

PART 2: ECONOMIC OUTLOOK

The Australian economy is expected to record solid growth of 3 per cent in 2004-05, a downward revision from the 3½ per cent growth forecast in the *Pre-Election Economic and Fiscal Outlook 2004* (PEFO) and in the 2004-05 Budget. In 2005-06, growth is forecast to be 3¼ per cent, ¼ of a percentage point lower than at PEFO.

World economic growth prospects remain favourable. As anticipated at Budget, the world economy has continued to grow strongly, and is forecast to grow by 4½ per cent in 2004. In 2005, world economic growth is expected to ease to 4 per cent. World growth next year had been expected to ease as fiscal and monetary policies became less stimulatory. However, the outlook has softened further since PEFO, reflecting the impact of high oil prices and recent weaker than expected economic growth in Japan and the euro area.

At Budget, the drivers of Australian economic growth for 2004-05 were anticipated to gradually shift from domestic to external sources. However, domestic expenditure, while easing from rapid growth in 2003-04, has nevertheless held up more than expected. Moreover, exports have not responded as quickly as forecast to the favourable external environment.

Domestic expenditure has continued to grow strongly, although in recent quarters there has been some moderation in consumption and investment. Household consumption is expected to remain robust through 2004-05 supported by continued strong growth in incomes and the high level of household wealth. However, with high debt servicing payments and household wealth expected to grow much more slowly than in recent years, consumption growth is likely to ease back to slightly below average in 2005-06.

Adding to recent strong domestic conditions has been the dramatic increase in the terms of trade. Rising export prices and falling import prices have seen national income grow more rapidly than output. In 2004-05, national income is expected to grow more strongly than anticipated at Budget given the stronger outlook for Australia's export prices. High export prices — especially resource prices — have fuelled an improvement in corporate profits and provided an incentive for firms to increase investment. Firms have also increased employment, which in turn has increased household incomes. Strong profits, continued global demand for resources and high capacity utilisation are expected to support high levels of business investment in 2004-05 and 2005-06.

The housing market remained stronger than expected through the first half of 2004. However, a slowing in the housing market is now evident. Dwelling investment fell in the September quarter, as did house prices. Approvals data suggest that dwelling investment will decline further in 2005. However, the decline in dwelling investment is still forecast to be relatively muted compared with previous cycles, with generally

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favourable economic conditions partly offsetting the effects of expected lower capital gains.

Export growth in 2004-05 is expected to be solid, although lower than forecast at Budget. Generally dry conditions and the late arrival of spring rain in some areas, has resulted in a smaller than expected grain harvest in 2004. Growth in the volume of mineral and energy exports has been weaker than forecast at Budget, reflecting long lead times for investment in the mining sector and some transportation bottlenecks. Nevertheless, a strong world economy is supporting very high prices for non-rural commodities and this is providing an incentive for further investment in production and transportation capacity in the mining sector. As this capacity comes on line, non-rural commodity exports should grow strongly, leading to above average export growth in 2005-06. Future resource export growth will, however, remain vulnerable to the pace of infrastructure investment.

The labour market has improved since Budget, with employment growing more quickly than anticipated and the unemployment rate falling to 27-year lows. Looking forward, employment growth is expected to be robust supported by high profits and business confidence. The unemployment rate is forecast to remain around current levels in 2004-05 and 2005-06.

The inflation forecast has increased slightly since Budget, to around 2¼ per cent in 2004-05, and is expected to remain around this rate in 2005-06. The slight increase in the 2004-05 forecast reflects the higher Australian dollar price of oil.

RISKS TO THE OUTLOOK

With clear evidence of a cooling in dwelling investment and house prices, developments in the housing market are key to domestic demand. The forecast remains for an orderly and relatively mild decline in dwelling investment. However, the high level of investment in housing, the rapid rise and subsequent softening in house prices, and evidence that investors are exiting the housing market, leaves the dwelling sector finely balanced.

If house prices were to fall more sharply than expected this would have implications for consumption. Rising house prices over recent years have encouraged households to increase consumption. People were able to borrow against their accumulating wealth and household saving fell. Although there are few signs of financial stress, Australian households are now spending an historically high proportion of their income on debt servicing. While most households are not at risk — for example, much of the increase in investor activity in the housing market appears to have been by older people and high income earners — some households are more vulnerable to unexpected events. Although the increase in debt has been largely balanced or exceeded by an increase in assets, problems may still emerge as, unlike many financial assets, housing assets cannot be quickly converted into cash.

Despite having weathered significant international economic shocks in recent years, the Australian economy is not immune to external developments. The depreciation of the US dollar over the past six months — around 9 per cent against the Australian dollar, 8 per cent against the euro and 6 per cent against the yen — is continuing a trend decline dating from late 2001. A sustained depreciation of the US dollar will assist the unwinding of the US current account deficit and associated global imbalances. However, unless accompanied by stronger domestic demand growth in Japan and the euro area, this depreciation will reduce overall world economic growth. Such an outcome could harm the anticipated recovery in Australian export growth.

The world economy is currently experiencing an oil price shock of uncertain duration and size. Despite recent falls, strong demand, tight supply capacity and distributional bottlenecks are likely to see oil prices maintained at high levels for some time yet. The futures market has prices persisting around \$US40 per barrel to the end of 2006, which is significantly higher than the five-year average of \$US31 per barrel.

High oil prices have had a negative, albeit relatively modest, impact on the world economy to date. Just as for the world, the initial impact on the Australian economy of higher oil prices has been slightly negative. Since Australia is a net energy exporter, the longer-run impact will depend on the extent to which higher oil prices spill over into the price of other forms of energy and the extent to which world growth prospects are dampened.

INTERNATIONAL ECONOMIC OUTLOOK

World economic growth peaked in the June quarter 2004. Growth in our major trading partners (MTPs) reached 5.7 per cent through the year to the June quarter 2004, the highest rate of growth since the March quarter 2000. While growth is expected to ease, world economic prospects remain favourable.

Forecasts for world and MTP growth for 2004 have been revised down since PEFO, but are unchanged from Budget. For 2005, forecasts for world and MTP growth have been lowered by $\frac{1}{4}$ of a percentage point from Budget, reflecting the impact of high oil prices and recent softer than expected economic growth in Japan and the euro area. In East Asia, the slowing of the Chinese economy and the downturn in the information and communication technology cycle, are dampening East Asian export growth and are reflected in the easing of output growth forecasts across the region.

Ongoing competitive pressures and the anchoring of inflation expectations in developed countries are limiting the pass-through of high oil prices to more generalised inflation, providing scope for policy settings to remain accommodative. Such policy settings are expected to continue to support growth going into 2005. World growth is forecast to ease to around average rates of growth in the second half of 2005 and into 2006 as policy support is progressively unwound.

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

	Actual 2003	Forecasts	
		2004	2005
World	3.8	4 1/2	4
Total OECD	2.2	3 1/4	2 3/4
United States	3.0	4 1/2	3 1/2
Japan	1.3	3	1 3/4
Euro area	0.5	1 3/4	1 3/4
Major Trading Partners	3.2	4 3/4	3 3/4
Non-Japan East Asia(c)	4.8	6 3/4	5 1/2

(a) Growth rates for the world and euro area are calculated using GDP weights based on purchasing power parity, while growth rates for Major Trading Partners and non-Japan East Asia are calculated using export trade weights.

(b) Per cent change from previous year.

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

Source: National statistical publications, IMF and Treasury.

The economic outlook for the **United States** is broadly unchanged from PEFO, although the forecasts have been downgraded slightly in 2005 due to the impact of higher oil prices. Despite the oil price shock, growth is still expected to be strong, moderating from the above average rates recorded in the initial stages of the recovery to around 3½ per cent in 2005 and 2006.

Conditions in the US business sector are extremely favourable and are expected to continue to support investment over the next year. Reflecting strong growth in productivity and profitability, confidence is high, the cost of capital is low, and business finances are healthy. These conditions should see employment outcomes continue to improve over the next year.

Over the past few years, US household consumption has continued to grow well ahead of income, driving the household saving ratio to record low levels. This has been supported by expansionary fiscal policy and strong gains in net worth from appreciating asset prices. As the influence of these factors wanes, consumption growth is expected to moderate to levels more consistent with income growth. The risk is that households will move abruptly to consolidate their financial position.

Despite recording weak growth in the September quarter 2004, the **euro area** is on track to record a modest recovery. Easing exports are expected to be offset by moderately stronger domestic conditions. Export demand has underpinned growth over 2004, especially for the large economies of Germany, France and Italy. However, the slowing global economy and higher euro exchange rate mean that an increased contribution from domestic demand is needed for the recovery to be sustained.

While euro area investment activity remains sluggish, business conditions have improved over the course of 2004. Corporate profits are healthier and balance sheet restructuring has advanced, providing some potential for the corporate sector to provide more impetus to growth once uncertainties over demand prospects have

eased. But stronger consumption growth is being constrained by poor labour market conditions, weak income growth and uncertainties over the effect of structural reforms.

The **United Kingdom** continues to outperform the euro area, and solid growth is expected to continue. While UK output growth slowed in the September quarter, private consumption is strong, underpinned by strong income growth and the high level of household wealth.

Japan's economic recovery is forecast to continue, albeit more slowly than expected at Budget. Japanese output growth slowed markedly in the middle of 2004 after having been underpinned by booming exports and a related rebound in business investment since late 2003. Nevertheless, the underlying economic conditions for a continuation of growth are intact. Business sentiment and corporate profits are high, supporting the outlook for business investment, and improving employment conditions should help underpin consumption growth.

China's economy is showing signs of slowing from the very high rates of growth experienced at the beginning of 2004. While recent data suggest that activity has moderated slightly, there is still uncertainty about the extent of the slowing. Rapid investment growth and the risk that capital is not being allocated efficiently may lead to excess capacity in some sectors and place pressure on China's still fragile financial system. Looking forward, growth is expected to continue to ease but remain robust, with strong consumption buoyed by rising per capita incomes, partially offsetting a policy-induced slowdown in investment.

Economic growth in the **rest of East Asia** appears to have peaked, with high oil prices, the downturn in the information and communication technology cycle, and slowing world demand dampening growth. Growth should remain underpinned by strengthening domestic demand and supportive monetary policies in 2005 and 2006. Relative to the region, Korea's economic prospects remain subdued, with domestic demand still weak following the bursting of the consumer credit bubble in 2003.

There are downside risks to the world economic outlook. High oil prices and global imbalances have persisted and still represent a key risk to the outlook. Other risks include the persistence of the economic 'soft-patch' in the euro area and Japan and the capacity of the world economy to adjust smoothly to higher interest rates. These downside risks outweigh the possibility that still-expansive policy settings could generate a more vigorous pick-up in momentum than currently anticipated.

The withdrawal of monetary stimulus in the United States and elsewhere to date has had limited global consequences; however, there is the potential for the transition to tighter monetary policy to cause financial market disruptions. Developing economies are particularly vulnerable to increasing global interest rates. Increasing US interest rates may result in a widening spread between emerging and mature market interest rates as international investors reassess their risk/return preferences. Higher interest

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rates could also have a large impact on the balance sheets of highly leveraged consumers in a number of developed economies.

The US fiscal and current account deficits remain the most serious medium-term risks to the economic outlook for the US and the world, particularly in light of longer term demographic pressures. There is a risk that the recent – and necessary – depreciation of the US dollar may become rapid and destabilising in response to foreigners changing their risk appetite for US dollar assets.

DOMESTIC FORECASTS

The forecasts for the domestic economy are underpinned by several key technical assumptions. The exchange rate is assumed to remain around the average level of recent months (a trade weighted index of around 63 and a \$US exchange rate of around 76c). Interest rates are assumed to remain around current levels. Oil prices are assumed to move in line with market expectations as of early December, at that time the price of West Texas Intermediate oil was expected to fall gradually to around \$US43 per barrel by June 2006. The farm sector forecasts are based on an assumption of average seasonal conditions in 2005-06.

The Australian economy is forecast to grow by 3 per cent in 2004-05 and by 3¼ per cent in 2005-06. The key domestic economic forecasts are summarised in Table 4.

Table 4: Domestic economy forecasts^(a)

	2003-04	2004-05	
	Outcomes(b)	Forecasts	
	Year average	Budget Year average	MYEFO Year average
Panel A - Demand and output(c)			
Household consumption	5.6	4 1/4	4 1/2
Private investment			
Dwellings	7.4	-3	0
Total business investment(d)	8.9	7	7
Non-dwelling construction(d)	12.5	6	2
Machinery and equipment(d)	7.0	8	10
Intangible fixed assets	4.6	7	10
Private final demand(d)	6.1	4	4 1/4
Public final demand(d)	3.9	3 1/2	5
Total final demand	5.6	4	4 1/2
Change in inventories(e)			
Private non-farm	0.5	0	0
Farm and public authorities(f)	0.0	- 1/4	0
Gross national expenditure	6.1	3 3/4	4 1/4
Exports of goods and services	1.6	8	4
Imports of goods and services	12.3	9	10
Net exports(e)	-2.4	- 1/2	-1 1/2
Gross domestic product	4.0	3 1/2	3
Non-farm product	3.4	3 1/2	3
Farm product	28.5	4	-2
Panel B - Other selected economic measures			
External accounts			
Terms of trade	7.0	4 1/2	7 1/4
Current account balance			
\$billion	-47.4	-43 1/2	-51
Percentage of GDP	-5.8	-5	-6
Labour market			
Employment (labour force survey basis)	1.8	1 3/4	2
Unemployment rate (per cent)	5.8	5 3/4	5 1/2
Participation rate (per cent)	63.5	63 1/2	63 1/2
Prices and wages			
Consumer Price Index	2.4	2	2 1/4
Gross non-farm product deflator	3.4	2 1/2	3 1/4
Wage Price Index	3.6	3 3/4	3 1/2

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

(b) Calculated using original data.

(c) Chain volume measure.

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

(e) Percentage point contribution to growth in GDP.

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

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Household consumption is expected to grow by a robust 4½ per cent in 2004-05, albeit easing from the rapid increases recorded in recent years. Consumption continues to be supported by growth in household incomes flowing from solid employment and wage increases. Initiatives in the 2004-05 Budget and policies announced in the federal election are also expected to support consumption, although in recent quarters the increase in after-tax incomes appears to have been saved rather than spent.

Past gains in wealth from rising house prices and strengthening equity markets continue to support household spending. Strong growth in wealth has seen consumption run ahead of income, particularly as households drew down on the increased equity in their housing assets. However, with relatively high debt servicing payments and household wealth expected to grow much more slowly than in recent years, consumption growth is likely to ease to slightly below average rates during 2005-06.

Dwelling investment is forecast to be flat in 2004-05 and to fall in 2005-06. The expected decline in total dwelling investment reflects a reduction in both medium-density and detached housing construction.

Over the first half of 2004, dwelling investment remained higher than expected, held up by strong market sentiment. However, a slowing in the housing market is now evident. Dwelling investment fell in the September quarter and a broad range of forward-looking housing sector indicators suggest that dwelling investment will continue to decline into 2005.

The forecast decline in dwelling investment is muted compared with previous cycles as there is an absence of the usual triggers for a housing downturn – namely high interest rates or rising unemployment. In addition, investment in alterations and additions – which represents nearly half of total dwelling investment – is anticipated to hold up more strongly than new dwelling investment.

The outlook for **business investment** is one of ongoing strength, with continued global demand for resources and high capacity utilisation rates. Business investment is forecast to grow by 7 per cent in 2004-05, with continued strong growth in machinery and equipment expenditure partially offsetting a moderation in non-dwelling construction.

Investment in machinery and equipment is forecast to grow by 10 per cent in 2004-05, supported by high levels of business confidence, strong corporate profitability and the low cost of capital.

Growth in non-dwelling construction is expected to moderate to 2 per cent in 2004-05, following exceptionally strong growth in recent years. High office vacancy rates and low rental yields point to a slowdown in new building construction. Growth in new engineering construction is expected to ease slightly, but should remain at high levels as large-scale investments continue in the resource sector and in the provision of

public infrastructure. The moderation of growth in non-dwelling construction is expected to continue into 2005-06.

Public final demand is expected to increase by 5 per cent in 2004-05 before easing back to more modest growth rates in 2005-06. The strong growth in 2004-05 largely reflects a range of infrastructure investment projects, particularly at the state and local government level.

Net exports are forecast to subtract around 1½ percentage points from overall growth in 2004-05, less than the 2.4 percentage point subtraction recorded in 2003-04. Over the course of 2005-06, as exports continue to expand and imports moderate, the net export subtraction is expected to be further reduced.

Exports of non-rural commodities are forecast to grow solidly in 2004-05 before accelerating in 2005-06. Strong global demand for non-rural commodities is supporting Australia's mining sector. Due to the time lags involved in expanding capacity, this demand is currently being reflected in export prices rather than export volumes. However, the mining industry is undertaking considerable investment — in both mines and mining infrastructure — to address the current capacity constraints and this will progressively lift production over the forecast period. There is already evidence of increased production in the iron ore and coal sectors.

Rural exports are forecast to grow solidly in 2004-05 and 2005-06 in year-average terms. However, through the year to June 2005, rural exports are expected to fall, as winter crop production was lower than last season's record harvest. Some rural production is still suffering from low subsoil moisture, a legacy of the drought. Assuming average seasonal conditions, rural production and exports should increase in 2005-06.

The translation of stronger global growth into demand for Australia's exports of elaborately transformed manufactures (ETMs) has been relatively muted to date. Manufacturers are facing strong competition in export markets from the increased ability of low-cost competitors to produce more sophisticated goods. The appreciation of the exchange rate — by over 25 per cent in trade-weighted terms since its low in 2002 — is also making it more difficult for Australian exporters of manufactures to compete on world markets. Growth in services exports has also been muted as tourism is still recovering from heightened security concerns following the terrorist attacks of recent years.

Imports are forecast to increase by 10 per cent in 2004-05 before moderating slightly in 2005-06. This profile is consistent with easing, but robust, growth in domestic demand and the relatively high exchange rate.

The **terms of trade** are forecast to increase by 7¼ per cent in 2004-05 and to increase further in 2005-06. The stronger outlook since Budget largely reflects a more

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favourable outlook for export prices and ongoing decreases in prices of imported information and communications technology and consumer electronics.

The **current account deficit** (CAD) is forecast to remain around 6 per cent of gross domestic product in 2004-05. The upward revision since Budget reflects weaker exports and a widening in the net income deficit. Nonetheless, the CAD is expected to narrow over 2005-06, with the anticipated improvement in the terms of trade and export growth.

Employment has grown more quickly than anticipated at Budget and the unemployment rate has fallen to 27-year lows in recent months. Forward-looking indicators of labour market conditions continue to support the positive outlook and, consistent with the pace of activity in the non-farm economy, employment is expected to grow by 2 per cent in 2004-05. The participation rate is forecast to increase slightly over the forecast period and the unemployment rate is expected to average around 5½ per cent in both 2004-05 and 2005-06.

Wages, as measured by the Wage Price Index, are forecast to grow by 3½ per cent in 2004-05 and by 3¾ per cent in 2005-06. Business surveys and liaison suggest it is harder to find high quality labour. These shortages are most evident for skilled tradespeople and some professionals. However, there are currently few signs of systemic wage pressures.

The outlook for **inflation** is benign, despite the large increase in oil prices since Budget. With moderate growth in labour costs and continued low import prices, headline CPI is forecast to increase by 2¼ per cent in both 2004-05 and 2005-06. The forecast for inflation in 2004-05 is slightly higher than at Budget, but lower than at PEFO, largely reflecting movements in the Australian dollar price of oil. There is little evidence of sustained inflationary pressure either from oil prices or from labour costs.