

PART 3: ECONOMIC OUTLOOK

The Australian economy is expected to grow by 4¼ per cent in 2007-08, stronger than the 3¾ per cent forecast at Budget. The economy's supply potential is expected to expand at a faster-than-usual pace, reflecting strong and sustained business investment. Growth in export volumes is forecast to accelerate as increased capacity comes on line. The prospects for the household sector are favourable, buoyed by growth in incomes and wealth. The forecast for 2007-08 also reflects a partial recovery from the drought, which is expected to add ½ of a percentage point to GDP growth.

The economic forecasts have been framed against a backdrop of significant turbulence in global financial markets. Rising default rates on sub-prime mortgages in the United States have led to reduced liquidity and increased volatility in world financial markets. The ongoing implications of this turbulence for the domestic and world economies are uncertain, introducing greater risks to the outlook. These events have occurred at a time when there has been significant momentum in the domestic and global economies.

World GDP is forecast to grow by 5 per cent in 2007 and 4¾ per cent in 2008. The slight downward revision to the outlook for 2008 from the Budget forecast of 5 per cent reflects weaker growth in the United States. Growth is expected to be strong across emerging market economies, and demand from these regions is expected to continue to support export growth in major developed economies.

The Australian economy will continue to be influenced by strong global demand for mineral and energy resources. Business investment grew by 7.1 per cent in 2006-07, following double-digit growth in each of the preceding four years. The increase in commodity prices has boosted mining profits and investment. Investment is also strong in other sectors such as manufacturing, and property and business services. A continuation of strong business investment is forecast for 2007-08 and 2008-09. The strength of corporate balance sheets and profits will continue to support high levels of business investment, notwithstanding possible upward pressure on financing costs as a result of recent financial market developments.

Growth in mining production and export volumes is expected to accelerate from 2007-08 as projects come on line. The mining industry has invested \$76 billion over the past six years and strong investment is expected to continue. Nominal business investment as a share of GDP is at its highest level in 33 years and is anticipated to remain around this level.

The terms of trade are forecast to rise modestly by 1¼ per cent in 2007-08, rather than fall slightly as expected at Budget. The upward revision largely reflects anticipated strength in the prices of Australia's bulk commodity exports of iron ore and coal. World demand is expected to outpace supply in these markets. In contrast, falls in base metal prices are expected as global supply in these markets increases. The increased

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downside risks to the world economy create more uncertainty around the outlook for commodity prices.

Ongoing growth in household incomes, wealth and employment is expected to result in strong household consumption growth, and a pick-up in dwelling investment growth in 2008-09. Household incomes are expected to be higher than forecast at Budget. Employment growth is forecast to be strong, supported by strong domestic demand, high participation and increased immigration.

Wage and inflation pressures are expected to ease over the forecast horizon. Current pressure on food prices reflects unfavourable weather conditions and low water allocations in the Murray-Darling Basin. An easing in underlying inflation is expected as demand pressures ease and growth in unit labour costs slows as productivity strengthens.

INTERNATIONAL ECONOMIC OUTLOOK

As reported at Budget, the world economy recorded its fastest growth rate in over 30 years in 2006. World growth remained strong in the first half of 2007, although recent disruptions in global financial markets have resulted in a more uncertain outlook. While continued robust growth in emerging market countries, particularly China and India, is expected to underpin global growth in the coming period, downside risks have increased and require careful monitoring.

Growth in China and India accelerated over the first half of 2007, continuing to exceed expectations. Growth has also been exceptionally strong across other emerging market economies in Latin America, Eastern Europe, the Commonwealth of Independent States and sub-Saharan Africa, with high commodity prices supporting economic activity in a number of these regions. Demand from these regions has fuelled export growth in major developed economies, in particular the euro area and Japan. Growth in the United States has remained constrained by weakness in its housing market and a recent tightening in corporate credit conditions. A return to trend growth for the US in 2008, as expected at Budget, now appears unlikely.

The world economic growth forecasts for 2007 remain unchanged at 5 per cent and have been revised down slightly to 4¾ per cent in 2008 (Table 4). The downward revision in 2008 reflects a weaker outlook for the United States.

In contrast, major trading partner growth has been revised up by ½ of a percentage point to 5 per cent in 2007 and by ¼ of a percentage point to 4¾ per cent in 2008. This upward revision is largely due to higher-than-expected growth in China and India, and the other East Asian economies in the first half of 2007, and an expectation of continued strong growth for China and India in 2008. The upward revisions more than offset a downward revision to the outlook for the US economy over both years. In the

absence of the forecast deeper slowdown in the United States, economic growth in emerging economies would likely have been stronger than currently forecast.

Table 4: International GDP growth forecasts^{(a)(b)}

	Actual	Forecasts	
	2006	2007	2008
United States	2.9	2	2 1/4
Euro area	2.9	2 3/4	2 1/4
Japan	2.2	2	2
China	11.1	11 1/4	10 1/2
India	9.6	9 1/4	8 1/2
Other East Asia(c)	5.6	5 1/4	5 1/4
Major trading partners	5.1	5	4 3/4
Total OECD	3.1	2 1/2	2 1/2
World	5.4	5	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.

Recent financial market developments present a significant downside risk to the favourable world outlook. Continued deterioration in the US sub-prime mortgage market, and concerns over exposures to financial securities backed by sub-prime mortgages, have triggered a repricing of risk, a flight to liquid financial assets and a tightening in corporate credit conditions across global markets. The flight to liquid assets has generated a large rise in the spread between policy rates and inter-bank lending rates.

Major central banks have responded by injecting large amounts of liquidity into banking systems. Further, at its September meeting, the US Federal Reserve lowered the target for its main policy rate, the federal funds rate, by 50 basis points to 4.75 per cent. The Fed noted that its action was 'intended to help forestall some of the adverse effects on the broader economy that might otherwise arise from the disruptions in financial markets'. Other major central banks have adopted a 'wait-and-see' approach with regard to their policy rates. Prior to the recent financial market turbulence, the European Central Bank, the Bank of England and the Bank of Japan had all been expected to raise rates further this year.

Developments in the US sub-prime mortgage market have the potential to cause further disruption in global financial markets. With a large number of outstanding sub-prime mortgages originated over 2005 and 2006, in the latter stages of the US housing boom, arrears and defaults could increase throughout the remainder of 2007 and into 2008.

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While there are some pressures to headline inflation around the world from sharp increases in food and fuel prices, core inflation generally remains contained. Crude oil prices (West Texas Intermediate) have trended upwards since May this year, underpinned by increasing demand from US refiners. Global oil markets remain tight, which could lead to further rises in oil prices and consequently add to global inflationary pressures.

The recent financial market turbulence increases the possibility of a recession in the **United States** in 2008. Notwithstanding this possibility, most forecasters continue to expect modest growth. We now expect the US economy to grow by 2 per cent in 2007, $\frac{1}{4}$ of a percentage point lower than at Budget, and $2\frac{1}{4}$ per cent in 2008, $\frac{3}{4}$ of a percentage point lower than at Budget. These forecasts factor in some impact from the repricing of risk on housing and consumption.

The US labour market has shown signs of gradual softening over the past year. Nevertheless, continued employment growth, together with solid growth in personal incomes, has supported ongoing consumption growth. In addition, business investment appears to be firming, with high corporate profits and capacity utilisation rates likely to support further investment. US exports have been growing at a strong rate over the past year and robust world growth is likely to support a further expansion into 2008.

The economic outlook for **Japan** is unchanged since Budget, with growth of 2 per cent expected in both 2007 and 2008. The 2007 outlook reflects solid, but slowing, business investment growth and firm export growth. In 2008, a modest improvement in consumption and continued support from exports is expected to offset a moderation in the pace of business investment. A key challenge remains to generate and sustain rising consumer prices, something that has been absent from Japan for a decade.

Economic growth in **China** has exceeded expectations since Budget, driven largely by a pick-up in investment and net exports. Growth for 2006 was also revised up from 10.7 per cent to 11.1 per cent. The Chinese economy is now forecast to grow by $11\frac{1}{4}$ per cent in 2007 and $10\frac{1}{2}$ per cent in 2008, upward revisions of $\frac{3}{4}$ and $\frac{1}{4}$ of a percentage point since Budget.

Strong GDP growth, along with a recent surge in consumer prices, has seen increasing concern about the sustainability of China's growth. However, economic fundamentals in China remain relatively favourable, with growth more broadly based than in earlier periods. Investment growth appears more sustainable, company profits are strong and domestic consumption is increasingly contributing to growth. In addition, core inflation remains subdued, with little evidence of wider price pressures.

Economic conditions in **India** have also been stronger than expected, with growth revised up to 9.6 per cent in 2006. The stronger growth has continued into 2007, driven by strong domestic demand, particularly from the service and industry sectors. The Indian economy is now forecast to grow by $9\frac{1}{4}$ per cent in 2007 and $8\frac{1}{2}$ per cent

in 2008, a little higher than expected at Budget. The expected mild slowing in 2008 reflects a moderation in domestic demand, partly due to a recent tightening of monetary conditions by the Reserve Bank of India.

Expectations for growth in the rest of **East Asia** have been revised up slightly since Budget, with the 2007 and 2008 forecasts both higher by $\frac{1}{4}$ of a percentage point to $5\frac{1}{4}$ per cent. Since Budget, growth has converged across the region due to stronger-than-expected consumption and investment in the NIEs. Growth in the rest of East Asia is now forecast to be supported by solid domestic demand in 2007 and a slight pick-up in exports in 2008.

Expectations for **euro area** growth in 2007 have improved modestly since Budget, with the 2007 forecast revised up by $\frac{1}{4}$ of a percentage point to $2\frac{3}{4}$ per cent. Although GDP growth fell below trend in the June quarter, it is expected to rebound over the remainder of 2007. In 2008, growth is expected to moderate to $2\frac{1}{4}$ per cent, reflecting the impact on domestic demand of previous monetary tightening and slightly slower export growth, reflecting the high euro exchange rate.

RISKS TO THE OUTLOOK

Recent financial market developments present a significant downside risk to the world and domestic economic outlooks. Further volatility in financial markets has the potential to result in slower growth in the United States and consequently dampen world growth more broadly through trade and financial market linkages.

In the Australian economy, higher borrowing costs would weigh on dwelling and business investment, as well as household consumption. A significant slowdown in world growth would also slow the demand for Australia's exports and could result in falls in commodity prices. Significant commodity price falls would lower growth in national income and activity.

Alternatively, should the recent financial market turbulence continue to be resolved in a relatively benign fashion, stronger outcomes for the domestic economy are possible. This is especially the case given the magnitude of investment projects in the pipeline. In this event, stronger growth in an economy that is close to full employment could add to wage and price pressures, although these pressures may be offset somewhat by a higher exchange rate. The Australian dollar has appreciated significantly recently and, were this appreciation to be sustained, it would have some dampening effect on economic activity and prices.

Dry weather conditions and low water storage levels continue to pose a downside risk to farm production. While timely rains provided for a good start to the 2007 winter cropping season, a lack of follow-up rains has adversely affected the winter crop. The forecasts take this and the current low water allocations in the Murray-Darling Basin

into account, but rely on the usual Budget assumption of average seasonal conditions for the remainder of the forecast period.

DOMESTIC ECONOMY FORECASTS

The domestic economy forecasts are based on several technical assumptions. The exchange rate is assumed to remain around its average level of recent months – a trade weighted index of around 67.5 and a United States dollar exchange rate of around 85 US cents. Domestic interest rates are assumed to remain unchanged at current levels. World oil prices (West Texas Intermediate) are assumed to move in line with market expectations and remain around US\$75 per barrel on average over the forecast period. The farm sector forecasts are based on an assumption of average seasonal conditions in the future, but take into account weather outcomes experienced in the early part of 2007-08 and the current very low water storage levels.

The Australian economy is forecast to grow by 4¼ per cent in 2007-08 and 3½ per cent in 2008-09. The key domestic economy forecasts are summarised in Table 5.

Table 5: Domestic economy forecasts^(a)

	2006-07	2007-08	
	Outcomes(b)	Forecasts	
	Year average	Budget Year average	MYEFO Year average
Panel A - Demand and output(c)			
Household consumption	3.7	3 1/2	4 1/4
Private investment			
Dwellings	3.6	2 1/2	3
Total business investment(d)	7.1	7 1/2	9 1/2
Non-dwelling construction(d)	12.6	7	9
Machinery and equipment(d)	3.1	6 1/2	8
Private final demand(d)	4.2	4 1/4	5 1/4
Public final demand(d)	5.2	3 3/4	4 1/2
Total final demand	4.5	4	5
Change in inventories(e)			
Private non-farm	0.3	0	0
Farm and public authorities(f)	-0.2	1/4	0
Gross national expenditure	4.5	4 1/4	5
Exports of goods and services	3.9	5	4 1/2
Imports of goods and services	9.5	6 1/2	8 1/2
Net exports(e)	-1.4	- 1/2	-1
Gross domestic product	3.3	3 3/4	4 1/4
Non-farm product	3.9	3 1/2	4
Farm product	-19.2	18	14
Panel B - Other selected economic measures			
External accounts			
Terms of trade	7.3	-1 1/2	1 1/4
Current account balance			
\$billion	-59.2	-65 3/4	-71 1/4
Percentage of GDP	-5.7	-6	-6 1/4
Labour market			
Employment (labour force survey basis)	2.7	1 1/2	2 1/4
Unemployment rate (per cent)	4.5	5	4 1/2
Participation rate (per cent)	64.8	65	65 1/4
Prices and wages			
Consumer Price Index	2.9	2 1/2	2 3/4
Gross non-farm product deflator	4.9	2 1/2	2 3/4
Wage Price Index	4.0	4 1/4	4 1/4

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

(b) Calculated using original data.

(c) Chain volume measures.

(d) Excluding second-hand asset sales from the public sector to the private sector and including the impact of the privatisation of Telstra.

(e) Percentage point contribution to growth in GDP.

(f) For presentational purposes, 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 4¼ per cent in 2007-08, stronger than forecast at Budget, before moderating in 2008-09. The upward revision reflects a more positive outlook for household incomes, largely as a result of stronger anticipated employment growth. Household income growth is expected to outpace consumption growth and hence the household saving ratio is anticipated to rise. The recent interest rate rise, combined with the possible impact of increased credit market spreads on household borrowing costs, will have a moderating effect on consumption.

Dwelling investment is expected to continue its modest recovery in 2007-08, with forecast growth of 3 per cent. Dwelling approvals and housing finance data indicate a modest near-term outlook for dwelling investment, with the recent interest rate rise and uncertainty around the flow-on effects from the US sub-prime housing market likely to be weighing on the market. Further, there are also ongoing supply constraints on dwelling investment. However, the indicators of underlying housing demand remain strong, supported by strong population growth. As such, dwelling investment growth is expected to pick-up in 2008-09.

Business investment is expected to grow by 9½ per cent in 2007-08, with the outlook for both machinery and equipment, and engineering construction investment improving since Budget. The Australian Bureau of Statistics' *Survey of Private New Capital Expenditure and Expected Expenditure* suggests broad strength in plant and equipment investment in the period ahead. Strength in new engineering construction investment reflects planned new projects and a record amount of work under construction. Strong corporate balance sheets and profits will continue to support high levels of business investment. However, the recent global financial market volatility has put some upward pressure on financing costs. This is likely to result in slightly lower levels of investment than would have otherwise been the case.

Public final demand is expected to grow by 4½ per cent in 2007-08, stronger than expected at Budget. State and local government investment is expected to increase strongly, reflecting a large number of infrastructure projects. Public consumption growth is expected to remain solid.

Net exports are expected to subtract 1 percentage point from GDP growth in 2007-08, a larger subtraction than forecast at Budget. While a recovery in export volumes is expected, imports are forecast to grow more strongly, consistent with stronger consumption and higher investment. Significant growth in non-rural commodity exports is expected, while rural exports are anticipated to be constrained by the weakness in farm production. Elaborately transformed manufactures and services exports are expected to grow solidly, although the uncertainty around the world outlook poses some downside risk.

The **terms of trade** are expected to rise modestly by 1¼ per cent in 2007-08, rather than fall slightly as forecast at Budget. The upward revision largely reflects anticipated strength in Australia's bulk commodity export prices, with world demand expected to outpace supply in iron ore and coal markets. Falls in base metal prices are expected, in

line with increasing global supply in these markets. While world growth is expected to support increases in commodity prices, there is a risk that weaker-than-expected world demand could have a significant negative impact on prices.

The **current account deficit** (CAD) is forecast to widen to 6¼ per cent of GDP in 2007-08, reflecting expected higher investment and relatively unchanged national saving as a share of GDP. The net income deficit component of the CAD is expected to widen, reflecting growth in corporate profits and rising net interest payments from a higher stock of net foreign debt.

Employment growth is expected to be 2¼ per cent in 2007-08, consistent with strong GDP growth. The participation rate is expected to rise to 65¼ per cent, while the unemployment rate is forecast to rise modestly from current levels to 4½ per cent. The rise in the participation and unemployment rates partly reflects the new eligibility and participation requirements for Disability Support Pension and Parenting Payment recipients. Employment growth is expected to moderate in 2008-09, in line with a moderation in economic growth and higher near-term growth in labour costs.

Wages are expected to grow by 4¼ per cent in 2007-08 and 2008-09. Strong wage growth is expected to continue in the States and industries most directly affected by robust mining and construction activity. Wage growth is expected to ease over the forecast horizon to 4 per cent through the year to the June quarter 2009.

Inflation is forecast to be 2¾ per cent in 2007-08 and 2008-09. In through-the-year terms, inflation is forecast to ease to 2½ per cent in the June quarter 2009. There are some inflationary pressures, with low water allocations in the Murray-Darling Basin and ongoing dry weather, combined with one-off weather events such as frost, contributing to higher food prices. Underlying inflationary pressures are expected to ease over the forecast horizon in line with moderating domestic demand, increases in the economy's supply potential and lower growth in unit labour costs.

