

PART 2: ECONOMIC OUTLOOK

The Australian economy is expected to grow solidly in 2005-06 and 2006-07, with GDP forecast to increase by 3 per cent in both years. The forecast for GDP growth in 2005-06 is unchanged from that presented in the 2005-06 Budget. An acceleration of exports is expected to support economic growth, while growth in household consumption and dwelling investment is expected to be relatively subdued. This gradual rebalancing of growth from domestic to external sources is desirable and will underpin the sustainability of the current economic expansion. A major change to the economic environment since the Budget has been a further increase in oil prices. As the effects of these higher oil prices flow through the economy, inflation is expected to rise to 3 per cent in 2005-06, before easing back to 2½ per cent in 2006-07.

Prospects for world economic growth remain favourable. World GDP is forecast to grow by 4½ per cent in 2005, ¼ of a percentage point higher than at Budget. In 2006, world GDP is forecast to grow by 4½ per cent, up from the 4 per cent forecast in the 2005-06 Budget. The revised forecasts reflect an improved outlook for the economies of China, Japan and India. Strong growth in the world economy is contributing to higher prices for some commodities, notably oil, coal and iron ore.

The effects of high commodity prices on the Australian economy have been significant. Australia's real purchasing power increased strongly in 2004-05, with real gross domestic income increasing by 4.1 per cent, well above the GDP growth rate of 2.4 per cent. Gross domestic income is also forecast to increase faster than GDP in 2005-06, as the effect of higher coal and iron ore prices flows through to export income. As additional supply of coal and iron ore reaches world markets, their prices are forecast to stabilise in 2006, but still remain well above the prices that prevailed before 2004.

The strong growth in incomes has been supporting domestic spending, with gross national expenditure expanding by 4.1 per cent in 2004-05. Gross national expenditure is forecast to slow to 3½ per cent in 2005-06 and 3¼ per cent in 2006-07, mainly reflecting slower forecast growth for household consumption.

Household consumption grew quickly in 2004-05. In recent quarters, higher petrol prices and slower growth in housing wealth have constrained household spending and consumption growth in 2005-06 is expected to be lower than in 2004-05. However, consumption will continue to be supported by strong employment and 2005-06 Budget measures that provide tax cuts and increased support for families.

Business investment is expected to remain solid in both 2005-06 and 2006-07 as businesses take advantage of strong balance sheets to fund increases in productive capacity. The latest expectations data from the Australian Bureau of Statistics indicate that business investment growth should be broadly based across industries. Investment in the mining sector will continue to be spurred by high commodity prices.

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Strong world demand is expected to support solid export growth in 2005-06 and 2006-07. An expansion of output in the mining sector will contribute to higher growth in non-rural commodity exports. High commodity prices are likely to continue to support the exchange rate, which will constrain growth in manufactured and service exports, as will strong competition from newly industrialising countries. World tourism continues to be affected by security and health-related concerns.

Employment growth was very strong through 2004-05, leading to a fall in the unemployment rate to 28-year lows. Employment growth is forecast to slow through 2005-06 and 2006-07 in response to slower GDP growth through late 2004 and early 2005. Easing employment growth should see the unemployment rate stabilise near current levels.

Aggregate wage growth has increased reflecting tighter labour market conditions over the past year. Wage growth is expected to peak in 2005-06, before slowing in 2006-07. The increase in wage growth has been concentrated in those sectors experiencing strong demand, such as construction and mining, with a smaller pass-through to wage outcomes in other sectors than would have been the case in the past. This enhanced relative wage flexibility is a benefit of Australia's more efficient labour market and reduces the propensity of higher wage outcomes in some sectors to flow through to higher consumer prices.

Higher petrol prices are forecast to contribute $\frac{1}{2}$ of a percentage point to inflation through the year to the June quarter 2006. As a result, headline inflation is expected to be 3 per cent in 2005-06, before falling back to $2\frac{1}{2}$ per cent in 2006-07. Inflation expectations remain well-anchored and the second-round effects from higher petrol prices are expected to be modest.

RISKS TO THE OUTLOOK

As identified at Budget, the path of commodity prices remains an important risk for the Australian economy. The timing and extent of the expected increase in the world supply of commodities and the likely reversion of prices to more normal levels is uncertain. In the forecast period, aggregate non-rural commodity prices are expected to stabilise and remain at very high levels compared with the experience of recent years. Beyond the forecast period, a broader fall in non-rural commodity prices is incorporated into the projections – this follows the methodology adopted in the 2005-06 Budget.

Oil prices are assumed to remain high over the forecast period, in line with expectations from the futures market. Nevertheless, conditions in the oil market are volatile, making the future path of oil prices uncertain. Were oil prices to increase above their current levels, it is likely that consumption growth would slow by more than expected. However, to the extent that any increase was reflected in the prices of

other energy products such as coal and liquefied natural gas, Australia may benefit through a higher terms of trade.

Strengthening wage growth has been largely confined to particular industries and geographic regions that have been experiencing strong growth. To date, strong wage growth in some sectors has not spilled over into more generalised wage pressures. However, the risk that higher wage demands may flow to other sectors remains, particularly as higher petrol prices push headline inflation temporarily higher. Were higher wage demands to be met without offsetting productivity increases, then this would present an upside risk to the inflation forecasts.

House prices have begun to adjust following the run-up experienced through the first half of this decade. Prices have plateaued in most capital cities over the past year, and fallen in some. This steady adjustment path is expected to continue over the next few years. Nevertheless, there remains a risk that a shock to the economy could induce a sharper adjustment in house prices, with negative implications for consumption and dwelling investment. Even without a large fall in house prices, there is still a possibility that consumption is weaker than expected, with households choosing to consolidate their balance sheets more rapidly.

Forecasts for world growth have been revised up since Budget, with some earlier risks affecting the near term outlook ameliorating somewhat. Nevertheless, some negative risks remain. In particular, while oil prices have moderated from spikes in August and September they remain relatively high and volatile. A sustained period of high oil prices could adversely affect global growth. In addition, there remains the potential for a disorderly adjustment of global saving and investment imbalances. Such an outcome could have substantial impacts on exchange rates and global growth. Notwithstanding these downside risks, several factors continue to support the global expansion. Monetary policy is still, on balance, accommodative; corporate balance sheets are strong; and financial market conditions are generally benign across most regions.

INTERNATIONAL ECONOMIC OUTLOOK

At Budget, the world economy was slowing from the exceptional pace recorded in 2004. The return to a more sustainable, but still robust, growth path in 2005 reflects the unwinding of expansionary monetary and fiscal policies across a wide group of economies and higher oil prices. In 2006, barring major unforeseen events, monetary policy in the United States should be less accommodative than in 2005 and oil prices are likely to remain at high levels (although below the peaks reached in late August 2005). The global economic outlook remains positive, given the expected continuation of robust growth in the US, the strong performance of the Chinese and Indian economies, and the recovery in Japan.

The August and September hurricanes in the Gulf of Mexico caused major disruptions to already tight global energy markets. However the world economy appears to have

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weathered the impacts of this disruption, and growth remains on track. This resilience is testament to the strength of the underlying fundamentals supporting the global economy, particularly benign financial conditions and the healthy corporate balance sheets in the major regions. Some inflationary pressures are emerging, but inflation expectations remain reasonably well contained.

The world growth forecast for 2005 has been revised to 4½ per cent, ¼ of a percentage point higher than at Budget, while the 2006 forecast has been revised to 4½ per cent, ½ of a percentage point higher than at Budget (Table 3). Major trading partner (MTP) growth is expected to be 4¼ per cent in 2005 and 2006, an upward revision from Budget of ½ of a percentage point in each year. These upward revisions are due largely to higher expected growth in China, Japan and India.

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

	Actual	Forecasts	
	2004	2005	2006
United States	4.2	3 3/4	3 1/2
Euro area	2.0	1 1/2	1 3/4
Japan	2.3	2 1/2	2
China	9.5	9 1/4	8 3/4
Other East Asia(c)	6.1	4 3/4	5
Major Trading Partners	4.9	4 1/4	4 1/4
Total OECD	3.4	2 3/4	3
World	5.1	4 1/2	4 1/2

(a) Percentage change from preceding year.

(b) Growth rates for the World and euro area are calculated using GDP weights based on purchasing power parity, while growth rates for Major Trading Partners and other East Asia are calculated using export trade weights.

(c) Other East Asia comprises Korea, Singapore, Taiwan, Hong Kong, Indonesia, Malaysia, Thailand, and the Philippines.

Source: National statistical publications, IMF and Treasury.

The economic expansion in the **United States** has matured, and growth is expected to remain around recent trend rates. US growth is forecast to be 3¾ per cent in 2005 and 3½ per cent in 2006.

To date, domestic demand has shown a high degree of resilience to tightening policy and adverse economic shocks, and is likely to remain the key driver of growth. Conditions for business investment remain positive, with corporate profits around record levels and external financing conditions still favourable. Against this background, the labour market is expected to continue to firm at a steady pace. Combined with recent increases in house prices, this should provide support for household consumption as the effects of higher interest rates and energy prices take hold.

Headline inflation has spiked in recent months reflecting the effects of higher petrol prices, although, to date, underlying measures of inflation remain contained. A key

risk remains that higher energy prices could result in more generalised inflationary pressure, particularly as excess capacity in the economy is reduced.

In **Japan**, economic activity has picked up since budget, with GDP growing by 2.9 per cent through the year to the September quarter 2005. GDP growth to date in 2005 has been relatively balanced, with contributions from nearly all sectors of the economy. This growth pattern is encouraging for a sustainable economic recovery. The deflation that has plagued the economy for over five years is waning and the decade long decline in asset prices appears to have bottomed out.

Growth in the **Chinese** economy has been stronger than anticipated, with GDP expanding by 9.4 per cent through the year to the September quarter 2005. Recent signs suggest that this growth is being underpinned by a recovery in domestic demand, following a slowdown engineered by the Chinese authorities in response to the investment boom in 2004. A shift in investment from overheated sectors to those experiencing bottlenecks suggests that current levels of investment may be less worrisome than in the past, particularly as this investment is being led by the private sector rather than state-owned enterprises. While expectations remain for a gradual deceleration in growth, the timing of the slowdown has been pushed out.

In the **rest of East Asia**, economic activity moderated in the first half of 2005, reflecting higher oil prices, weaker Chinese imports, and slower world demand for information and communication technology (ICT) products. High oil and commodity prices and the reduction of oil subsidies generated inflationary pressures in some East Asian economies, prompting central banks to tighten monetary policy. The outlook is for growth to pickup in 2006, supported by an upturn in the world ICT cycle and solid domestic demand, particularly in Korea. However, high and volatile oil prices remain a significant risk to East Asia, due to the region's heavy dependence on oil imports and because oil costs form a relatively large part of these economies' expenditure baskets.

Expectations for **euro area** GDP growth in 2005 have remained on track since Budget, but the 2006 forecast has been revised down by $\frac{1}{4}$ of a percentage point to $1\frac{3}{4}$ per cent. GDP grew by 0.6 per cent in the September quarter 2005 to be 1.6 per cent higher through the year. This growth was supported by accommodative monetary conditions, a pick-up in business investment, and a positive contribution from net exports. The recovery remains fragile however, as consumption and household sentiment indicators remain weak, partly due to high oil prices. Headline inflation in the euro area is around $2\frac{1}{2}$ per cent and the European Central Bank raised official interest rates in December 2005 to $2\frac{1}{4}$ per cent, noting that monetary conditions are still accommodative. The euro area unemployment rate has steadily declined in 2005 to be 8.3 per cent in October.

In the **United Kingdom**, growth has moderated from the strong pace recorded in 2004. GDP increased by 0.4 per cent in the September quarter, to be 1.6 per cent higher through the year. Consumption growth fell away markedly in the first half of 2005, reflecting the lagged effects of past interest rate increases, sharp reductions in house

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price growth and some easing in the labour market. Recent indicators suggest that growth is expected to pick up in 2006 and 2007.

The risks to the near term world economic outlook are broadly balanced. A positive development is the broadening of world growth, with the strengthening of the Japanese economy and an expected improvement in activity in the euro area. Though oil prices have moderated somewhat from the highs experienced in August and September following the hurricanes in the Gulf of Mexico, they remain high and volatile. A sustained period of high oil prices could adversely affect world growth. To date, the inflationary effects of high oil prices have been limited, with significant second round effects yet to be seen in most major economies and regions.

There remains the potential for a disorderly adjustment of global saving and investment imbalances. Such an outcome could affect exchange rates and global growth. Since Budget, global imbalances have continued to widen, with the US current account deficit now at a record 6.4 per cent of GDP. In oil exporting nations, such as Saudi Arabia, higher oil prices have led to considerable increases in public saving.

That said, several factors are supporting the global expansion, particularly accommodative monetary policy, generally benign global financial market conditions, and strong corporate balance sheets in the major regions.

DOMESTIC FORECASTS

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 of around 64 and a \$US exchange rate of around 74c). Interest rates are assumed to remain unchanged at current levels. World oil prices (West Texas Intermediate) are assumed to remain around \$US60 per barrel until June 2007, in line with current market expectations. The farm sector forecasts are based on an assumption of average seasonal conditions in 2006-07.

The Australian economy is forecast to grow by 3 per cent in both 2005-06 and 2006-07. The key domestic economic forecasts are summarised in Table 4.

Table 4: Domestic economy forecasts^(a)

	2004-05	2005-06	
	Outcomes(b)	Forecasts	
	Year average	Budget Year average	MYEFO Year average
Panel A - Demand and output(c)			
Household consumption	4.3	3 1/4	2 3/4
Private investment			
Dwellings	-1.6	-2	0
Total business investment(d)	12.2	6	11
Non-dwelling construction(d)	7.7	2	8
Machinery and equipment(d)	16.5	7	13
Private final demand(d)	4.5	3 1/2	3 3/4
Public final demand(d)	4.4	3 3/4	3
Total final demand	4.5	3 1/2	3 1/2
Change in inventories(e)			
Private non-farm	-0.3	1/4	0
Farm and public authorities(f)	-0.1	0	0
Gross national expenditure	4.1	3 3/4	3 1/2
Exports of goods and services	2.5	7	4
Imports of goods and services	12.0	8	7
Net exports(e)	-2.0	-1	- 3/4
Gross domestic product	2.4	3	3
Non-farm product	2.6	3	3
Farm product	-6.5	5	0
Panel B - Other selected economic measures			
External accounts			
Terms of trade	10.0	12 1/4	9 1/2
Current account balance			
\$billion	-57.5	-48	-51 1/2
Percentage of GDP	-6.4	-5 1/4	-5 1/2
Labour market			
Employment (labour force survey basis)	3.0	1 3/4	2
Unemployment rate (per cent)	5.3	5	5 1/4
Participation rate (per cent)	64.0	63 3/4	64 1/4
Prices and wages			
Consumer Price Index	2.4	2 3/4	3
Gross non-farm product deflator	3.9	4 1/2	4
Wage Price Index	3.8	4	4 1/4

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

(b) Calculated using original data. Outcomes have been calculated using September 2005 Quarterly National Accounts, where possible.

(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.

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

Household consumption is forecast to grow by 2¾ per cent in both 2005-06 and 2006-07, significantly slower than the 4.3 per cent growth recorded in 2004-05. A slowing in household consumption was evident through the year to the September quarter 2005, suggesting that the combined impact of lower growth in housing wealth, higher debt servicing ratios and higher petrol prices are affecting households' consumption decisions. Despite the anticipated consolidation of household finances over the next two years, continuing high house prices are likely to result in further increases in household debt-to-income levels.

Petrol prices increased from an average of around \$0.60 per litre in early 1999 to close to \$1.00 per litre in late 2000 and remained around that level until early 2005. The increase in oil prices in 2005, however, has seen petrol prices move significantly higher, to average between \$1.20 and \$1.30 per litre in recent months. Following this increase, there has been some evidence of increased usage of public transport and a shift to purchases of more fuel efficient vehicles by some households, but it is difficult for households to reduce their consumption of petrol in the short run. Therefore, higher petrol prices are expected to remain a significant factor for household budgets through 2005-06, reducing the scope for faster growth in the volume of consumption.

Very strong employment growth has supported household incomes over the past year, partly offsetting the negative impact of higher petrol prices. Employment growth is expected to slow through 2005-06 in response to relatively slow GDP growth through 2004-05, but household incomes will continue to benefit from the tax cuts and increases to family assistance announced in the 2005-06 Budget.

Dwelling investment plateaued through 2004-05, after strong growth in earlier years. Dwelling investment is expected to be flat in 2005-06. The current housing construction cycle has been very moderate compared with past cycles, in part reflecting the stability of the broader macroeconomic environment. The sharp run-up in established house prices experienced in the first half of this decade has come to an end and the adjustment process to date has been very orderly. The forecasts assume that established house prices remain flat on average as this adjustment process continues.

The investor segment of the housing market, in particular, has been affected by the slowdown in house price growth. By mid-2005, finance for investor housing had fallen to a little above \$5 billion per month, well below its peak of \$7.7 billion in October 2003. Finance for owner occupied housing, in contrast, has surpassed its 2003 peak, and first home buyers are moving back into the housing market in larger numbers. These trends are expected to continue into 2005-06.

Business investment is expected to grow by 11 per cent in 2005-06 and 7 per cent in 2006-07. Growth in both non-dwelling construction and machinery and equipment investment is expected to be strong through the forecast period.

As outlined at Budget, strong world demand for commodities is spurring investment in the mining industry. This has led to substantial activity on mining production

facilities and associated infrastructure, particularly in Western Australia. With commodity prices expected to remain high for some time yet, the incentive to invest remains strong. The Australian Bureau of Statistics' most recent CAPEX survey estimate of mining investment intentions for 2005-06 was 23.4 per cent higher in nominal terms than the equivalent estimate for 2004-05. The CAPEX survey also pointed to strong investment intentions for other industries in 2005-06, with expectations for the manufacturing and other selected industries categories also increasing by around 16 per cent on the equivalent 2004-05 estimates. These increases would build on the widespread increase in business investment seen since early 2002.

Public final demand is forecast to grow by 3 per cent in 2005-06 and $2\frac{3}{4}$ per cent in 2006-07. Continuing solid public investment spending is expected to support growth in 2005-06 and 2006-07.

Net exports are expected to subtract $\frac{3}{4}$ of a percentage point from GDP growth in 2005-06 and $\frac{1}{2}$ of a percentage point in 2006-07. Export growth is forecast to increase in 2005-06, with the largest contribution coming from non-rural commodity exports. Import growth is expected to ease in 2005-06 and 2006-07 as gross national expenditure slows.

Exports are forecast to increase by 4 per cent in 2005-06 and 6 per cent in 2006-07. Rural exports are expected to fall in 2005-06, before increasing in 2006-07, while the other categories of exports are expected to grow solidly in both years.

Disappointing winter crops in 2004 led to a fall in rural export volumes that will be felt into 2005-06. While dry weather conditions earlier in 2005 saw a smaller area planted for winter crops than would normally be the case, good spring weather conditions have resulted in higher yields. Improved weather conditions this spring will also assist with rebuilding livestock numbers after the drier conditions of recent years.

Non-rural commodity exports are expected to grow strongly over the next two years reflecting significantly increased capacity in the mining sector. However, since Budget, forecast growth for non-rural commodity exports has been revised down. This partly reflects lower than expected growth in oil production. Exports fell in the September quarter 2005, reflecting delays to the export of some liquefied natural gas and iron ore from Western Australia and the closure of the Hay Point coal terminal in Queensland for upgrade work. These factors are expected to be temporary and, as they recede, export growth is expected to lift significantly in coming quarters.

Exports of elaborately transformed manufactures (ETMs) are forecast to grow solidly over the next two years, supported by continuing strong world growth. Two factors are, nevertheless, likely to continue to constrain ETM export growth over the period ahead. Australian manufacturers are facing increased competition from manufacturers in industrialising countries and high commodity prices may also be contributing to the exchange rate remaining higher than would otherwise be the case.

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Service exports are expected to grow only slowly over the next two years. As for ETM exports, strong world demand will support service exports, partly offset by the effects of the exchange rate. Exports of tourism services are also likely to be constrained by continuing global health and security concerns.

Imports are forecast to grow by 7 per cent in 2005-06, before slowing to 6 per cent in 2006-07. The forecast for import growth reflects the expected slowing in gross national expenditure. Falling prices for a range of imported consumer and capital goods, particularly those with a high technology component, should support growth in those categories of imports.

The **terms of trade** are expected to increase by 9½ per cent in 2005-06 before falling by ½ per cent in 2006-07. The expected increase in 2005-06 largely reflects movements in contract prices for Australia's coal and iron ore exports. The expected increase, if realised, will take the terms of trade to around 30-year highs.

New contracts negotiated in early 2005 were for an increase in iron ore prices of around 70 per cent and an increase in metallurgical coal prices of around 120 per cent. These increases have already begun to affect the terms of trade and will continue to do so into 2006 as existing contracts are fulfilled and rolled over. Iron ore and coal prices are expected to stabilise in the next round of contract negotiations, although there is considerable uncertainty around this forecast.

The **current account deficit** (CAD) is expected to narrow to around 5½ per cent of GDP in 2005-06. Increasing commodity prices are contributing to an improvement in the trade deficit, but this is being partially offset by an increase in the net income deficit as the ownership of part of the additional profits accrues overseas.

Employment growth was very strong in 2004-05, supported by high levels of activity in the construction and mining sectors of the economy. Employment is expected to slow to 2 per cent in 2005-06 and 1 per cent in 2006-07 in response to the lower GDP growth experienced through 2004-05. This would imply a cyclical rebound in productivity growth.

The unemployment rate is anticipated to remain around 5¼ per cent in 2005-06, slightly above the Budget forecast. In 2006-07, the unemployment rate is expected to stay at 5¼ per cent.

Wage growth is expected to increase in 2005-06 following strong growth in employment, before moderating in 2006-07 as employment growth eases. The Wage Price Index is forecast to grow by 4¼ per cent in 2005-06 and 4 per cent in 2006-07. Tight labour market conditions in some sectors, such as mining and construction, have led to substantial relative wage movements. However, these pressures are not expected to spill over into significant generalised wage increases.

Inflation is forecast to increase to 3 per cent in 2005-06, before falling back to 2½ per cent in 2006-07. The forecast rise in inflation in 2005-06 largely reflects higher oil prices, with petrol prices expected to add around ½ of a percentage point to inflation through the year to the June quarter 2006. While the increase in petrol prices has led to some increases in other prices, particularly in the transport sector, the overall impact is expected to remain contained.

The cyclical slowing in labour productivity over the past year has contributed to an acceleration of unit labour costs. However, as noted, with employment growth slowing through 2005-06 and 2006-07, labour productivity growth is expected to strengthen. This will cause growth in unit labour costs to moderate through 2006-07, reducing the pressure on inflation from labour costs.

