

STATEMENT 3: ECONOMIC OUTLOOK

This statement presents the economic forecasts that underlie the budget estimates.

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STATEMENT 3: ECONOMIC OUTLOOK

The Australian economy has remained resilient over the past year despite a weak world economy and the most extensive drought in Australian meteorological records. While the economy should continue to grow in 2003-04, the pace is likely to be a little below trend. Non-farm economic growth is expected to slow, although a rebound in farm production is likely to boost overall economic growth if the drought breaks. Solid employment growth should see the unemployment rate remain around current levels and inflation is forecast to decline to around the middle of the 2-3 per cent target band. World economic growth is likely to remain weak in the near term, although a subdued recovery is in prospect in 2004. Nonetheless, there is still a substantial possibility of a further deterioration in global conditions, which poses a significant downside risk to the domestic outlook.

OVERVIEW

In 2002-03, economic growth in Australia is forecast to be 3 per cent in year-average terms, unchanged from the forecast presented in the *Mid-Year Economic and Fiscal Outlook 2002-03 (MYEFO)*. Despite the drought, the Australian economy has been one of the developed world's top-performing economies over the past year.

In 2003-04, economic growth is forecast to be 3¼ per cent in year-average terms, with slower growth in non-farm production likely to be more than offset by a rebound in farm production. Employment growth is likely to slow, after very strong growth in 2002-03, with the unemployment rate remaining around 6 per cent over the coming year. Inflation is forecast to decline to around the middle of the target band. The current account deficit (CAD) as a share of GDP should narrow a little as the pace of domestic demand eases and global conditions gradually improve through the year.

The forecast slowdown in non-farm production growth in 2003-04 follows a period of robust growth. Despite weakness elsewhere in the world, non-farm GDP grew by nearly 4 per cent through the year to the December quarter 2002, with strong growth in domestic demand, particularly investment spending, offsetting weak external demand. Growth in consumption and business investment is likely to ease a little over the next year while dwelling investment is expected to contract. Nevertheless, still-solid growth in domestic demand and a gradual recovery in external demand should underpin solid growth in the non-farm economy.

The expected rebound in farm production should provide a boost to overall economic growth in 2003-04. Although the farm sector typically produces around 3 per cent of the economy's output, production should increase substantially if the drought breaks. The drought is estimated to have directly reduced economic growth by nearly

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1 percentage point in 2002-03. If rural conditions improve, the recovery in farm production should contribute around $\frac{1}{2}$ to $\frac{3}{4}$ of a percentage point to economic growth in 2003-04.

Despite the positive domestic outlook, the performance of the Australian economy over the next year will be heavily influenced by international developments. After a protracted period of weakness, and despite substantial policy stimulus, a sustained global recovery has not yet taken hold. The most likely outcome is a gradual improvement in the global economy with world growth expected to be around 3 per cent in 2003, rising to around $3\frac{1}{2}$ per cent in 2004. Trading partner growth is expected to be around $2\frac{1}{2}$ per cent in 2003 and 3 per cent in 2004.

Tempering this outlook, however, is a confluence of pre-existing, and some new, downside risks to the international economic outlook. There are economic risks around growth prospects for the major economies, and financial risks around financial systems in Japan and Europe and financial markets more generally. On top of this there are geopolitical risks around the situation in the Middle East and North Asia and, more recently, risks associated with the spread of Severe Acute Respiratory Syndrome (SARS). While conditions may improve quickly once some of the current uncertainty dissipates, many of the pre-existing international risks will remain. Many of these risks are due to deep-seated structural problems in the major economies, so it is likely that it will take some time before they abate. Until then, they cloud an otherwise healthy outlook for the Australian economy.

Domestically, the outlook continues to be underpinned by solid, albeit moderating, domestic demand. Household consumption looks set to grow solidly, although slower than over the past year. Solid employment growth and real wage increases should continue to support household income growth. Incomes in rural areas, which declined sharply in 2002-03, should rebound in the coming year. Strong increases in wealth in recent years, easier access to finance and low interest rates should provide additional support for household spending. However, the pace of wealth accumulation and household borrowing, which has supported strong consumption growth, is expected to slow after the rapid expansion during the past few years.

Dwelling investment is expected to weaken in 2003-04 following a period of strong growth. While the low interest rate environment remains supportive of dwelling construction, oversupply in some markets and easing expectations of capital gains from housing investment should see a return to more sustainable levels of dwelling construction activity over the coming year. Spending on alterations and additions should partially offset some of the decline. An expected easing in capacity constraints in the building industry should allow pent-up demand for renovations to be met.

The outlook for business investment remains positive, although ongoing global uncertainty has tempered the outlook. Balance sheets are generally sound, profitability and cash flows are solid, interest rates are low and, despite recent falls, confidence has held up well against the unsettled global backdrop. Investment has been subdued over

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the past few years and relatively high levels of capacity utilisation now point to the need for further investment to meet increased demand. Business costs have increased in recent months with the run-up in oil prices. However, other cost pressures, including wages, generally remain contained, underpinning healthy rates of return.

Although investment intentions have eased a little in recent months, businesses still plan a solid increase in plant and equipment investment in 2003-04. The outlook for non-dwelling buildings and structures investment is very strong with several large investment projects now underway or ready to commence. Notwithstanding this, business investment is likely to be sensitive to global economic developments and the level of uncertainty surrounding the outlook. Further deterioration in the international environment could see investment plans downgraded.

Export growth should pick up in 2003-04, underpinned by continued, albeit weak, economic growth in Australia's major trading partners and a rebound in rural exports in line with the expected recovery in rural conditions. Import growth is likely to remain solid next year, but should slow as domestic demand growth moderates. Net exports are forecast to subtract $\frac{1}{4}$ of a percentage point from growth in 2003-04, after subtracting around $2\frac{3}{4}$ percentage points in 2002-03. Despite weak export prices, the terms of trade is likely to continue to rise, benefiting from falling prices of imported manufactured goods, including information and communication technology goods.

The current account deficit as a share of GDP is forecast to narrow marginally in 2003-04, following substantial widening in 2002-03. Stronger export growth, slightly slower import growth and an expected increase in the terms of trade should underpin the narrowing. Nevertheless, with the Australian economy expected to continue to grow solidly in the face of weak global conditions, the current account deficit is likely to remain at relatively high levels for another year.

The outlook for inflation remains moderate, with the CPI forecast to increase by $2\frac{1}{4}$ per cent through the year to the June quarter 2004. With wage increases expected to remain steady and productivity growth solid, labour costs should remain subdued. Global weakness also should help contain inflation pressures. With temporary price pressures from the run-up in oil prices and the drought, headline inflation is expected to remain at around the top of the target band in the near-term. However, domestic demand growth is slowing and underlying price pressures are subdued. Together with the recent appreciation of the exchange rate and expected lower oil prices in coming months, this should see inflation decline to around the middle of the medium-term target band by the end of 2003-04.

Employment growth is expected to slow in 2003-04, following very strong growth in 2002-03. Slower employment growth is expected in the retail sector and in the labour-intensive construction industries, where employment growth has surged over the past year. Rural employment should slowly recover if the drought breaks. The unemployment rate is forecast to average around 6 per cent in the June quarter 2003 and remain around that level over the next year.

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Uncertainties surrounding the outlook have increased since MYEFO, particularly on the international front. Increased uncertainty and risk aversion have exacerbated underlying structural risks around an already weak and fragile global economy and financial markets. This has increased their vulnerability to further shocks. It is possible that global uncertainty will quickly dissipate and that the substantial policy stimulus in place in the US and elsewhere will see a substantial global recovery sooner than currently expected, providing a fillip for the Australian economy. On balance, though, the bulk of the international risk is on the downside.

Domestically, the risks are more balanced, although the possibility of adverse external developments coming on top of a slowing non-farm domestic economy provides a sombre backdrop to the outlook. Consumption remains robust, but any sustained deterioration in sentiment or a protracted period of slower growth in income or wealth could cause spending growth to slow as households move to consolidate their financial position. Dwelling investment also could decline more sharply than expected if the economic climate deteriorates and investors adopt a more conservative investment position. Business investment and employment are particularly sensitive to global and domestic economic developments and to the level of uncertainty surrounding the outlook.

Export growth could be weaker than expected if global growth falters, the exchange rate appreciates further, or other factors, such as health and security concerns, adversely affect global trade. It is also possible that the drought will not break evenly. Large parts of the country are still experiencing severe drought conditions and the timing, extent and pattern of the rainfall may not allow the expected recovery in farm production this year.

On the upside, the economy has already successfully weathered a protracted global slowdown, the drought and war in Iraq. Income growth is solid and wealth has continued to rise, despite the long downward adjustment in equity markets. Households and businesses have looked through some of the current uncertainties and have continued to consume and invest solidly. If a solid cyclical global recovery takes hold, structural problems notwithstanding, and the drought breaks as appears likely, the economy could grow strongly next year. In addition low interest rates could moderate the downturn in dwelling investment. If low inflation and low interest rates are further capitalised into house prices, wealth accumulation could provide further support for consumption. Petrol prices, which have been a drag on the economy this year, could fall significantly, also boosting economic growth. Together, these factors provide some upside possibility to the otherwise predominantly downside risk.

On balance, with solid fundamentals and supportive policy settings, the most likely outcome is that Australia's economy will continue to grow solidly despite the weak international backdrop, particularly if a gradual world recovery proceeds as expected. Nevertheless, the real and significant risks to Australia's growth prospects should not be discounted.

Table 1: Domestic economy forecasts^(a)

	Outcomes(b)	Estimates	Forecasts	
	2001-02 year average	2002-03 year average	2003-04 year average	Four quarters to June 2004
Panel A - Demand and output(c)				
Household consumption	3.4	3 3/4	3 1/4	3 1/4
Private investment				
Dwellings	19.5	18	-5	-7
Total business investment(d)	4.6	15	7	9
Other buildings and structures(d)	9.7	28	14	11
Machinery and equipment(d)	2.1	12	4	8
Intangible fixed assets	0.7	9	9	9
Private final demand(d)	4.9	6 1/4	3	3 1/4
Public final demand(d)	4.3	3 3/4	3 1/4	4
Total final demand	4.8	5 3/4	3	3 1/4
Change in inventories(e)				
Private non-farm	-0.1	1/4	0	1/4
Farm and public authorities(f)	0.1	- 1/4	1/2	0
Gross national expenditure	4.8	5 3/4	3 1/2	3 1/2
Exports of goods and services	-1.5	0	6	8
Imports of goods and services	2.3	13	6	6
Net exports(e)	-0.9	-2 3/4	- 1/4	1/4
Gross domestic product	4.0	3	3 1/4	3 3/4
Non-farm product	3.9	4	2 3/4	2 3/4
Farm product	6.1	-27	25	59
Panel B - Other selected economic measures				
External accounts				
Terms of trade	2.2	2 1/4	1 3/4	1/2
Current account balance				
\$billion	-21.6	-42 1/2	-42 3/4	
Percentage of GDP	-3.0	-5 3/4	-5 1/4	
Labour market				
Employment (labour force survey basis)	1.1	2 1/2	1 3/4	1 1/2
Unemployment rate (per cent)(g)	6.6	6	6	6
Participation rate (per cent)(g)	63.7	64	64	64
Prices and wages				
Consumer Price Index	2.9	3 1/4	2 3/4	2 1/4
Gross non-farm product deflator	2.0	3	2 1/4	1 3/4
Average earnings(h)	4.3	3 1/4	4	3 3/4

(a) Percentage change on previous 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) For presentational purposes, forecast changes in inventories held by privatised marketing authorities are included with the inventories of the farm sector and public marketing authorities.

(g) The estimate in the final column is the forecast level in the June quarter 2004.

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

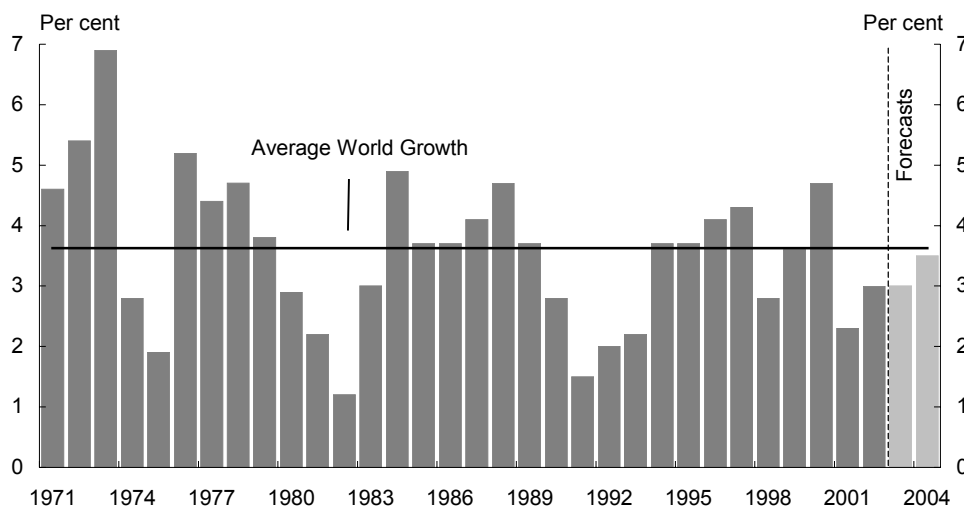
Source: Australian Bureau of Statistics (ABS) Cat. No. 5206.0, 5302.0, 6202.0, 6401.0, unpublished ABS data & Treasury.

THE OUTLOOK FOR THE INTERNATIONAL ECONOMY

Global economic growth is expected to continue to be subdued in a highly uncertain environment, with risks being predominantly on the downside. Despite tentative signs in early 2002 that recovery had commenced, growth slowed markedly later in the year and the outlook has been pared back. This occurred as many of the previously identified risks materialised, such as heightened geopolitical tensions and associated higher oil prices, and continued volatility in equity markets. These developments have slowed global growth and exacerbated other ongoing risks and vulnerabilities, such as weak economies, equity markets and financial systems. In addition, new risks have emerged, with the spread of SARS and tensions on the Korean Peninsula. The combination of these factors has created a weak and uncertain international economic environment.

Overall, the world economy grew by 3 per cent in 2002 in year-average terms. Against a backdrop of continued structural weakness and heightened uncertainties, world GDP growth is expected to remain around 3 per cent in 2003, increasing to around 3½ per cent in 2004.

Chart 1: World GDP growth^(a)



(a) World GDP growth rates are calculated using GDP weights based on purchasing power parity.

Source: National statistical publications, International Monetary Fund (IMF) and Treasury.

Many of the risks identified in the last Budget and at MYEFO have come to pass, including high oil prices and continued volatility in equity markets. Oil prices rose to very high levels in late 2002 and the first quarter of 2003 due to concerns about the war in Iraq, oil supply disruptions in Venezuela and Nigeria, low private sector oil stocks, strong demand for oil and low investment in the oil industry. While the price of oil fell

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as the uncertainty surrounding Iraq abated, it remains at relatively high levels. Notwithstanding recent falls, the full impact of the high price of oil over recent months has not yet been seen. Oil prices continue to present a downside risk to global economic growth prospects.

While the unfolding of events in Iraq resulted in a rally in equity markets, markets remain very volatile and have been in a long decline. Ongoing equity market weakness and volatility could impact on consumer and business expenditure via wealth and confidence effects.

These realised risks have been overlayed on some other major pre-existing risks.

- Global growth continues to rely excessively on developments in the United States (US), as domestic demand in Japan and the Euro area remains hampered by corporate and financial weakness and the slow pace of product and labour market reforms.
- The high US current account deficit and offsetting current account surpluses elsewhere risk a possible disorderly unwinding, which would result in a sharp adjustment to exchange rates and a disruption to growth.
- Concerns exist over the stability of the global financial system due to the vulnerability of the financial sectors in both Japan and the Euro area, and the significant vulnerabilities remaining in a number of emerging markets.
- Other risks include concerns surrounding the sustainability of house price growth in some developed countries, and deflationary pressures in a number of East Asian economies, both of which could impact on business and consumer activity.

Add to these tensions in the Korean Peninsula and the outbreak of SARS, and the picture is one of weak global prospects.

Set against the combined impact of all of these international risks are the very supportive fiscal and monetary policy settings in many economies. For example, in the US, official interest rates are at around 40-year lows, and the fiscal situation has moved from a surplus to a deficit, with a turn around of about 5 per cent of GDP over the last two years. As uncertainties abate, these very supportive macroeconomic policy settings should see the global economy continue to recover in the second half of 2003, before gathering more momentum in 2004. However, in the medium term, ongoing structural problems will continue to hamper sustained and balanced global growth unless decisive policy actions are taken.

Global inflation is expected to remain low in 2003, allowing macroeconomic policies to remain accommodative, although the effects of the run up in oil prices may temporarily raise inflationary pressures. Most advanced economies are experiencing low inflation, while deflation persists in Japan and some other East Asian economies.

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

	1999	2000	2001	2002	2003	2004
	Actual	Actual	Actual	Actual	Forecast	Forecast
World	3.6	4.7	2.3	3.0	3	3 1/2
Total OECD(c)	3.1	3.8	0.8	1.8	1 3/4	2 1/2
United States	4.1	3.8	0.3	2.4	2 1/4	3 1/4
Japan	0.2	2.8	0.4	0.3	3/4	3/4
Euro area	2.8	3.5	1.4	0.8	1	2
Major Trading Partners	4.1	5.3	1.4	3.0	2 1/2	3
Non-Japan East Asia(d)	6.5	7.9	1.9	4.8	3 3/4	4 1/2

(a) Percentage change on previous year.

(b) Growth rates for World and the Euro area 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) Total OECD comprises the United States, Japan, Germany, France, Italy, the United Kingdom, Canada, Australia, Austria, Belgium, the Czech Republic, Denmark, Finland, Greece, Hungary, Iceland, Ireland, Korea, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, Slovak Republic, Spain, Sweden, Switzerland and Turkey.

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

Source: National statistical publications, IMF and Treasury.

After the US economy emerged from the 2001 recession with some promising strength in early 2002, the economy hit a soft patch in the second half of the year, with falling equity prices and a very sharp fall in consumer confidence. This fed through to weak industrial production and retail sales, and consequently lower GDP growth. Overall, the US economy grew by 2.4 per cent in 2002.

The near-term outlook for the US economy is for continued recovery, albeit at a slower pace than earlier expected. However, there are increasing concerns over budgetary difficulties facing the US and the sustainability of its current account deficit, which increased to a record 5.2 per cent of GDP at the end of 2002. With the US economy performing poorly and world demand weak, and with the fiscal position deteriorating, it may become increasingly difficult to attract the capital inflows needed to fund the current account deficit. In this case, the burden of any unwinding of the current account deficit in the US would fall on the private sector, requiring higher saving and reduced expenditures.

Based on early estimates, the US economy grew by a sluggish 0.4 per cent (1.6 per cent annualised) in the March quarter of 2003. Consumption, residential fixed investment, and government expenditure contributed to growth, more than offsetting declines in inventories, investment in non-residential structures and equipment and software, and exports. Higher investment spending in the US is unlikely to occur until at least the second half of 2003, provided that uncertainties abate and sentiment improves. Should this occur, the very stimulatory policies already in place, together with strong productivity growth, advanced adjustment and a low inflation environment, should support investment and overall economic growth in the US. GDP growth in the US is expected to pick up moderately in 2004.

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Japan's economy surprised on the upside in 2002 although trade and production data present a much weaker picture. Growth was entirely export driven, and this is expected to be the case in 2003, as domestic demand remains subdued. The recovery in household consumption in Japan evident during 2002 now appears to be fading, consistent with declining real incomes and employment. Investment has been showing some signs of bottoming, but is far from staging a full recovery as deflation continues. Overall, domestic demand in Japan remains seriously hampered by structural weaknesses and economic growth is expected to remain weak over the forecast period.

Specific risks to the Japanese outlook include the vulnerability of the financial sector, which is struggling with a large share of non-performing loans, very weak share prices and inadequate capital-asset ratios. Investors in Japan are also very sensitive to heightened instability in the Korean Peninsula.

GDP growth in Non-Japan East Asia was robust in 2002, driven by continued strong growth in China and a robust pick-up in Korea, although growth remained well below that achieved prior to the Asian financial crisis. Exports and consumption spending, stimulated by expansionary macroeconomic policies, supported growth, while investment remained restrained by risks surrounding the global economic outlook.

Looking forward, exports and domestic demand in Non-Japan East Asia are both expected to contribute to growth, but overall growth is expected to weaken across the region. Exports could falter in light of weaker global growth prospects and SARS is weakening domestic demand. While governments will seek to support economic activity, this is likely to be limited as interest rates in the region are already low and most governments (except Korea) are already running budget deficits.

The unexpected outbreak of SARS is disrupting life in many East Asian countries. Governments across East Asia and the international community more generally, have responded to limit the outbreak. The impact on the countries affected has been heavy, with both loss of life and major disruptions to economic activity. In particular, retail travel and other service industries have been hard hit. The impact on the travel industry already suffering from the fallout of the Bali bombings and the threat of further terrorist attacks could be particularly significant. Unless the spread of SARS is contained quickly, the overall economic consequences for the region could be substantial.

In addition to the general global risks, the outlook for the Asian region remains particularly vulnerable to stalling prospects in the information and communication technology sector and tensions in the Korean Peninsula.

The Euro area recorded weak GDP growth of less than 1 per cent in 2002 as the recovery that was expected in the second half of the year failed to materialise. Growth prospects in the near term remain weak. The area's weakness remains centred on Germany, which accounts for nearly a third of the output of the single currency zone. The German economy was stagnant in the December quarter 2002 and recent surveys

suggest further weakening in early 2003. The prospects for Germany remain bleak, with industrial production, business confidence, and retail sales continuing to be weak, and the jobless rate at a three-year high.

Overall, domestic demand in the Euro area is likely to remain subdued. Additional fiscal stimulus in Germany and France is already at the limit prescribed by the Stability and Growth Pact, while rising unemployment and heightened uncertainties are likely to restrain consumption and investment over the short term. In addition, the recent appreciation of the euro has dampened exports, which have been the primary source of growth across the Euro area.

Investment in the Euro area is being hampered by financial sector weakness, with the faltering economy putting additional stress on the vulnerable financial system. In particular, severe weakness of the German banking and insurance sectors has already seen financial sector share prices plummet and threaten the stability of the Euro area's financial system. Moreover, structural rigidities in product and labour markets are hampering any sustainable recovery in consumption and investment.

In light of continued weakness and receding inflationary pressures in the Euro area, monetary policy has become more stimulatory. In addition, France and Germany have also called for a more relaxed interpretation of the Stability and Growth Pact to allow large deficit spending.

GDP in the United Kingdom (UK) grew by 1.8 per cent in 2002, somewhat better than in the Euro area. While growth prospects in the UK remain slightly better than in the Euro area, confidence in the UK declined in the March quarter of 2003 and the economy grew by a weak 0.2 per cent. Consumption spending, which has been supported by rising house prices, is expected to moderate, with household debt rising to record levels and weak equity markets reducing wealth.

The balance of risks to the global economic outlook remains predominantly on the downside. However, this needs to be set against monetary and fiscal policies that have been eased substantially around the globe. A quick resolution or abatement of some of the major uncertainties currently facing the world economy could easily see the recovery gather momentum more quickly than is currently expected. However, any cyclical pick up in growth is likely to be constrained in the medium term unless policy actions are taken to address ongoing structural problems.

THE OUTLOOK FOR THE DOMESTIC ECONOMY

Key assumptions

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 (TWI) of around 55 and a \$US exchange rate of

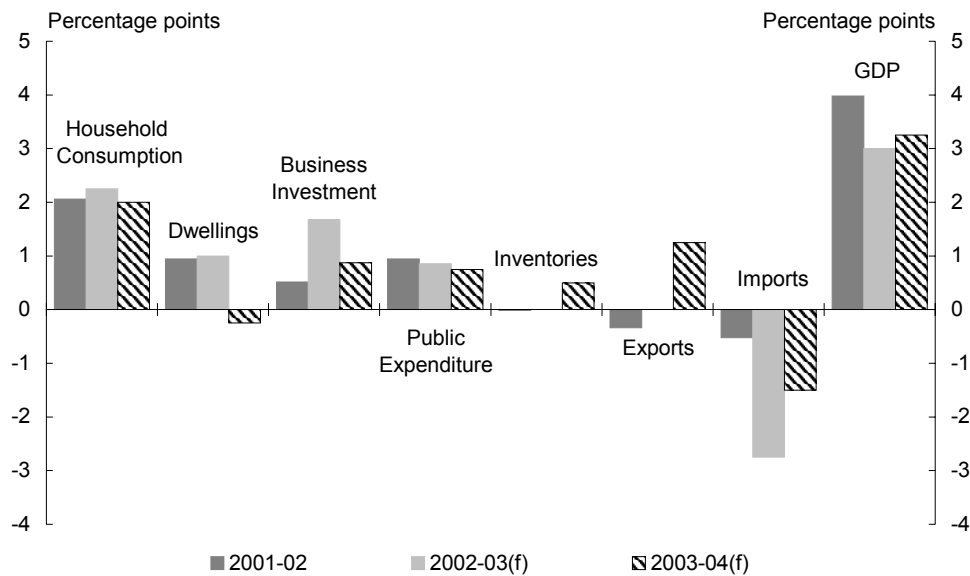
a little above 60c). Interest rates are assumed to remain around current levels. World oil prices (\$US per barrel – West Texas Intermediate) are assumed to remain in the \$US25-30 range over the next few months and then fall to around \$US25 per barrel by June 2004, broadly in line with market expectations. The farm sector forecasts are based on an assumption of a return to average seasonal conditions in 2003-04.

Demand and output

In 2003-04, the Australian economy is forecast to grow by $3\frac{1}{4}$ per cent in year-average terms. Slower growth in non-farm production is expected to be more than offset by a rebound in farm production. Employment growth is likely to slow, after very strong growth in 2002-03, with the unemployment rate remaining around 6 per cent over the coming year. Inflation is forecast to decline to around the middle of the target band. The current account deficit as a percentage of GDP should narrow to around $5\frac{1}{4}$ per cent as the pace of growth of domestic demand slows and global conditions gradually improve.

The solid outlook comes after another year in which the extraordinary resilience of the Australian economy has been demonstrated. This resilience – a consequence of sustained economic reforms – helped deliver solid growth despite a weak global economy and a very severe drought. GDP growth is forecast to be 3 per cent in 2002-03, unchanged from the forecast presented in MYEFO. The drought is forecast to directly subtract nearly 1 percentage point from GDP growth in 2002-03, with non-farm GDP growth forecast to be 4 per cent.

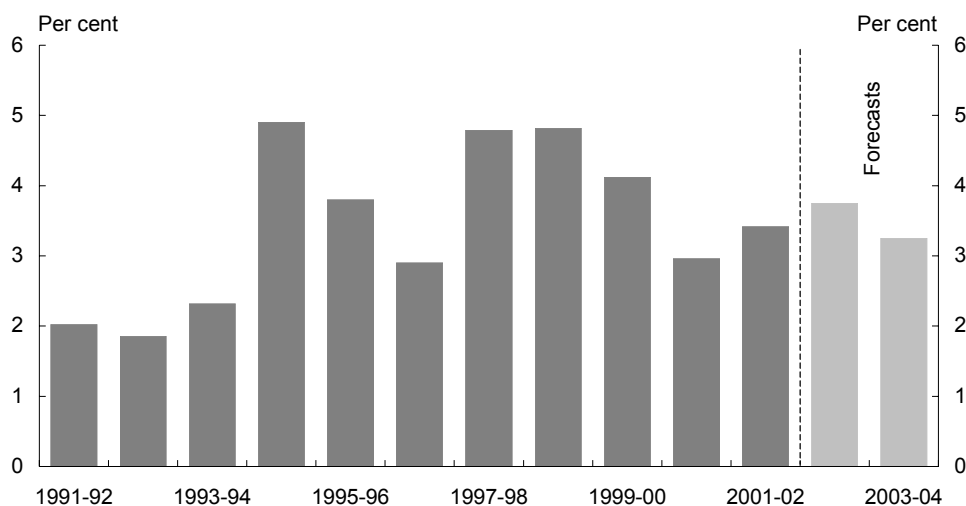
The solid GDP growth outcome expected for 2002-03 reflects very strong domestic demand. Gross national expenditure is forecast to grow by $5\frac{3}{4}$ per cent in 2002-03 in year-average terms, with net exports expected to subtract $2\frac{3}{4}$ percentage points from GDP growth. Growth in final domestic demand is forecast to slow to around 3 per cent in 2003-04, with slower growth in consumption and business investment and a fall in housing investment. A recovery in farm inventories will add to growth, while the net export subtraction is forecast to be around $\frac{1}{4}$ of a percentage point, with stronger exports and slower import growth supporting the turnaround (Chart 2).

Chart 2: Contributions to GDP growth^(a)

(a) Adjusted for second-hand asset sales.
Source: ABS Cat. No. 5206.0 and Treasury.

Household consumption

Household consumption growth is forecast to slow a little in 2003-04 to 3¼ per cent, following solid growth of 3¾ per cent in 2002-03 (Chart 3). This expected moderation reflects slower growth in employment and in wealth accumulation, and slower growth in household borrowing.

Chart 3: Growth in household consumption

Source: ABS Cat. No. 5206.0 and Treasury.

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Consumer spending has grown solidly during 2002-03, underpinned by sustained income growth, rapid accumulation of wealth and low interest rates. Some slowing has been apparent through the year but this has likely been due to the combined effects of a number of temporary factors: the run-up in oil and petrol prices; drought-related food price increases; and lower farm incomes.

Household consumption growth in 2003-04 should continue to be supported by low interest rates and solid, albeit moderating, growth in household income. Some of the short-term factors that were a drag on consumption in 2002-03 may also start to abate. Oil prices have already fallen from pre-war highs and there are tentative signs that the drought may break in coming months. Offsetting this, however, the anticipated downturn in dwelling investment should reduce consumption growth in 2003-04, as some of the bring-forward of spending on housing-related durables in the last two years is unwound.

More importantly, some of the powerful underlying forces driving consumption growth may start to ease over the next year. After very strong growth in 2002-03, employment growth is forecast to slow through 2003-04, moderating the pace of household income growth, one of the main drivers of consumption spending.

The growth in wealth is also expected to slow. Over the past few years, household wealth has increased strongly, underpinning spending and household borrowing capacity. The increase in wealth, and new financial instruments that allowed improved access to unrealised wealth accumulation, supported and facilitated a substantial increase in household debt, as did historically low interest rates. These developments underpinned consumer spending, with consumption running ahead of disposable income for several years, and the household saving rate falling to current lows.

Going forward, a slower pace of wealth accumulation is likely to provide a moderating influence on consumer spending. House prices are unlikely to sustain the rapid pace of increase experienced over the past few years, and with equity prices subdued, the rate of increase in wealth is likely to slow. Against this backdrop, and with debt servicing costs around 6 per cent of disposable income, some consolidation of household balance sheets is in prospect over the next few years (Box 1).

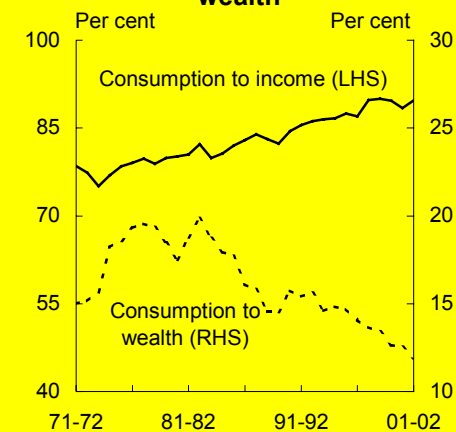
Taken together, these influences should see the pace of consumption growth slow in 2003-04, to a little below that of household disposable income. There is a risk, however, that consumption could slow more than expected, particularly if overall economic conditions weaken. With households more heavily geared than in the past, they are likely to be more sensitive to changes in economic circumstances. For example, a deterioration in labour market conditions could increase debt-servicing burdens for some households with attendant effects on consumption. Adverse shifts in asset markets, such as a sharp correction in the housing market, could also see consumption weaken.

Box 1: Consumption and wealth

Household consumption has been a key driver of economic activity in recent years, growing at an annual rate of around 4 per cent over the past five years, well above its historical growth rate.

One of the important drivers of consumption has been strong gains in household wealth. Real wealth has increased by around 45 per cent over the past five years.

The sharp pick-up in wealth has funded higher spending and facilitated additional borrowing by households. Consumer spending has run ahead of income, although the increase in spending has not kept pace with the increase in wealth (Chart A).

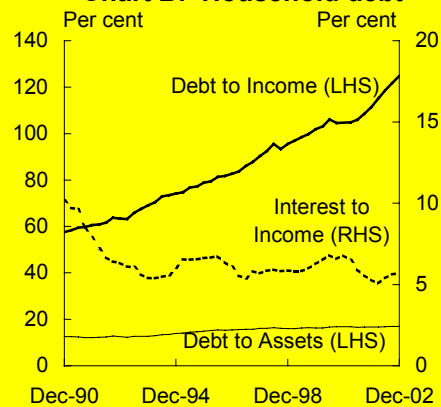
Chart A: Consumption, income and wealth

Source: ABS Cat. No. 5206.0 and Treasury.

Household debt levels have increased concomitant with the rise in wealth, with much of the increase going into

housing and, to a lesser extent, underpinning higher consumption spending. Total household debt has increased to 125 per cent of income, and 17 per cent of assets, and debt-servicing costs are around 6 per cent of income (Chart B).

Households are vulnerable to adverse shifts in economic conditions — particularly changes in labour market conditions, interest rates and house prices.

Chart B: Household debt

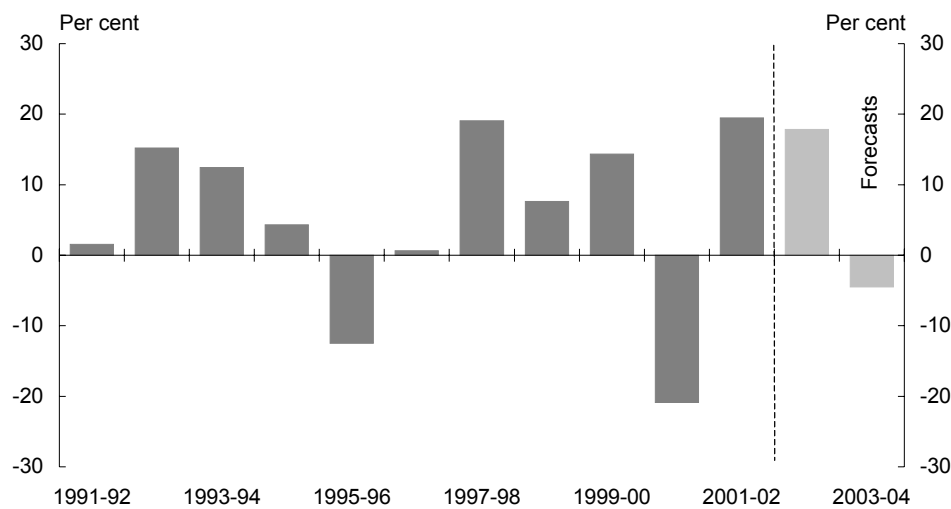
Source: ABS Cat. No. 5206.0, 5232.0 and Treasury.

The above-trend pace of wealth accumulation is unlikely to be sustained. Accordingly, with economic growth slowing a little, households are likely to consolidate their balance sheets by bringing back spending growth to around or below the pace of income growth. It is possible, however, that households may rein in consumption more sharply than expected.

Dwelling investment

Dwelling investment is forecast to decline by around 5 per cent in 2003-04, following growth of around 18 per cent in 2002-03 (Chart 4). The expected fall in dwelling investment comes after a period of very strong growth in the construction of new dwellings and a solid pick-up in spending on alterations and additions. The prospect of a longer-than-expected period of low interest rates, strongly rising house prices and subdued returns from alternative investments have extended the current cycle for longer than anticipated.

Chart 4: Growth in dwelling investment



Source: ABS Cat. No. 5206.0 and Treasury.

Much of the strength in dwelling investment has come from the investor segment of the market, which has increased rapidly in recent years. Moreover, despite the prospect of substantial oversupply in some segments of the market — particularly the multi-unit sector — there are few signs yet of a substantial easing (Box 2). Rental vacancy rates are at relatively high levels and rents have weakened a little in the major markets. However, with interest rates low and continuing increases in dwelling prices, investment demand has remained firm. Some planned major inner-city projects have been cancelled but, to date, much of the planned work still appears to be proceeding. Building approvals for multi-unit dwellings increased strongly over the past year, while loan approvals to investors remain at high levels.

There remains considerable work in the pipeline in the medium-density sector. Projects in this sector also tend to take up to 18 months to complete. As a result, the expected downturn in activity in this part of the market may still be some time away. Nonetheless, there is now a substantial risk that the looming oversupply will see a sharp and protracted correction once sentiment turns. Heavily geared investors may

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come under increased financial pressure if yields fall further or prices decline. Any resulting distressed selling could exacerbate the price impact of the downturn.

In sharp contrast, growth in the owner-occupier segment of the housing market has been more muted as the bring-forward of activity associated with the additional grant available under the First Home Owners Scheme has been unwound through the year. Leading indicators suggest that owner-occupier housing activity is set to fall over the next year. The number of owner-occupier housing loan approvals for new construction has fallen by 17 per cent in the year to February 2003 and building approvals for new houses have fallen by 15 per cent in the year to March 2003.

Partially offsetting the expected decline in new dwelling investment, alterations and additions are forecast to continue to grow in 2003-04. Unlike the new dwelling segment of the market, there does not seem to have been the same bring-forward of renovation work. Indeed, there may be pent-up demand for alterations and additions, with the high levels of work on new houses and apartments crowding out renovation work in recent times. As capacity constraints in the building industry ease, some of the pent-up demand for renovation work is likely to be met. Work yet to be done on alterations and additions is currently at high levels. This should reduce the overall decline in dwelling investment. However, house price increases are likely to be more subdued next year and this may dampen demand for alterations and additions from investors seeking capital gains on renovated properties. A moderation in the pace of growth of income and wealth may also slow spending on alterations and additions.

Box 2: Investment in medium-density dwellings

Dwelling investment has continued to grow strongly over the past year, and is expected to directly contribute around 1 percentage point to GDP growth in 2002-03. The increase has been largely driven by the strength in the medium-density market, which is dominated by investors.

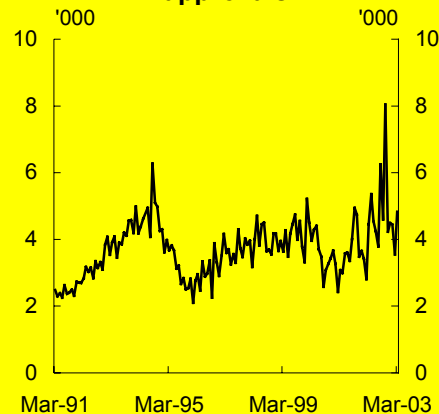
Investors have been motivated by the prospect of capital gains following substantial price rises in recent years, low interest rates and the potential negative gearing advantages of investment property. Poor short-term prospects for alternative investments are also likely to have seen increased investor interest in property. In addition, a range of new financial products has supported investor demand.

While the bulk of investor funds have been used to purchase existing dwellings, a growing amount has

gone towards the construction of new dwellings (Chart A).

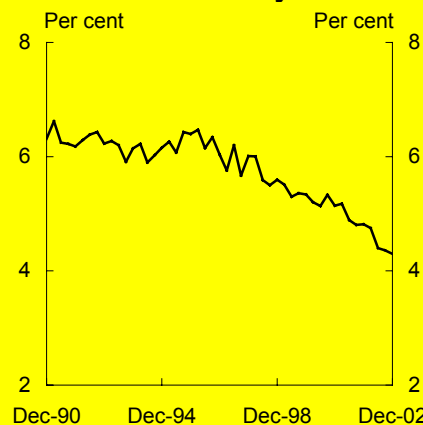
After a period of strong growth in medium-density construction, signs of oversupply in the market are becoming apparent. Vacancy rates have continued to rise and rental yields have declined (Chart B).

Chart A: Medium-density building approvals



Source: ABS Cat. No. 8731.0.

Chart B: Rental yields^(a)



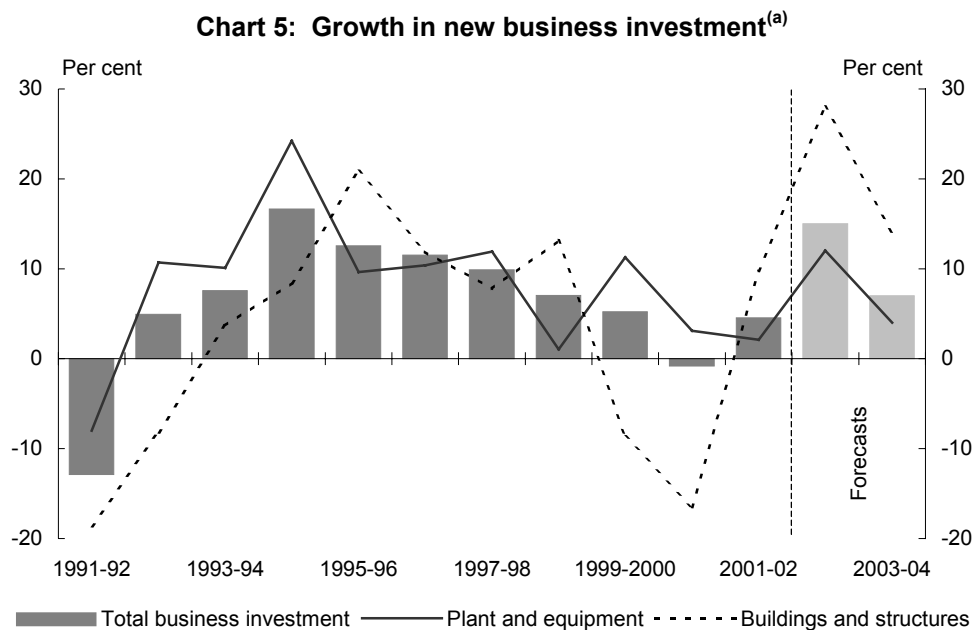
(a) Ratio of median unit rents & median unit prices. Source: Real Estate Institute of Australia and Treasury.

However, the construction of medium-density dwellings, particularly the high rise apartments of four or more storeys in which investor interest has been concentrated, tend to have long lead-times to completion, typically between six and eighteen months.

With a large number of apartments still to come onto the market, particularly in Sydney, Melbourne and Brisbane, there is a possibility of substantial oversupply and a sharp correction in prices and building activity.

Business investment

Business investment is forecast to increase by 7 per cent in 2003-04, following growth of around 15 per cent in 2002-03 (Chart 5). Overall, conditions are supportive of investment growth, but uncertainty clouds the near-term outlook.



(a) Excluding net purchases of second-hand public sector assets by the private sector.
Source: ABS Cat. No. 5206.0 and Treasury.

The fundamental drivers of business investment remain strong. Capacity utilisation is at high levels and the outlook for the non-farm economy, although moderating, remains solid. In addition, corporate profits have grown very strongly over the past year and interest rates are around historically low levels. Corporate balance sheets are generally sound.

There are also some special sectoral factors that should support business investment in 2003-04. These include ongoing strong growth in mining investment and the upgrade of the aviation industry's fleet of aircraft, which is expected to extend into 2003-04. A significant increase in infrastructure expenditure is also in train, especially in NSW, and much of this appears likely to be undertaken by the private sector.

Nevertheless, there is still considerable uncertainty around the outlook for business investment, with a number of downside risks. Heightened global uncertainty is likely to see firms scale back discretionary investment plans in the near term, with growth in plant and equipment investment expected to slow from a forecast 12 per cent in 2002-03, to around 4 per cent in 2003-04, despite the strong underlying fundamentals.

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The latest Australian Bureau of Statistics capital expenditure survey showed that firms' first estimate of plant and equipment intentions for 2003-04 was a little below their first estimate for 2002-03. However, early estimates provide only a broad indication of likely outcomes. It is possible that as the year progresses, firms will become more confident and upgrade their investment intentions significantly. However, firms did not upgrade investment intentions by as much as would usually be expected as 2002-03 progressed. It is possible that investment intentions for 2003-04 will follow a similar path unless the current uncertainty dissipates quickly. Business confidence has generally held up reasonably well considering the global backdrop, but has weakened a little in recent months.

Investment in buildings and structures is expected to grow by 14 per cent in 2003-04, following growth of 28 per cent in 2002-03. The increase is expected to be driven by very strong growth in engineering construction, which is underpinned by a number of large mining and infrastructure projects. Unlike plant and equipment investment, large mining engineering construction projects typically look through short-term fluctuations in global economic activity. Infrastructure projects are also relatively unaffected by global conditions. The commencement of engineering construction work on major projects has increased the level of engineering construction work yet to be done to around \$7 billion in December 2002. Several additional large projects, which are expected to commence in 2002-03 in the mining and transport and storage sectors, are also expected to support growth next year. Investment in new non-residential buildings is expected to moderate in 2003-04, with growth being driven by building activity in office and business-park construction.

Inventories

In 2003-04, investment in private non-farm inventories (excluding private marketing authorities) is expected to broadly keep pace with solid sales growth, with no net contribution to GDP growth. This follows an expected positive contribution to GDP growth of around $\frac{1}{4}$ of a percentage point in 2002-03 as the level of inventories is rebuilt. Nevertheless, the degree of uncertainty surrounding the international economic outlook is likely to influence decisions regarding investment in inventories, with businesses likely to hold off building up stocks until the outlook clears.

Farm and private marketing authority inventories are forecast to be rebuilt in 2003-04, assuming the drought breaks. This follows a sharp rundown in 2002-03, when existing stocks were used to augment drought-affected supplies. Investment in farm and private marketing authority stocks is forecast to contribute around $\frac{1}{2}$ of a percentage point to GDP growth in 2003-04.

Public final demand

Public final demand (abstracting from second-hand asset sales) is expected to increase by around $\frac{3}{4}$ per cent in year-average terms in 2003-04. This is a slight moderation in the pace of growth from 2002-03, reflecting slower growth in public investment at the Commonwealth, state and local levels.

The easing in public final demand in 2003-04 comes after an expected pick-up in 2002-03, in which growth is expected to be around 3¾ per cent in year-average terms. This above-average growth in public final demand partly reflects additional Commonwealth spending on the war in Iraq and national security. Increases in state and local government spending on insurance and superannuation expenses, along with additional expenditure on education, health, and public order and safety are also expected to contribute to growth in public final demand. Spending on infrastructure projects should also support demand.

Net exports and the current account

Net exports

Exports are forecast to increase by 6 per cent in 2003-04, a modest rebound from the flat outcome expected in 2002-03. The mild recovery is expected to be underpinned by subdued global growth and an assumed breaking of the drought.

Over the past year, weak trading partner demand and the effects of the drought have seen export growth stagnate. The exchange rate has also appreciated, with the Trade Weighted Index increasing by around 8 per cent over the past year, adding to the drag on export growth.

Although some pick-up in exports is in prospect over the next year, conditions are still far from ideal. Nevertheless, there are welcome signs that the El Niño pattern has ended and that there will be at least average levels of rainfall over much of Australia in the coming year. While this should result in a recovery in rural production and exports, the outcome will also depend on a number of other factors: the timing of the rain; the distribution of rainfall; and subsoil moisture conditions. In the near term, further falls in farm production are in prospect.

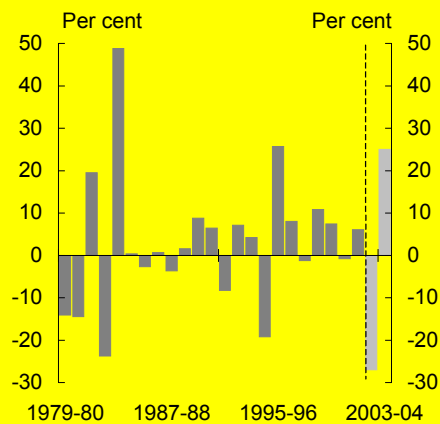
In line with the assumed breaking of the drought, rural exports are expected to rise substantially in 2003-04. The rebound in rural exports is expected to be driven by a sharp rebound in broadacre crop production, reflecting both an increase in the area planted and a recovery in yields. However, irrigated crops are expected to show a more muted recovery in production, being constrained by ongoing low levels of water storage. In addition, the recovery in livestock production is also expected to be slower, with the herd rebuilding process taking a couple of years to complete (Box 3).

Box 3: Drought and farm production

Measured in terms of its impact on the rural economy, the drought in 2002-03 is forecast to be the worst on record. Farm production is expected to decline by a record 27 per cent, directly subtracting 0.9 of a percentage point from GDP growth in 2002-03 (Chart A).

The latest information from the Bureau of Meteorology suggests that the El Niño weather pattern has ended and more favourable seasonal conditions are likely in coming months. If the drought breaks, farm production is expected to rebound by around 25 per cent in 2003-04, contributing 0.6 of a percentage point to GDP growth.

Chart A: Growth in farm production



Source: ABARE, ABS and Treasury.

The rebound in farm production is likely to be led by a strong pick-up in crop production. The Australian Bureau of Agricultural and Research

Economics (ABARE) forecasts cereal crop production to increase by over 50 per cent in 2003-04, contributing significantly to growth in farm production (Table A).

Table A: Farm production^(a)

	2002-03	2003-04
Farm Production	-0.9	0.6
Farm Outputs		
Cereals	-0.7	0.7
Non-cereal crops	-0.2	0.2
Livestock & other	0.0	-0.2
Wool	-0.1	0.0
Farm Inputs	0.1	-0.1

(a) Contribution to GDP growth.

Source: ABARE, ABS and Treasury.

However, a less positive outlook for livestock and wool production will slow the pace of rural recovery. The drought saw a large reduction in the size of the livestock herd in 2002-03 and herd rebuilding is likely to take some time. Similarly, relatively low sheep numbers will reduce the scope for a recovery in wool production in 2003-04.

In the past, droughts generally have been followed by periods of above-average production, so it is possible that the rebound will be greater than forecast. Tempering this optimism, though, is the fact that large parts of the country remain drought declared, there is limited availability of stored water and the timing and distribution of rainfall may be uneven.

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Exports of elaborately transformed manufactures (ETMs) and services are highly sensitive to economic conditions in Australia's major trading partners. Following recent weak outcomes, ETM exports are forecast to pick up a little over the course of 2003-04, in line with the expectation of only modest growth in Australia's major trading partners, and against the mild drag from the appreciation of the exchange rate.

Services exports are expected to show a weak recovery in 2003-04. Services exports are yet to fully recover from recent shocks, including the collapse of Ansett and terrorist attacks (Box 4). More recently, security concerns surrounding travel during the war in Iraq, and the outbreak of SARS, are likely to weigh heavily on the outlook for services exports.

Exports of non-rural commodities, which account for the largest share of Australia's exports, are forecast to pick up in 2003-04, despite subdued trading partner growth. This reflects incremental increases in mining capacity and solid demand from key buyers, despite increasing competition. The mining sector has enjoyed very high levels of profitability in recent years which, combined with high commodity prices in Australian dollar terms, has seen a boom in mining investment. However, major increases in new capacity are not expected to flow through to export volumes until at least 2004-05.

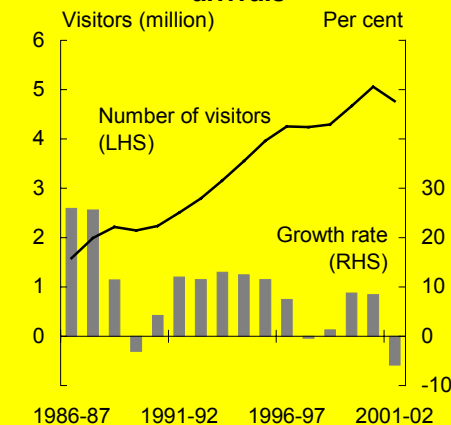
Box 4: The outlook for tourism

Inbound tourism experienced strong growth in 1999-2000 and 2000-01 (Chart A), supported by solid economic growth in Australia's major trading partners, a competitive exchange rate and a boost from the Sydney Olympic Games.

Since then, conditions have deteriorated markedly, with a number of factors weighing on the sector, including an unwinding of the Olympics effect, the collapse of Ansett, a slowing in world growth, and terrorist attacks which have adversely affected traveller security and confidence.

More recently, the war in Iraq and the outbreak of SARS have again demonstrated the sensitivity of travellers to adverse developments.

Chart A: Short-term overseas arrivals



Near-term prospects for international travel remain poor, particularly with

the weak world economy and ongoing concerns about health and security. In addition, the recent appreciation of the exchange rate may also have a negative impact on inbound tourism.

As a result, services exports, which account for around 4½ per cent of the economy, and particularly inbound tourism, are expected to be a drag on economic growth in 2002-03.

A modest recovery is expected in 2003-04, as global conditions gradually improve and the adverse effects of the war in Iraq and SARS subside. The staging of the Rugby World Cup in Australia in October and November 2003 should also provide a useful fillip.

However, a turnaround in confidence in international travel, and a more robust recovery in world growth, will be important for a stronger recovery in tourism activity. A further episode of global weakness, a prolonged period of international tensions or a significant spread of SARS, could undermine the outlook further.

Despite the poor prospects for inbound tourism, the outlook for domestic tourism, which accounts for around 76 per cent of the industry, remains sound. The domestic tourism sector is relatively less affected by international security issues and should benefit from an expected near-term switch from international to domestic destinations.

Imports are forecast to increase by around 6 per cent in 2003-04, following growth of around 13 per cent in 2002-03. Slower growth of imports in 2003-04 largely reflects the expected slower growth of domestic demand. There is also likely to be a fall in aircraft imports. The aviation industry's upgrading of its fleet of civil aircraft is expected to continue into 2003-04, but expenditures are likely to be lower than in 2002-03. Imports of services, particularly tourism services, are likely to remain subdued over the forecast horizon because of health and security concerns. Working in the other direction, the appreciation of the exchange rate will tend to support import volumes in 2003-04.

Taken together, the trade forecasts imply that net exports will subtract around $\frac{1}{4}$ of a percentage point from economic growth in 2003-04, following an expected $2\frac{3}{4}$ percentage points subtraction from growth in 2002-03.

The key risks to the outlook for the external sector remain the uncertainty around prospects for Australia's major trading partners and the possibility of a continuation of the drought. A slower-than-expected recovery in world economic activity would see slower export growth and possibly weaker commodity prices. A higher exchange rate, a sharp fall in the terms of trade (which occurred in many past episodes of global weakness, although not recently), or reduced international travel could also see export growth falter. Over 20 per cent of domestic production is exported, so even a modest reduction in export growth rates would impact noticeably on aggregate GDP growth.

The other key risk relates to the possibility that below-average seasonal conditions will persist into 2003-04, extending the drought for another year. The National Climate Centre notes that the El Niño weather pattern has ended, although a continuation of the drought cannot be ruled out. In 2002-03, some of the effects of the drought on rural exports were buffered by a rundown of stocks, but with private marketing authorities' stocks being run down to support exports this year, this offset will not be available in 2003-04 if the drought persists.

The terms of trade

The terms of trade is expected to increase in 2003-04, supported by an ongoing decline in the price of imported goods. While export prices are likely to remain subdued, weak global economic conditions, competitive pressures and ongoing productivity improvements in information and communications technology goods (ICT) should continue to place downward pressure on international prices.

Commodity prices have remained firm over the past year with a small pick-up in the prices of some rural commodities offsetting the weakness in non-rural commodity prices, particularly base metal prices. Oil and gold prices have also increased, although prices have fallen somewhat in the past month. The prices of other exports have been subdued, in line with weak export demand. On the import side, prices have continued to decline (even abstracting from the effects of the appreciation of the currency) reflecting subdued world inflation and ongoing falls in ICT prices.

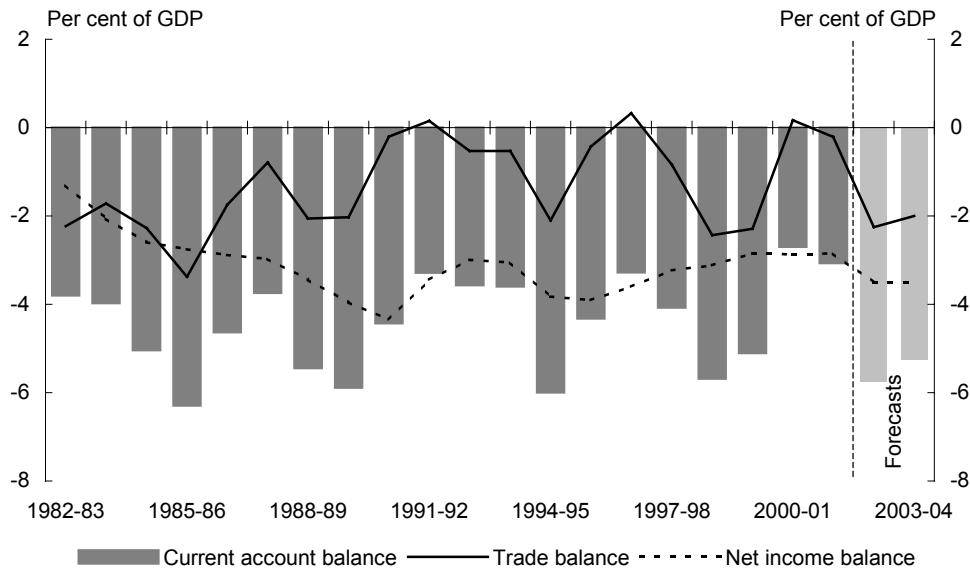
The good performance of the terms of trade during a period of global economic weakness has provided an important buffer for the economy. The cumulative increase in the terms of trade over the past four years has been over 10 per cent, with further increases expected in 2002-03 and 2003-04.

The current account

The current account deficit should narrow a little in 2003-04 to around 5¼ per cent of GDP, from around 5¾ per cent of GDP in 2002-03 (Chart 6). Most of the movement in the current account balance over the past year has been due to movements in the trade balance, which has widened sharply. The net income deficit is expected to widen a little this year, in line with the accumulation of net foreign liabilities associated with recent current account deficits. Interest rates remain low, however, helping to contain any increase in the net income deficit. The increase in the terms of trade has also slowed the increase in the current account deficit and should continue to do so over the next year.

The widening of the current account deficit reflects the desynchronised Australian and world economic cycles and the drought. The strong performance of the Australian economy has occurred at a time when many of Australia's trading partners are growing more slowly than usual. Strong imports, underpinned by high levels of investment and an appreciating exchange rate, are expected to contribute an amount equivalent to around 2 percentage points of GDP to the increase in the CAD in 2002-03. Of this, around ½ of a percentage point is expected to be due to aircraft imports. The drought is expected to contribute around ½ of a percentage point of GDP to the widening of the CAD in 2002-03 through lower rural commodity exports. Moreover, weak global demand is limiting the scope for manufactured and service exports.

In 2003-04, the CAD should narrow a little as a percentage of GDP. Import growth is expected to be lower and a gradual recovery in world demand and higher rural production should see a pick-up in exports.

Chart 6: Current account balance

Source: ABS Cat. No. 5302.0 and 5206.0 and Treasury.

Labour market, wages and prices

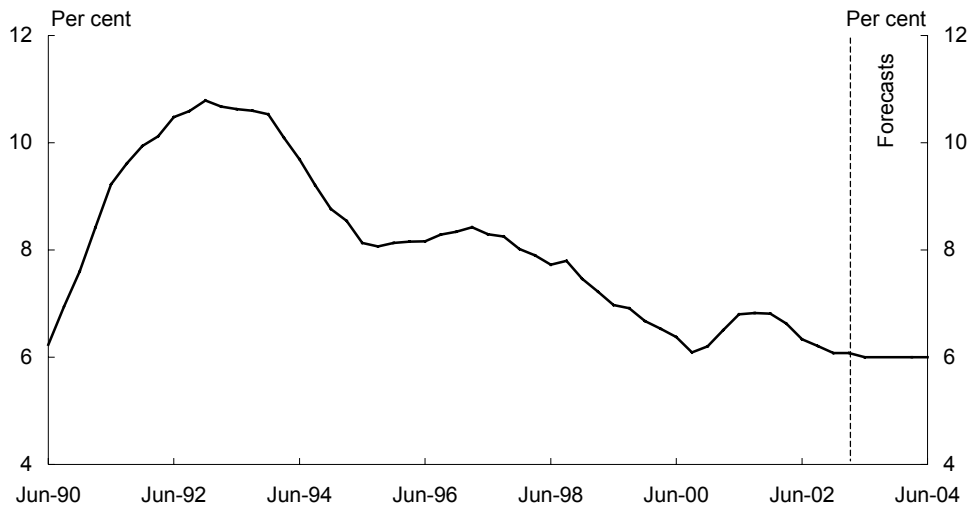
Labour market

Growth in employment is expected to slow through 2003-04, in line with slower growth in the non-farm economy. Rural employment is forecast to pick up if the drought breaks, but a full recovery may take some time. Employment growth is forecast to be $1\frac{3}{4}$ per cent in year-average terms and $1\frac{1}{2}$ per cent through-the-year to the June quarter of 2004. The expected moderation in employment growth is likely to see the unemployment rate remain around 6 per cent over the next year (Chart 7).

The expected slowdown in employment growth comes after very strong growth in the first half of 2002-03. Much of the strength appears to have been concentrated in retail and housing-related employment (Box 5).

Labour market leading indicators and business surveys of hiring intentions are broadly consistent with an expected slowing in the labour market. The ANZ newspaper job vacancy series, for example, is now showing a declining trend, although the ABS measure of vacancies is still rising. The labour-intensive residential construction sector and construction-related parts of the manufacturing sector are expected to slow from around mid-2003. This is expected to provide more impetus to a generalised slowing in employment growth. The expected gradual recovery in rural and regional employment should provide a partial offset.

Chart 7: Unemployment rate



Source: ABS Cat. No. 6202.0 and Treasury.

Wages

Wages growth is expected to be well contained in 2003-04, gathering pace a little in coming months in line with the recent tightening in labour market conditions, but steadying thereafter in line with the more subdued employment outlook and a steady unemployment rate. Average earnings on a national accounts basis are expected to grow by 4 per cent in 2003-04.

The slight pick-up in wage pressures in the early part of 2003 has been noted in recent business surveys, including the NAB and ACCI-Westpac surveys and in data on new enterprise agreements from the Department of Employment and Workplace Relations. Business liaison also points to some pick-up in wage pressures in the construction industry. However, overall labour market conditions do not appear to be overly tight and wage pressures are reported to be generally subdued. The increase in federal minimum award wages granted by the Australian Industrial Relations Commission following its Safety Net Review of wages may put upward pressure on wages growth, particularly if it flows through to increases in non-award wages.

Nevertheless, with inflation moderate, inflation expectations well in check, and labour market conditions unlikely to tighten much through the course of 2003-04, wage pressures generally should remain contained. With productivity growth expected to be solid, overall growth in labour costs should remain subdued.

Box 5: Industry employment growth

Australian employment increased by 3 per cent over the year to the March quarter 2003, compared with OECD employment growth of 0.3 per cent in the year to the December quarter 2002.

Solid consumption spending led to around 70,000 new retail jobs over the past year, mainly in the personal and household goods retail sector. Almost half of the retail jobs created were full-time positions.

Strong growth in dwelling and business investment drove large increases in employment in the labour-intensive construction industries. Almost 60,000 construction jobs were created in the year to the March quarter 2003, with over 42,000 additional full-time males employed. The strong jobs growth was centred in the construction trade services sector.

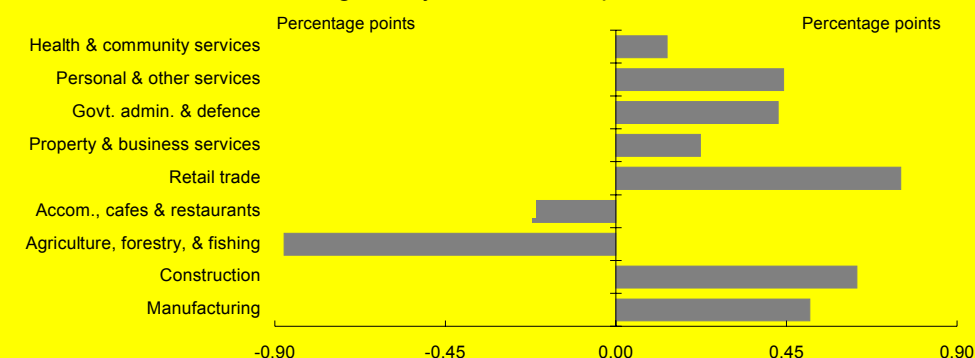
In contrast, the drought has seen job losses of around 80,000 in the farm sector over the past year.

Employment in tourism-related areas appears to have declined. Employment in accommodation, cafes and restaurants declined by around 20,000 over the year, most likely reflecting global weakness and uncertainty, and security concerns of international travellers. The recent outbreak of SARS has exacerbated tourism-related job losses.

Employment growth is likely to ease over the next year and the composition of growth is likely to shift away from the housing construction industry, manufacturing and housing-related services. These sectors are particularly labour intensive, so economy-wide employment outcomes will be sensitive to how the housing cycle evolves.

Employment outcomes will also be sensitive to the pace of recovery in rural and regional Australia, and to how adverse developments in the tourism industry play out.

Chart A: Contributions to employment growth
Through-the-year to March quarter 2003



Prices

Inflation is forecast to slow to 2¼ per cent in the year to June 2004, down from around 3¼ per cent expected in the year to June 2003, and within the medium-term inflation target band.

Inflation has been boosted over the past year by a number of one-off factors, in particular higher fuel prices, reflecting the substantial run-up in global oil prices, and by drought-related increases in food prices. There have also been substantial increases in housing costs and higher insurance premiums. Services prices have increased solidly, reflecting the strength of domestic demand and tighter labour market conditions, which have underpinned a slight pick-up in wages growth. These increases have been partly offset by subdued growth in import prices, reflecting weak global conditions and recently the appreciation of the Australian dollar. Headline inflation was 3.4 per cent in the year to the March quarter 2003, with measures of underlying inflation pointing to inflation of between 2 and 3 per cent through the year.

Looking ahead, inflation should decline once some of the temporary influences start to abate. While wages are expected to pick up a little in the first half of 2003, inflation expectations remain subdued and the pace of wages growth should ease over the course of 2003-04, in line with the anticipated easing in labour market conditions. With productivity growth expected to be solid, labour costs should remain well contained. The anticipated slowing in non-farm GDP growth in 2003-04 suggests that significant capacity constraints are unlikely to emerge over the forecast period, leaving little scope for generalised margin building.

The moderate outlook for inflation is also likely to be supported by external factors. The weak international environment is likely to hold down global inflation over the next year. This should reinforce other factors such as increased competition, productivity improvements (particularly for ICT goods) and substantial excess capacity, all of which are helping to constrain medium-term international price pressures. Oil prices are assumed to fall a little over the next year, in line with market expectations. The recent appreciation of the Australian dollar, if sustained, should also help to limit any increases in import prices in the near term.

Despite the positive outlook there is still a risk that inflation may not decline as expected, particularly if the current temporarily higher inflation starts to be reflected in inflation expectations and is incorporated into future wage claims. That said, the economy is expected to slow a little over the next year and with downside risks to the outlook it is also possible that inflation may temporarily fall even lower over the coming year.