

Part II: Economic outlook

Following economic growth of around 2 per cent in 2000-01, the Australian economy is expected to grow by around 3 per cent in 2001-02 in year-average terms, down slightly from the $3\frac{1}{4}$ per cent growth forecast at Budget. In through-the-year terms to the June quarter 2002, growth has been revised down from 4 per cent at Budget to $3\frac{1}{4}$ per cent. Growth is expected to remain somewhat below Australia's long-term average, mainly reflecting the expected impact of a much weaker global economic environment.

The outlook for world economic growth has deteriorated sharply since the 2001-02 Budget. Some of the downside risks identified at Budget had already come into play prior to the terrorist attacks in the United States (US) on 11 September, with the first major downturn since the early 1990s already underway. The events of 11 September, and subsequent developments, have created additional uncertainty and increased the likelihood of a deeper and more prolonged period of global weakness.

The world economy is now expected to grow by around $2\frac{1}{4}$ per cent in 2001, the lowest rate since the early 1990s, and down sharply from the 4.7 per cent growth recorded in 2000. The latest forecast is around one percentage point lower than at Budget, reflecting a more pronounced slowing in the US, and gathering weakness in European and East Asian economies. Recovery in the US, and the world more generally, is now expected to be delayed until mid-2002, with growth expected to return to around long-run average levels in 2003.

In response, macroeconomic policy has become more stimulatory in many economies. However, there remains more than the usual degree of uncertainty associated with the global economic outlook. While the balance of risks in the short-term is probably on the downside, it is more evenly balanced later in the forecast period – the medium-term outlook for world growth remains favourable, with economic fundamentals remaining generally sound.

While the international outlook is much weaker than at Budget, some components of domestic demand are expected to grow more quickly than forecast at Budget, which should ameliorate the impact on overall economic growth to some extent. In particular, dwelling investment is likely to grow very strongly, while public demand is also now likely to be stronger than at Budget.

The more pronounced weakness, and continuing uncertainty, surrounding the global economic outlook, combined with some recent business failures in Australia, has resulted in domestic business and consumer confidence declining from recent above-average levels. This may result in businesses delaying investment in plant and equipment, stock rebuilding, and the employment of new staff. Employment growth is now forecast to be $\frac{3}{4}$ of one per cent in 2001-02 in year-average terms, down from 1 per cent at Budget, with the unemployment rate forecast unchanged, at around 7 per cent in the June quarter 2002.

Lower employment growth, the impact of the recent decline in share prices on household wealth, and lower levels of consumer confidence are all expected to have a dampening influence on household consumer spending in 2001-02. However, recent declines in official interest rates to historical lows are likely to provide a partial offset.

Under this revised outlook, domestic demand is forecast to grow by a solid $3\frac{3}{4}$ per cent in 2001-02, with net exports, reflecting the weaker global environment, expected to detract around $\frac{3}{4}$ of a percentage point from overall domestic economic growth.

The headline Consumer Price Index (CPI) is forecast to increase by around $2\frac{3}{4}$ per cent in 2001-02 in year-average terms, up from 2 per cent at Budget. The upward revision mainly reflects the expected impact of a number of one-off factors, such as higher insurance premiums, electricity prices, meat prices and domestic airfares, rather than representing any significant increase in ongoing inflationary pressures.

The initial forecast for 2002-03 is for a strengthening in economic growth in Australia to around $3\frac{1}{2}$ per cent — a level more in line with Australia's longer-term average growth rate — facilitated by accommodative monetary and fiscal policies. Employment growth is expected to increase modestly to $1\frac{1}{4}$ per cent in 2002-03, with inflation expected to remain subdued at around $2\frac{1}{2}$ per cent. Business investment and household consumer spending are both expected to grow solidly in 2002-03.

There remain major uncertainties surrounding the economic outlook.

- The current world cyclical downturn could gather further momentum. The downturn would be exacerbated by further escalation of international tensions, disorderly adjustment in financial markets or by higher oil prices. Any combination of these factors would act as a further brake on Australian growth.
- On the other hand, growth in the US and elsewhere could rebound sooner, and at a faster pace, supported by the fiscal and monetary policy stimulus now in train and a restoration of business and consumer confidence. Under these circumstances, given Australia's supportive exchange rate, exports would be stronger than forecast and, with very low interest rates and a recovery in confidence, consumption and investment in Australia could rebound rapidly. The result would be substantially stronger domestic economic growth on average across 2001-02 and 2002-03 than currently forecast.

INTERNATIONAL ECONOMIC OUTLOOK

The outlook for the world economy has deteriorated sharply since the Budget (see Chart 1), with some of the downside risks identified at that time coming into play and being given additional impetus by the events in the US in the wake of 11 September. A more protracted period of weakness is now in prospect, with a recovery in world growth not expected until mid-2002. Growth is expected to be weaker in most countries, including Australia's major trading partners (MTPs). World growth is now expected to be around $2\frac{1}{4}$ per cent in 2001, compared with $3\frac{3}{4}$ per cent at Budget.

While this is above the growth recorded in the early 1990s, it remains below that achieved during the Asian crisis. Growth in Australia's MTPs is expected to be around $\frac{3}{4}$ of one per cent in 2001, two percentage points lower than forecast at Budget. While MTP growth should accelerate in 2002, cumulative growth in 2001 and 2002 is expected to be the weakest in any two-year period in the last three decades.

The weaker world outlook reflects a more pronounced slowing in growth in the US, Europe, Japan and in developing countries, including Australia's MTPs in East Asia (see Table 2). In the US, inventory accumulation has been wound back and investment spending reduced in line with weaker demand and overcapacity, particularly in the manufacturing and high technology sectors. The weakness has spread to Europe, where growth was already slowing following earlier tightening of monetary policy in response to inflationary pressures. The Japanese economy appears to have slipped back into recession under the weight of ongoing structural problems in the corporate and financial sectors and weaker world demand. Elsewhere in East Asia, links with the US through the information and computer technology (ICT) production chain have seen exports fall sharply and output contract in several countries.

The global economic weakness and the attendant risks were exacerbated by the events in the US on 11 September 2001. In addition to the direct effects, the attacks increased uncertainty, unsettling financial markets (share markets fell sharply in the immediate aftermath, although they have recovered somewhat in subsequent weeks) and undermining business and consumer confidence.

With uncertainty remaining high, it is anticipated that global economic growth is likely to weaken further in the latter part of 2001 and remain subdued in early 2002. Economic recovery is expected to gather momentum in the latter half of 2002 as the US inventory adjustment is completed, excess capacity worked off and the substantial stimulus in many countries from monetary and fiscal policies takes effect.

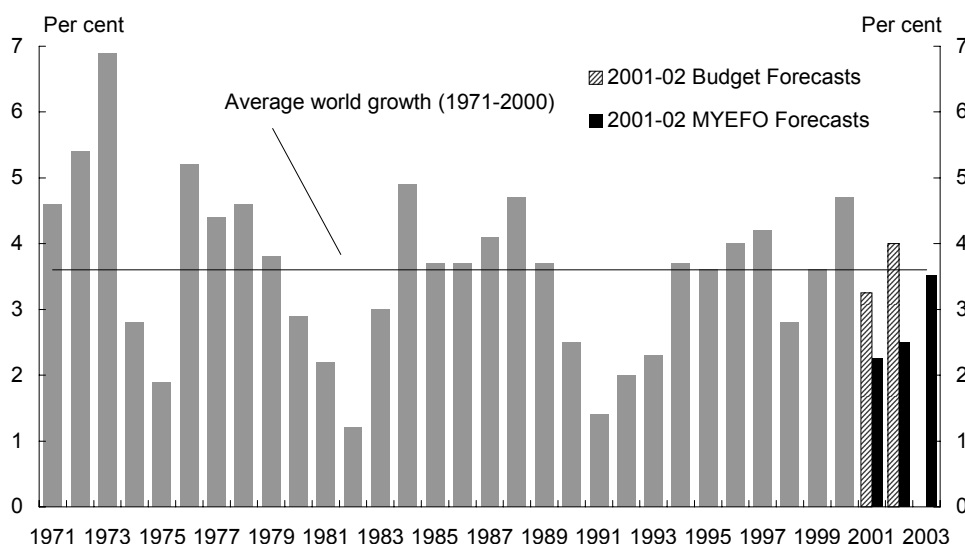
The forecasts for 2002, while well down on the Budget forecasts, reflect this pattern of recovery. World growth is expected to be $2\frac{1}{2}$ per cent in 2002, rising to $3\frac{1}{2}$ per cent in 2003 while MTP growth is expected to be around $1\frac{1}{2}$ per cent in 2002, rising to $3\frac{1}{2}$ per cent in 2003. In the longer-term, conditions are expected to be favourable, with ongoing productivity gains in the US likely to underpin solid growth once the current period of uncertainty abates.

There are a number of important uncertainties surrounding the world outlook. With the global economy already weak, there is a risk that sustained consumer and business uncertainty due to ongoing global tension may result in a deeper and more protracted period of low growth. The adjustments in financial markets arising from increased risk aversion (evidenced, for example, through higher credit spreads and risk premia), could become more substantial and self-reinforcing due to financial market linkages and confidence effects. This situation could also exacerbate vulnerabilities in financial and corporate sectors and adversely affect the recovery, particularly in emerging market economies.

World oil prices are assumed to be around \$22 per barrel for 2002 and 2003, around the bottom of the OPEC target band, reflecting the impact of weak world growth on global demand for oil. That said, the oil price outlook is very uncertain. Any large and sustained increases in oil prices would represent a further risk to the global outlook.

On the upside, there is a possibility that US and world growth could recover more quickly and at a faster pace than forecast. The adjustment process in the US economy is underway and some of the financial imbalances have been unwound by equity price falls and some exchange rate adjustment. Supportive monetary and fiscal policies already in place could underpin a quicker upturn than forecast if the uncertainty surrounding recent events were to dissipate quickly.

Chart 1: World GDP growth^(a)



(a) World GDP growth rates are calculated using GDP weights based on purchasing power parity.
Source: Various national statistical publications, International Monetary Fund (IMF) and Treasury.

Table 2: International GDP growth forecasts^{(a)(b)}

	1997	1998	1999	2000	2001	2002	2003
	Actual	Actual	Actual	Actual	Forecast	Forecast	Forecast
World	4.2	2.8	3.6	4.7	2 1/4	2 1/2	3 1/2
United States	4.4	4.3	4.1	4.1	1	1	3
Japan	1.9	-1.1	0.8	1.5	- 1/2	- 1/2	3/4
European Union	2.6	2.9	2.7	3.4	1 1/4	1 1/4	2 1/4
Major Trading Partners	4.2	-0.2	4.1	4.9	3/4	1 1/2	3 1/2
Non-Japan East Asia(c)	6.1	-2.1	6.4	7.8	1 1/4	2 1/2	5 1/2

(a) Percentage change on previous year.

(b) Growth rates for the World and the European Union are calculated using GDP weights based on purchasing power parity while growth rates for Major Trading Partners and Non-Japan East Asia are calculated using export trade weights.

(c) Non-Japan East Asia consists of Korea, Singapore, Taiwan, Hong Kong, China, Indonesia, Malaysia, Thailand, and the Philippines.

Source: Various national statistical publications, IMF and Treasury.

DOMESTIC FORECASTS

In preparing the forecasts for the domestic economy, the exchange rate is assumed to remain steady over the forecast horizon at around its average level over recent weeks (a TWI of around 48 and a US\$ exchange rate of 0.50), a little lower than the exchange rates used at Budget. The farm sector forecasts are based on an assumption of average seasonal conditions for the remainder of 2001-02 and in 2002-03. Interest rates are assumed to remain around their current levels over the forecast horizon. The key domestic macroeconomic forecasts for 2001-02 are summarised in Table 3.

Demand and output

Growth in **private consumption** is expected to be around 3¼ per cent in 2001-02, a little below the long-term average and well down on the very strong growth rates recorded in the late 1990s. The relatively subdued outlook for private consumption growth incorporates an allowance for a significant decline in consumer confidence, from earlier relatively high levels, in response to international developments and some domestic business failures. In through-the-year terms, growth has been revised down from 3¼ per cent at Budget to 3 per cent.

Growth in real household income in 2001-02 is expected to be below recent averages, primarily reflecting the softer outlook for employment growth. Growth in real wealth is also expected to moderate, as recent declines in the share market at least partly offset the strong increases in house prices over the last year.

At the same time, several factors are likely to be supportive of consumption growth in 2001-02. These include the decline in petrol prices over recent months and the reduction in official interest rates during 2001, which has resulted in a sharp fall in the debt servicing ratio of households. Strong growth in dwelling construction is also likely to support spending on durable items over the second half of 2001-02.

Dwelling investment is expected to rebound sharply from the very large slump in the second half of 2000, and is forecast to grow by around 20 per cent in 2001-02 – much stronger than the 5 per cent growth expected at Budget. This sharp rebound from the decline in 2000-01 reflects a combination of the Government's enhanced First Home Owners Scheme (FHOS) for new home buyers together with historically low housing interest rates. It is expected that there will be a significant bring-forward of dwelling investment into the first half of 2001-02 which will unwind late in 2001-02 and into 2002-03 as FHOS-related building is completed. The building of new dwellings for existing home owners, and alterations and additions, are both expected to grow strongly in 2001-02, aided by low interest rates. Recent volatility in share markets may

also encourage some switching of investment funds out of the share market into the dwellings sector.

The expected sharp rebound in dwelling construction, which is labour intensive in nature, should help support full-time employment growth and spending on durable items in 2001-02.

Table 3: Domestic economy forecasts^(a)

	Outcomes(b)	2001-02 Budget	2001-02 MYEFO
	2000-01	Forecasts	Forecasts
	Year average	Year average	Year average
Panel A - Demand and output(c)			
Household consumption	2.7	3	3 1/4
Private investment			
Dwellings	-20.5	5	20
Total business investment(d)	-2.6	5	-1
Other buildings and structures(d)	-19.8	6	5
Machinery and equipment(d)	1.3	3	-5
Private final demand(d)	0.0	3 1/2	4
Public final demand(d)	1.1	2 1/4	3 1/2
Total final demand	0.3	3 1/4	3 3/4
Change in inventories(e)			
Private non-farm	0.0	- 1/4	- 1/4
Farm and public authorities	-0.1	0	0
Gross national expenditure	0.2	3	3 3/4
Exports of goods and services	7.1	5	0
Imports of goods and services	-1.4	4	3
Net exports(e)	1.7	1/4	- 3/4
Gross domestic product	1.9	3 1/4	3
Non-farm product	2.1	3	3
Farm product(f)	-4.8	7	3
Panel B - Other selected economic measures			
External accounts			
Terms of trade	3.1	- 3/4	-1 1/4
Current account balance			
\$billion	-18.7	-20	-26
Percentage of GDP	-2.8	-3	-3 3/4
Labour market			
Employment (Labour Force Survey basis)	2.1	1	3/4
Unemployment rate (per cent)	6.4	7	7
Unemployment rate (per cent)(g)	6.9	7	7
Participation rate (per cent)	63.7	63 3/4	63 3/4
Prices and wages			
Consumer Price Index - headline	6.0	2	2 3/4
Gross non-farm product deflator	4.3	1 1/2	1 3/4
Average earnings(h)	3.9	3 3/4	4 1/4

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

(b) Calculated using original data.

(c) Chain volume measure.

(d) Excluding transfers of second-hand asset sales from the public sector to the private sector.

(e) Percentage point contribution to growth in GDP.

(f) Calculated at basic prices.

(g) The level in the June quarter of each year, seasonally adjusted.

(h) Average non-farm compensation of employees (national accounts basis).

Private business investment (abstracting from the purchase of second-hand assets from the public sector) is forecast to be weaker than expected at Budget, declining by around 1 per cent in 2001-02. The downward revision reflects the impact of the much weaker world outlook and an allowance for some decline in business confidence in Australia arising from recent terrorist attacks in the United States.

New machinery and equipment investment is expected to fall, by around 5 per cent in 2001-02. The most recent data on firms' equipment expenditure expectations (taken in June) suggest intentions slightly below the equivalent estimates for 2000-01. Given the deterioration in the global outlook since this survey was conducted, the revised forecasts are based on a conservative realisation ratio (that is, the ratio of actual to intended investment) broadly comparable to that experienced during the Asian crisis period.

In contrast, the outlook for non-residential construction appears to have consolidated. As foreshadowed at Budget, private engineering construction is expected to lead the recovery in non-residential construction, with investment intentions also remaining very strong in the mining sector.

Global risks aside, if the mining industry's investment intentions for 2001-02 are fully realised, private business investment could be stronger than forecast. Business investment will also be supported by low interest rates, and the Budget decision to bring-forward the commencement date for full GST input tax credits on motor vehicles.

Lower investment in private non-farm **inventories** is expected to subtract around $\frac{1}{4}$ of a percentage point from growth in 2001-02. Stock-to-sales ratios remain a little above trend levels, particularly in the retail sector, despite the modest run-down in non-farm inventories in the first half of 2001. Further, firms may adopt a more cautious approach to inventory investment over the coming year, particularly in the retail and wholesale sectors, in response to global uncertainties.

Public final demand, after adjusting for second-hand asset sales, is expected to grow by a solid $3\frac{1}{2}$ per cent in year average terms in 2001-02, following modest growth in the previous year. Growth in 2001-02 partly reflects increases in defence expenditure related to the development of Australia's armed forces announced in the Defence White Paper, increased spending to enhance Australia's health system and additional funding for education.

Net exports have been revised down significantly since Budget, and are now expected to detract about $\frac{3}{4}$ of a percentage point from GDP growth in 2001-02, following a large 1.7 percentage point positive contribution in 2000-01.

Reflecting the weaker outlook for the world economy, and notwithstanding a supportive exchange rate, growth in export volumes is forecast to be around zero in

2001-02, down from the 5 per cent growth expected at Budget. This comes on the back of two years of strong growth.

The subdued outlook for export volumes largely reflects a significant expected fall in services exports and very muted growth in exports of elaborately transformed manufactures (ETMs). Both categories of exports are very sensitive to economic conditions in the importing country and are more difficult to divert to other markets than are commodity exports. With Asia being an important destination for both ETMs and services, the very weak outlook for that region will put sharp downward pressure on exports. Heightened international tensions could result in a sharp decline in international air travel over coming months, adversely affecting Australia's tourism industry, coming off the Olympics-related highs in 2000-01. That said, the very competitive level of the Australian dollar should provide a partial buffer for these sectors.

In contrast, commodity export volumes are much less affected by international conditions in the short term. In Australian dollar terms, most rural and non-rural commodity prices remain relatively profitable. Modest growth is expected in export volumes of non-rural commodities, with rural export volumes largely unchanged relative to 2000-01.

Growth in import volumes has been revised down to 3 per cent in 2001-02, reflecting the impact of higher prices due to a lower exchange rate and the downward revision to the forecast for machinery and equipment investment in 2001-02.

Following large rises in the last two years, the terms of trade is expected to decline by 1¼ per cent in 2001-02, but to remain above pre-Asian crisis levels. The relatively small overall decline in the terms of trade reflects the net impact of continuing firm world prices for several of Australia's key export items such as beef, grains and bulk commodities, combined with substantial falls in world prices of base metals. Subdued world prices of some imports, reflecting weak world growth and very competitive market conditions, should also help to minimise the fall in Australia's terms of trade.

Consistent with lower net exports and lower terms of trade, the current account deficit (CAD) as a share of GDP is expected to rise somewhat, to 3¾ per cent, in 2001-02, after reaching the lowest annual level in 20 years in the previous year. Nevertheless, the CAD is expected to remain significantly below its long-term average as a share of GDP.

Labour market

Reflecting weaker overall economic growth, employment growth is expected to be around ¾ of one per cent in 2001-02 in year-average terms. The strong expected recovery in the labour intensive construction sector is likely to be increasingly reflected in employment growth in the second half of 2001-02, particularly in male full-time employment, the component of the labour market which has experienced the most marked weakness over the past 12 months. The unemployment rate is expected to

average around 7 per cent in 2001-02 and in the June quarter of 2002, as weaker employment growth is accompanied by a more muted rise in labour force participation (although the rounded participation rates set out in Table 3 remain similar).

Wages and prices

Average earnings on a national accounts basis (AENA) is forecast to grow by a moderate $4\frac{1}{4}$ per cent in 2001-02, marginally above the outcome in 2000-01.

The headline CPI is forecast to increase by $2\frac{3}{4}$ per cent in 2001-02 in year-average terms (compared with 2 per cent forecast at Budget) and by $2\frac{1}{2}$ per cent through the year to the June quarter 2002. The upward revision to the CPI since Budget mainly reflects the expected impact of a number of one-off factors, rather than representing any significant increase in ongoing inflationary pressures. In particular, higher insurance premiums, electricity prices, meat prices and domestic airfares are expected to put upward pressure on the CPI relative to earlier expectations. The recent modest decline in the exchange rate, if sustained, could also increase the CPI slightly over coming quarters. On the other hand, weak world growth and subdued domestic demand should help to contain inflationary pressures. Volatility in exchange rates and world oil prices represent key uncertainties for the inflation outlook in 2001-02.

Domestic economy — 2002-03

With a forecast gradual recovery in world economic growth as 2002 proceeds, and a return to around trend rates of world growth in 2003, a strengthening in economic growth is expected in Australia in 2002-03. GDP growth in Australia is expected to increase to around $3\frac{1}{2}$ per cent in 2002-03 in year-average terms and a strong $4\frac{1}{4}$ per cent in through-the-year terms, facilitated by accommodative monetary and fiscal policies.

Private consumption in 2002-03 is expected to increase in line with longer-term trend rates. In broad terms, private consumption growth is expected to be supported by firmer growth in employment, the lagged effects of recent falls in interest rates and the flow-on effects of the forecast recovery in the dwellings sector, particularly with respect to spending on consumer durables (such as whitegoods and furniture).

Business investment is forecast to return to solid growth in 2002-03, driven by a rebound in machinery and equipment investment, and supported by continued growth in non-residential investment. This predominantly reflects the low interest rate environment, combined with a pick up in global economic growth and a restoration of business confidence.

With an improved outlook for the domestic economy, employment growth is expected to increase to $1\frac{1}{4}$ per cent in 2002-03, allowing the unemployment rate to decline slightly by the June quarter 2003.

Slower growth is expected in public final demand in 2002-03, largely reflecting the winding down of various investment projects at the State and local level.

Wage increases are expected to remain at around the same rate in 2002-03 as forecast for 2001-02. This reflects lower underlying wages growth, which is expected to be offset by the increase in the superannuation guarantee charge in July 2002. This moderate growth in wages is consistent with subdued inflationary pressures.

The headline CPI is forecast to increase by 2½ per cent in 2002-03 in year-average terms, comfortably within the medium-term target band of 2-3 per cent.

Medium-term projections

Table 4 below sets out the major economic parameters used in preparing the revised budget estimates. The parameters comprise the forecasts for 2001-02 and 2002-03 and medium-term projections for the following two financial years. The outyears projections are based on medium-term average growth rates, consistent with the usual convention.

Table 4: Major economic parameters (percentage change from previous year)

	Forecasts		Projections	
	2001-02	2002-03	2003-04	2004-05
Real GDP	3	3 1/2	3 1/2	3 1/2
Employment(a)	3/4	1 1/4	2	2
Wages(b)	4 1/4	4 1/4	3 1/2	3 1/2
CPI	2 3/4	2 1/2	2 1/2	2 1/2

(a) Labour Force Survey basis.

(b) Average earnings (national accounts basis).