

PART 3: ECONOMIC OUTLOOK

The forecasts for MYEFO have been prepared against the backdrop of the most significant upheaval in global financial markets since the Great Depression. The fallout from the sub-prime crisis in the United States has spread around the world, with the global downturn now expected to be deeper and more widespread. The G7 economies are expected to be in recession in 2008, leading to a slowdown in growth in emerging economies. These global developments will have inevitable consequences for the Australian economy, with growth expected to slow to 2 per cent in 2008-09, $\frac{3}{4}$ of a percentage point lower than expected at Budget. However, Australia's sound fiscal and monetary policy position means it is better placed to navigate through this crisis than most countries.

The global economy is facing the most challenging set of economic conditions seen in several generations. A further escalation in financial market turbulence was identified as a significant downside risk at Budget in May – a risk that has now crystallised (Box 1). Although some measure of stability appeared to be returning to financial markets after the takeover of Bear Stearns in March, the collapse of Lehman Brothers in mid-September led to a renewed crisis of confidence in financial systems. This resulted in sharp rises in interbank lending rates, distortions in credit markets and large falls on global equity markets. The global financial crisis has come on top of large commodity and housing market shocks, and has seen growth forecasts revised down around the world.

The world economy is forecast to grow by $3\frac{3}{4}$ per cent in 2008 and 3 per cent in 2009. Although world growth outcomes were relatively favourable over the first half of 2008, there is now clear evidence of a global economy under severe stress and showing the effects of the global financial crisis on economic growth. World growth in 2009 has been revised down by 1 percentage point since Budget, with GDP growth expected to be weak across the advanced economies. Emerging market economies are also increasingly hampered by developments on global financial markets, as global trade slows, risk aversion among investors increases, and external financing becomes more difficult. Significant uncertainty remains around the extent, pace and distribution of the downturn in world growth.

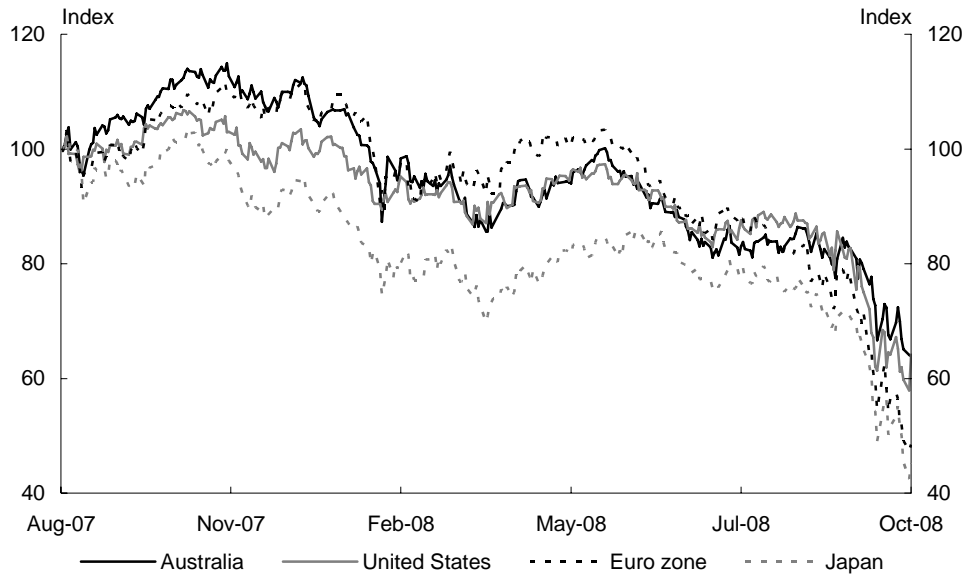
These global events will have an inevitable impact on Australia. The initial effects have been felt principally on financial markets, but increasingly will flow through to the real economy over the forecast period (Box 2).

Credit conditions have been tight. Banks have passed on higher funding costs stemming from the global financial crisis to consumers and businesses, and have taken a more cautious approach to lending as recent events have shaken confidence. Although official interest rates have been cut significantly in recent months, it will take some time for the full impact of these cuts to flow through to the economy. As in other countries, Australia has faced a sharp fall on share markets and increased volatility,

Part 3: Economic outlook

with swings of 5 to 10 per cent in intra-day trading (Chart 3.1). The All Ordinaries and ASX 200 have fallen by around 40 per cent since the beginning of 2008. The Australian dollar has also depreciated sharply, falling by around 30 per cent in trade-weighted terms from its peak in July this year.

Chart 3.1: Global equity markets



Source: Standard and Poor's and Reuters.

A weaker world economic outlook is already having implications for commodity prices. While current US dollar prices for the major bulk commodities of iron ore and coal have been largely locked into contracts until March 2009, expectations for prices after this contract period ends have been downgraded significantly, driven by a weaker outlook for growth and demand from emerging economies, including China. Prices for base metals have already seen sharp falls, and spot prices for iron ore and coal have also fallen below current contract prices (Chart 3.2). While the depreciation of the exchange rate will dampen the falls in Australian dollar terms, the terms of trade are expected to decline from recent peaks in 2009-10 (Chart 3.3).

The outlook for household consumption has deteriorated significantly since Budget. Consumers have been weighed down by an extended period of relatively high interest rates until mid-2008, and tighter lending conditions. The global financial crisis has led to sharp falls in asset values and confidence around the world. However, lower borrowing costs and the fiscal stimulus from the Government's Economic Security Strategy will support consumption growth over the forecast period.

Chart 3.2: Bulk commodity spot prices

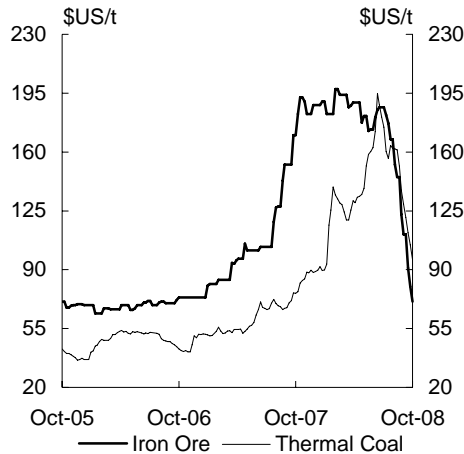
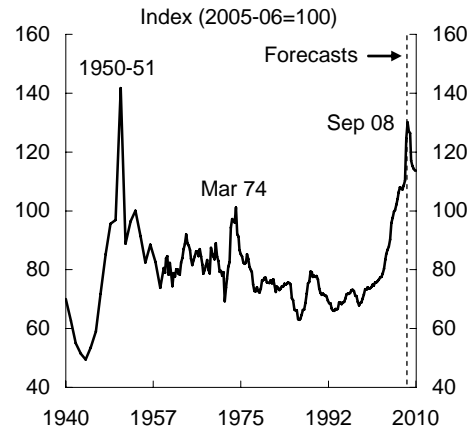


Chart 3.3: Terms of trade



Source: Bloomberg and Global Coal (Chart 3.2). From September quarter 1959, quarterly data from ABS cat. no. 5206.0; prior to September quarter 1959, M W Butlin (1977) 'A Preliminary Annual Database 1900-01 to 1973-74', RBA Discussion Paper 7701 (Chart 3.3).

Dwelling investment is expected to remain subdued in the near term as tighter credit conditions and low levels of confidence act to constrain activity. Interest rate cuts, together with strong underlying demand and the First Home Owners Boost for new houses should support a recovery in dwelling investment over the forecast horizon.

Business investment growth is expected to remain solid in 2008-09, albeit lower than expected at Budget. The large amount of work already underway, both mining and non-mining, is expected to support growth in the near term and keep investment at historically high levels. As these projects are completed, growth is expected to slow, as fewer projects are added to the pipeline. Investment intentions have been revised down due to tighter credit conditions and the increased cost of equity funding after the recent sharp falls in the share market. This has been coupled with a weaker outlook for domestic and global activity and softer commodity prices, and means that business investment is expected to be flat in 2009-10.

The Australian dollar is often treated by the markets as a bellwether for global growth, and it falls sharply when global growth prospects deteriorate. As in earlier episodes of global weakness in 1997-98 and 2000-01, the sharp depreciation of the Australian dollar will help insulate Australia from some of the effects of the global slowdown by boosting the attractiveness of our exports and supporting production in import-competing industries. Export volumes have also exceeded expectations as a period of strong growth in mining investment has resulted in extra capacity coming on line. As a result, the outlook for the external sector has strengthened slightly, with a lower net export subtraction from growth expected than at Budget.

Part 3: Economic outlook

The marked deterioration in the global growth outlook, and the resulting slowdown in Australian economic growth, is forecast to result in employment growing more moderately than at Budget. As a consequence, the unemployment rate is forecast to rise to 5 per cent by the June quarter 2009, and to 5¾ per cent by the June quarter 2010.

Inflation is high, with headline inflation rising to 5 per cent through the year to the September quarter 2008. Inflationary pressures are expected to moderate over the forecast period as world growth slows, flowing through to lower global oil and food prices. Inflation is forecast to be 3 per cent through the year to the June quarter 2010.

Box 1: Key developments in global financial markets

Emerging over a year ago from the US sub-prime mortgage market, the financial crisis has evolved into severe dislocations in broader credit and funding markets, affecting financial markets globally, and requiring extraordinary and unprecedented policy action from governments.

A deterioration in US lending standards, coupled with the revelation of perverse incentive structures in the lending market, led ultimately to a repricing of risk.

Under the originate-to-distribute model, commission-driven mortgage originators had reduced incentives to screen borrowers, as they could on-sell the full risk of mortgages to investors.

Following a period of rapid asset price growth and excessive financial sector risks, the collapse in the US housing market saw banks and other financial institutions around the world reveal large write-downs on sub-prime related debt from late 2007.

The first failure of a systemically important institution occurred with the collapse of Bear Stearns in mid-March, which led to its subsequent takeover by JPMorgan.

Shortly after the takeover of Bear Stearns, prompt intervention by the US Federal Reserve brought some stability back to financial markets. Financial markets remained relatively stable until early September when Fannie Mae and Freddie Mac were placed under conservatorship.

In mid-September, the crisis moved into its most virulent phase, triggered by the bankruptcy of Lehman Brothers, the fourth largest US investment bank. The absence of a bail-out package led to a pervasive lack of market confidence and placed considerable strains on the US financial system.

Soon after the collapse of Lehman Brothers, American International Group (AIG) was effectively nationalised. Merrill Lynch was taken over by Bank of America and JPMorgan assumed the banking operations of Washington Mutual, the collapse of which became the largest bank failure in US history.

Financial troubles spread to Europe in late September as Bradford & Bingley was partly nationalised and major financial institutions in the UK, Germany, France, Belgium and Iceland failed or required large injections of public capital.

Escalating financial stress led to a peak in interbank lending spreads (Chart 3.A), significantly lower global equity markets and sharp distortions in credit markets. More than 30 financial institutions around the world have failed or been bailed out.

In early October, US Congress passed a comprehensive financial rescue plan which provided US\$700 billion for the US Treasury to purchase troubled assets and take direct equity stakes in financial institutions.

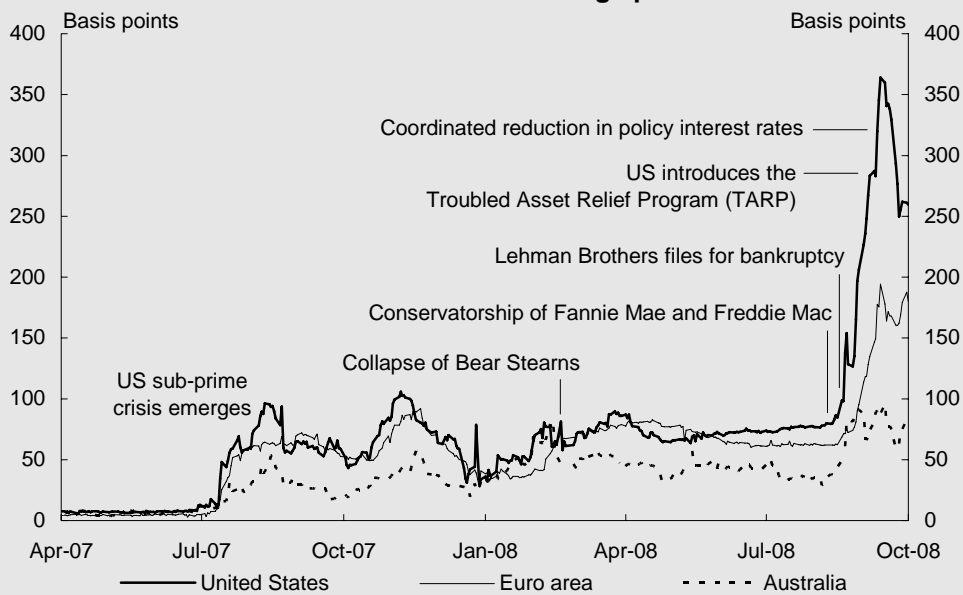
Part 3: Economic outlook

The UK Government announced a £50 billion facility to purchase preference shares and recapitalise UK banks, and other European governments announced similar financial rescue packages. Central banks around the world have also coordinated aggressive cuts in interest rates and undertaken significant

liquidity injections in order to support growth.

Following the IMF and G20 meetings in October, governments took action to guarantee deposits and wholesale funding to support global financial markets.

Chart 3.A: Interbank lending spreads



Note: Australia data are 90-day bank bill to OIS. United States and Euro area data are 3-month LIBOR to OIS.
Source: Reuters and Reserve Bank of Australia.

Box 2: The transmission of the global financial crisis to Australia

The global financial crisis and its impact on world growth present a serious threat to Australia's economic outlook. The channels through which the crisis will affect Australia can be broadly classified as financial, trade and confidence.

The **financial** transmission channel is the impact of adverse debt and equity market developments on growth. The effect of the global financial crisis on the price and availability of credit has constrained the borrowing ability of Australian households and businesses. Sharply lower equity prices have reduced the financing capacity of businesses, in addition to their effect on households' financial wealth.

These financial impacts will reduce consumption and investment spending relative to what they would have been in the absence of the financial crisis. A further deterioration on global stock markets, or increased volatility, would present a downside risk to growth.

The **trade** transmission channel relates to the indirect effect of the global financial crisis on Australia through its impact on growth prospects for our trading partners. The outlook for world growth has been sharply reduced, with flat or falling activity levels possible in a number of large advanced economies.

Lower growth in global demand will constrain Australia's export volumes and prices. As a result, it is expected that the terms of trade will fall in 2009-10, after rising by a large amount in recent years. This turnaround has direct implications for nominal GDP, a major determinant of the tax base, and any further deterioration in the outlook for world growth would increase the downside risks.

The global financial crisis has seen **confidence** fall around the world, and Australia has not been immune. The effects of the crisis on confidence are the hardest to quantify, but arguably the most important. Beyond a certain point, the precautionary spending cuts that consumers and businesses make can become the primary factor behind worsening economic conditions. Governments and central banks around the world have taken decisive steps to support confidence by acting to stimulate economic growth and ensure that credit markets continue to function as freely as possible.

INTERNATIONAL ECONOMIC OUTLOOK

Over the past four years, the world economy has expanded at its fastest pace since the mid-1970s, averaging nearly 5 per cent annual growth over this period. With advanced economies growing around trend, emerging market economies have accounted for almost two-thirds of world growth, with China contributing almost one quarter.

However, the prospects for global growth have deteriorated sharply with the intensification of the global financial crisis that first emerged more than a year ago. The rapid global growth over the past four years is set to come to an abrupt end, with only a gradual recovery expected in the second half of 2009.

World economic growth is forecast to be 3 per cent in 2009, with the G7 expected to grow by only $\frac{1}{4}$ of a per cent (Table 3.1). For the G7, this would represent the lowest rate of growth in more than a quarter of a century. It is also becoming increasingly clear that emerging market economies will be materially affected by developments in global financial markets. Following several years of strong growth, emerging market economies are likely to enter a period of below-trend growth, primarily as a result of weak growth in the advanced economies and the effects of the global financial crisis. Export-dependent economies and countries which rely heavily on foreign financing will be most negatively affected.

Table 3.1: International GDP growth forecasts^(a)

	Actual	Forecasts	
	2007	2008	2009
United States	2.0	1 1/4	0
Euro area	2.6	1 1/4	1/4
Japan	2.1	1/2	1/2
China(b)	11.9	9 3/4	8 1/2
India(b)	9.3	7 3/4	6 3/4
Other East Asia(c)	5.9	4 1/4	3 1/2
G7	2.2	1	1/4
Major trading partners	5.2	3 1/2	3
World	5.0	3 3/4	3

(a) World, G7 and euro area growth rates 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.

(b) Production-based measures of GDP.

(c) Other East Asia comprises the Newly Industrialised Economies (NIEs), which constitutes Hong Kong, South Korea, Singapore and Taiwan, and the Association of Southeast Asian Nations group of five (ASEAN-5) which constitutes Indonesia, Malaysia, the Philippines, Thailand and Vietnam.

Source: National statistical publications, IMF and Treasury.

The **US** economic outlook for 2009 has deteriorated markedly since Budget. Even before the recent intensification of the global financial crisis, economic activity was decelerating. Along with the financial markets, the US housing market continues to be a primary source of weakness in the economy, with a recovery only expected in the latter part of 2009.

The US economy is now expected to register zero growth in 2009, compared with 1½ per cent forecast at Budget. This would mark the weakest performance for the US economy since its 1990-91 recession. Although growth in 2008 is expected to be ½ of a percentage point stronger than forecast at Budget, much of this difference is the result of a resilient global economy in the first half of 2008, which provided a huge boost to US exports. This source of strength, however, is forecast to dissipate as growth outside the US weakens.

Amid the enormous erosion in wealth that has occurred from falling asset prices, combined with a rapidly deteriorating labour market and depressed levels of business and consumer confidence, the US economy is falling into recession. While lower oil and other commodity prices will provide some support by delivering a boost to household purchasing power, the stresses in financial markets will ultimately determine the trajectory of economic activity in the period ahead and, by implication, the depth and duration of the anticipated US recession.

Like the US, the outlook for the **euro area** has shifted dramatically since Budget. Growth has been revised down slightly to 1¼ per cent for 2008, but the 2009 forecast has been revised down sharply to ¼ of a per cent. The sharp reduction in growth prospects for 2009 largely reflects a slowing in the global industrial cycle, a tightening in financial conditions that is set to slow lending growth markedly, and concerns over future employment prospects that will dampen consumption considerably.

While the euro area is expected to post marginally positive growth in 2009, the **UK** is forecast to record negative growth – bringing to an end a sequence of 16 years of positive growth. Domestic demand is forecast to contract, while the slowing global economy is likely to restrain exports despite the depreciation of the UK's trade-weighted exchange rate.

The economic outlook for **Japan** has also deteriorated significantly since Budget, with forecasts revised down to ½ of a per cent in both 2008 and 2009. Although the global financial crisis has not significantly affected Japan's financial sector, growth has slowed in 2008 as export growth has weakened and the terms of trade reached their lowest level since 1980. Over the course of 2009, the economy is expected to recover gradually as investment and exports pick up and inflation moderates.

The outlook for growth in **China** has been downgraded since Budget, as a result of the weaker external environment. The Chinese economy is now forecast to grow by 9¾ per cent in 2008 and 8½ per cent in 2009, down ¼ and 1 percentage point since Budget. A rebalancing of growth towards domestic demand should occur as exports moderate in line with the slowdown in major developed economies.

Apart from sharp falls in the stock market, China's financial system has so far remained largely unaffected by the turbulence in global financial markets, reflecting both its lower level of integration into world capital markets and the absence of complex financial products. More broadly, the economy has not suffered significantly

Part 3: Economic outlook

from the turmoil, but adverse effects on confidence and reduced trade flows are expected to slow GDP growth somewhat.

Financial market turbulence, weaker external demand and moderating inflation have shifted the Chinese Government's priority away from reducing high inflation to supporting growth. Authorities have eased monetary policy and are likely to provide further fiscal stimulus in order to sustain the momentum in growth.

India's reliance on internally-generated growth has insulated it somewhat from the financial crisis. However, falling foreign investment, high domestic inflation, along with an expanding fiscal deficit and rising input and financing costs, are expected to constrain GDP growth. India's economy is expected to grow by 7¾ per cent in 2008, before moderating to 6¾ per cent in 2009, slightly below potential. There appears to be little scope for the Indian Government to provide fiscal stimulus as high government spending has led to a large deterioration in the budget deficit, leaving very little fiscal space for counter-cyclical spending.

Expectations for growth in the rest of **East Asia** remain unchanged at 4¼ per cent in 2008 and have been revised down to 3½ per cent in 2009 – 1¼ percentage points lower than expected at Budget. The Newly Industrialised Economies (NIEs) have been most adversely affected by the global financial crisis so far, largely reflecting their greater exposure to developments in the external environment. The moderation in export growth is expected to extend more broadly throughout the ASEAN-5 economies and become more pronounced as global growth slows, flowing through to weaker domestic demand in the region. While strong capital inflows have supported growth over the past few years, increased risk aversion from investors arising from the global financial crisis has sparked concerns of a sharp reversal of capital that could curtail investment and act as a drag on growth in East Asia.

RISKS TO THE OUTLOOK

The global financial crisis continues to present serious risks to the world and domestic economic outlook. Recent developments have demonstrated the acute sensitivity of financial markets to new information, as the crisis became more severe from mid-September. Markets have yet to move into a sustained period of stability, and the ultimate impact of recent events on the world and Australian economies remains difficult to quantify.

Although governments and central banks around the globe have acted swiftly to restore confidence in financial systems and bolster economic growth, it is yet to be seen whether these actions will be sufficient to stabilise financial markets. Further weakness in growth in the advanced economies beyond that currently anticipated remains a distinct possibility should financial markets not stabilise and confidence not be restored. This creates downside risks to growth in emerging economies through trade and financial linkages with the rest of the world, and there is a risk that a negative

feedback loop may exacerbate the downturn now underway and constrain the recovery in world growth anticipated for the second half of 2009.

The outlook for China remains critical for Australia. Should China slow more than expected, a more serious fall in export demand and commodity prices could result, which would slow growth in national income and activity.

The Government and the Reserve Bank of Australia have acted swiftly and decisively to support growth in Australia. Further, unlike many other advanced economies, Australian policy makers would have ample policy ammunition to respond to further negative developments should they materialise.

Alternatively, if stability returns to financial markets relatively quickly, stronger outcomes for world growth and the domestic economy are possible.

DETAIL OF SECTORAL FORECASTS FOR THE AUSTRALIAN ECONOMY

The domestic economy forecasts are based on several technical assumptions. The exchange rate is assumed to remain around its recent average level – a trade weighted index of around 54 and a United States dollar exchange rate of around 66 US cents. Interest rates are expected to decline broadly in line with market expectations. This is a departure from the usual assumption of unchanged interest rates, reflecting the fact that markets are forecasting a significant easing in the near term, and it would be unrealistic not to take this into account. Oil prices (Malaysian Tapis) are assumed to remain around US\$68 per barrel. The farm sector forecasts are based on an assumption of average seasonal conditions in the future, but take into account current low water storage levels.

The Government intends to introduce a Carbon Pollution Reduction Scheme in 2010. As the detailed design of the scheme is not yet finalised, an estimate of the scheme's impact has not been included in these forecasts.

The Australian economy is forecast to grow by 2 per cent in 2008-09 and 2¼ per cent in 2009-10. The key domestic economy forecasts are summarised in Table 3.2.

Table 3.2: Domestic economy forecasts^(a)

	Outcomes(b)	Forecasts	
	2007-08	2008-09	
		Budget	MYEFO
Panel A - Demand and output(c)			
Household consumption	3.9	2 3/4	2
Private investment			
Dwellings	1.5	2	0
Total business investment(d)	11.7	8 1/2	5 1/2
Non-dwelling construction(d)	10.7	5 1/2	1/2
Machinery and equipment(d)	11.7	11	8
Private final demand(d)	5.2	4	2 1/2
Public final demand(d)	4.7	3	3 1/2
Total final demand	5.1	3 3/4	2 3/4
Change in inventories(e)	0.3	- 1/4	- 1/4
Gross national expenditure	5.4	3 1/2	2 1/4
Exports of goods and services	4.1	6	6 1/2
Imports of goods and services	12.2	9	7
Net exports(e)	-2.0	-1	- 1/2
Real gross domestic product	3.7	2 3/4	2
Non-farm product	3.7	2 1/4	1 3/4
Farm product	7.3	20	13
Nominal gross domestic product	8.1	9 1/4	7 3/4
Panel B - Other selected economic measures			
External accounts			
Terms of trade	5.8	16	10 3/4
Current account balance (per cent of GDP)	-6.0	-5	-4 1/2
Labour market			
Employment (labour force survey basis)(f)	2.5	3/4	1/2
Unemployment rate (per cent)(g)	4.3	4 3/4	5
Participation rate (per cent)(g)	65.3	65	65
Prices and wages			
Consumer Price Index(f)	4.5	3 1/4	3 1/2
Gross non-farm product deflator(f)	6.8	4 1/4	2
Wage Price Index(f)	4.2	4 1/4	4 1/4

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

(b) Calculated using original data from ABS cat. no. 5206.0

(Does not include revisions from ABS cat. no. 5204.0).

(c) Chain volume measures except for nominal gross domestic product which is in current prices.

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

(e) Percentage point contribution to growth in GDP.

(f) Through the year growth rate to the June quarter for 2007-08 and 2008-09.

(g) Estimate for the June quarter.

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

Household consumption is expected to grow by 2 per cent in 2008-09, significantly weaker than Budget expectations of 2¾ per cent growth. Although household consumption growth was expected to slow at Budget, the outlook has deteriorated markedly since then, driven by the fallout from the global financial crisis. The crisis has reduced household wealth significantly, with Australian stock markets down around 40 per cent since the start of 2008, and the outlook for house prices softening due to lower activity. Australian households have also endured an extended period of relatively high interest rates, with the full impact on economic activity of recent cuts expected to take some time. Consumer confidence, already at low levels, has been driven down further by the fallout from the global financial crisis, and has made households more cautious about spending and borrowing.

The substantial fiscal stimulus from the Government's Economic Security Strategy, as well as interest rate cuts, will help counter these negative influences on consumption growth over the forecast horizon.

Dwelling investment is expected to be flat in 2008-09, down from the moderate growth of 2 per cent expected at Budget. The outlook in the near term is dominated by tighter credit conditions, weakness in household confidence and a consolidation of household balance sheets constraining the appetite for borrowing. However, dwelling investment growth is expected to strengthen in 2009-10, as the impact of lower interest rates and improved credit conditions, as well as activity prompted by the First Home Owners Boost, flow through the housing market. Investment will also be supported by strong underlying demand.

Business investment growth, which has been supporting strong growth in the Australian economy in recent years, is expected to slow to 5½ per cent in 2008-09, down from the 8½ per cent expected at Budget. Activity in the near term will be supported by momentum from the large number of projects, both mining and non-mining, that have already commenced. The majority of large mining projects appear likely to continue as planned and, while some smaller projects may not go ahead, this will free up resources for major projects currently facing labour and materials shortages.

Investment is expected to slow over the forecast horizon as fewer projects are added to the pipeline, weighed down by a softer outlook for GDP growth, difficult credit conditions and weakness in the outlook for commodity prices. Investment is forecast to be flat in 2009-10, although remaining at a high level. The slowdown is expected to be primarily in the non-mining sectors. Larger mining firms are expected to remain mostly insulated from financing concerns due to their more robust profit outlooks and lower gearing ratios.

The global financial crisis has greatly intensified the risks surrounding the investment outlook and, should this cause funding costs to rise further or the outlook for commodity prices to continue to deteriorate, it is possible that investment could be significantly lower than expected. However, measures by the Government and the

Part 3: Economic outlook

Reserve Bank of Australia to increase liquidity and support the smooth operation of financial markets will help moderate the impact of the global financial crisis on investment.

Public final demand is expected to grow by 3½ per cent in 2008-09, slightly stronger than at Budget. Public consumption growth is expected to remain solid. A large number of infrastructure projects are expected to drive strong State and local government investment, despite some moderation in new investment growth in Queensland and New South Wales. Further project delays and tighter credit conditions remain a risk to the investment outlook.

Net exports are expected to subtract ½ of a percentage point from GDP growth in 2008-09, smaller than the 1 percentage point detraction forecast at Budget. The change largely reflects a weaker outlook for imports, as slowing domestic activity and a lower exchange rate act to slow demand for imports. In contrast, the outlook for exports is slightly stronger than at Budget, although this masks divergences at a sectoral level. Commodity exports are expected to account for around three-quarters of total export growth over 2008-09, as further capacity comes online and demand remains solid despite a sharp slowing in the global economy. In contrast, exports of elaborately transformed manufactures and services are expected to soften, as weaker world growth outweighs the boost from the sharp depreciation of the Australian dollar.

The **terms of trade** are still expected to rise strongly in 2008-09, albeit at a slower pace than at Budget, with growth of 10¾ per cent, before falling 8½ per cent in 2009-10. The strong gains in 2008-09 reflect previous increases in US dollar contract prices for iron ore (up around 85 per cent) and coal (up between 125 and 240 per cent), which are locked in until the end of March 2009. The outlook for commodity prices after this period has deteriorated, as the expected recession in advanced economies flows through to slowing growth in emerging economies, reducing demand. This impact has already been reflected in recent rapid falls in spot prices.

The **current account deficit** (CAD) is expected to narrow to 4½ per cent of GDP in 2008-09, lower than the 5 per cent of GDP forecast at Budget. The net income deficit (NID) is expected to narrow relative to estimates at Budget due to the sharp depreciation of the Australian dollar, which raises the Australian dollar value of foreign currency assets more than foreign currency liabilities. Slightly lower profits growth due to the weaker outlook for commodity prices also contributes to the narrowing in the NID as fewer profits are expatriated offshore. The trade balance is expected to be in surplus in 2008-09 as export growth strengthens and import growth slows.

From a saving and investment perspective, the narrowing of the CAD reflects higher saving as a share of GDP, particularly driven by households rebuilding their balance sheets, coupled with a slowdown in growth of national investment.

Employment growth is expected to slow to $\frac{1}{2}$ of a per cent through the year to the June quarter 2009, slightly weaker than the $\frac{3}{4}$ of a per cent expected at Budget. Strong outcomes to the September quarter 2008 mean that the year average figure is unchanged at $1\frac{1}{4}$ per cent. The slowing is the result of the weaker outlook for the Australian economy ensuing from the global financial crisis. With the participation rate remaining at a high level, employment growth will not be sufficient to absorb all new entrants to the labour market. The unemployment rate is forecast to rise to 5 per cent by the June quarter 2009 and $5\frac{3}{4}$ per cent by the June quarter 2010.

Wages are expected to grow by $4\frac{1}{4}$ per cent through the year to the June quarter 2009, unchanged from Budget. The labour market has remained relatively tight and strong growth has continued in the States and industries most directly affected by mining and construction activity. The easing in the labour market will reduce the rate of wage growth, which is expected to slow to 4 per cent through the year to the June quarter 2010.

Inflation is forecast to fall from current high levels, to be $3\frac{1}{2}$ per cent through the year to the June quarter 2009 and 3 per cent through the year to the June quarter 2010. Underlying inflation is also expected to ease to $3\frac{1}{2}$ per cent and 3 per cent for the same periods. Inflationary pressures are expected to moderate over the forecast period as world growth slows, flowing through to lower global oil and food prices. The recent depreciation of the Australian dollar, which has fallen by around 30 per cent in trade-weighted terms from its July 2008 peak, will limit the speed at which inflation can fall. The recent volatility surrounding exchange rates and oil prices creates risk around these forecasts.

Nominal GDP is expected to grow by $7\frac{3}{4}$ per cent in 2008-09, lower than the $9\frac{1}{4}$ per cent expected at Budget. The downward revision reflects the weaker outlook for the terms of trade in 2008-09, partially offset by stronger domestic price pressures. The fall in commodity prices will principally be felt in 2009-10, with nominal GDP forecast to grow by 3 per cent.

Nominal GDP provides a measure of total income for the economy. It broadly comprises compensation of employees, gross operating surplus and gross mixed income. The lower than expected growth in nominal GDP in 2008-09 has flowed through to weaker growth across all these categories. Compensation of employees is forecast to grow by $5\frac{3}{4}$ per cent in 2008-09, down $\frac{1}{2}$ of a percentage point from the rate expected at Budget. This largely reflects the slightly softer outlook for the labour market, with wages growth expected to remain solid.

Growth in the gross operating surplus of private non-financial corporations, a broad measure of profits, is expected to remain strong at $15\frac{3}{4}$ per cent in 2008-09, albeit slightly weaker than forecast at Budget, reflecting the strong gains in commodity prices that are locked in until March 2009. The weaker outlook for commodity prices after this, and the consequent slowing in nominal GDP growth, will principally be seen in weaker profits, which are forecast to fall by $5\frac{3}{4}$ per cent in 2009-10.

Part 3: Economic outlook

Expected growth in gross mixed income has been revised down to 5 per cent in 2008-09 from the 9½ per cent expected at Budget, driven by a weaker outlook for profits in the farm sector, on the back of softer export prices and lower output due to the continuing effects of the drought.