underlying inflationary pressures have also been present. As petrol and fruit prices unwind in 2007, inflation is expected to fall temporarily below 2 per cent. The indirect effects of higher fuel prices and solid unit labour cost growth have also

contributed to recent inflationary pressures. With petrol prices now below recent highs and productivity growth expected to strengthen, these underlying inflationary pressures are expected to moderate, resulting in inflation returning to around the middle of the target band by 2008.

Box 1: Drought

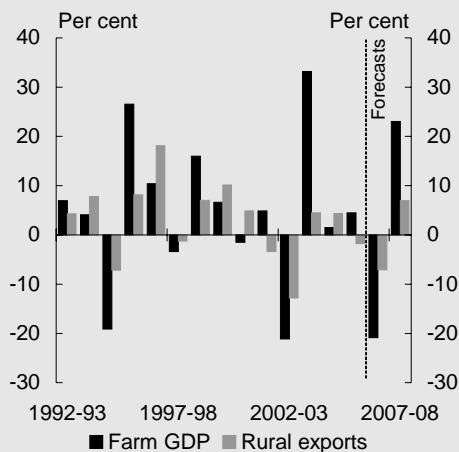
Severe drought conditions have affected large areas of Australia during 2006. As a result, farm production is forecast to fall by around 20 per cent in 2006-07. The drought is expected to subtract $\frac{3}{4}$ of a percentage point from GDP growth in 2006-07, reflecting its impact on the farm sector and related industries, such as transport and storage.

The expected fall in farm production is close to that experienced in the 2002-03 drought (Chart A). The effect of the drought on rural exports is expected to be reduced slightly by running down the current high level of grain stocks. Nevertheless, rural exports are forecast to fall by 7 per cent in 2006-07.

Most components of farm production are expected to be affected significantly by the drought, with winter grain production expected to be hardest hit. Wheat production is likely to fall by more than 60 per cent and be the smallest harvest since the 1994-95 drought. Very poor pasture conditions, water shortages and high feed prices are resulting in sharp reductions in sheep and cattle numbers.

The impact of the drought is expected to be more pronounced across southern Australia. Rainfall deficiencies during the winter cropping season were particularly bad in Western Australia's grain belt and across much of New South Wales, Victoria and South Australia.

Chart A: Farm production and rural exports



Source: ABS cat. no. 5302.0, 5206.0 and Treasury.

Farm incomes are expected to be severely affected by the drought. Lower farm incomes are likely to lead to lower consumption, investment and employment in rural communities. To some degree this will be mitigated by the Farm Management Deposits scheme, which allows farmers to draw down savings, and by Exceptional Circumstances assistance.

Higher grain and fruit and vegetable prices will flow through to retail prices. However, in the short term, retail meat prices are likely to moderate in response to increased livestock slaughter rates. Overall, the net effect on inflation is expected to be relatively small.