

STATEMENT 2: ECONOMIC OUTLOOK

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

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STATEMENT 2: ECONOMIC OUTLOOK

Powerful countervailing forces are confronting the Australian economy. Slower global growth, tighter credit conditions and higher interest rates are expected to slow Australia's economic growth. Counteracting this, robust growth in emerging economies is supporting large rises in Australia's terms of trade, providing further stimulus to incomes and contributing to already heightened price pressures.

OVERVIEW

After a sustained period of strong growth, the global economy is expected to slow in 2008 and 2009. A sharp slowdown in the US economy is now evident in official data, with implications for growth in other countries, including Australia. Turbulence in global financial markets also remains an impediment to global growth, particularly in advanced economies.

These global developments come at a time when several years of strong demand in the Australian economy has not been matched by a commensurate expansion in supply capacity. This has led to a significant build-up in underlying inflationary pressures. In response, the Reserve Bank of Australia has tightened monetary policy substantially.

The slowdown in global growth, tighter credit conditions and significantly higher interest rates are expected to slow growth in the Australian economy. As a result, conditions in the labour market are expected to ease, with some rise in the unemployment rate. Tighter monetary and fiscal policies are expected to gradually ease underlying inflation from 16-year highs.

While the outlook for the global economy has weakened, areas of strength remain, particularly in emerging economies. The Chinese economy has so far remained largely insulated from negative developments elsewhere, reflecting both its lower level of integration into world capital markets and its substantial capacity for internally generated growth. Demand from China and other emerging economies is supporting large rises in non-rural commodity prices, particularly for iron ore and coal and, as a result, Australia's terms of trade are forecast to reach new highs. This will lead to an acceleration in domestic incomes, which will contribute to already heightened price pressures.

Slower global growth and financial market turbulence, and the further stimulus from the terms of trade, are powerful opposing forces buffeting the economy. On balance, these forces, combined with the significant tightening in monetary policy that has occurred over recent years, are likely to result in a slowing in real GDP growth even as income growth remains high.

Summary of forecasts

Global growth, in real terms, is expected to be 4 per cent in 2008 and 2009. Growth in the advanced economies is expected to slow significantly, while the emerging economies are forecast to grow robustly, notwithstanding some slowing from growth rates recorded in recent years.

Australia's real GDP is forecast to increase by $2\frac{3}{4}$ per cent in 2008-09. The non-farm economy is forecast to grow by $2\frac{1}{4}$ per cent, while the farm sector is forecast to contribute $\frac{1}{2}$ of a percentage point to growth given a recovery from drought. It is expected that the main contributors to growth will be household consumption and business investment, with net exports subtracting 1 percentage point from growth.

Household consumption is expected to grow by $2\frac{3}{4}$ per cent in 2008-09. Significantly higher interest rates, tighter credit conditions, an easing in labour market conditions and confidence impacts from uncertainty in global financial markets are expected to weigh on consumption.

Dwelling investment is also expected to be affected by higher interest rates and tighter credit conditions, with growth forecast to be a subdued 2 per cent in 2008-09. Most of the growth is likely to come from alterations and additions. Higher interest rates are expected to result in slower house price growth, and subdued dwelling investment will continue to add pressure to rents.

Business investment is expected to grow by $8\frac{1}{2}$ per cent in 2008-09. The outlook for both machinery and equipment and non-dwelling construction is favourable, but the risks around these forecasts are heightened. Businesses are facing higher interest rates, and labour and material cost pressures persist. The potential for further deterioration in global capital markets is a risk for the business investment outlook.

Public final demand is forecast to grow by 3 per cent in 2008-09. The slowing in growth reflects a moderation in Australian Government consumption expenditure and a slowing in State and local government investment from high growth rates in 2007-08.

Exports are expected to grow by 6 per cent in 2008-09, with more than three quarters of this growth coming from commodity exports. Rural exports are expected to rebound as the farm sector recovers from drought, while the increase in non-rural commodity exports reflects the continuing ramp-up and commencement of mining investment projects. Growth in exports of elaborately transformed manufactures and services is expected to be subdued, given the higher exchange rate and slower global growth.

Imports are forecast to grow by 9 per cent in 2008-09, with the moderation in growth from 11 per cent in 2007-08 reflecting an easing in the non-farm economy. It is expected that growth in consumption and services imports will ease as household consumption slows, and intermediate imports will ease as domestic production slows. However, strong growth in business investment is expected to support capital imports.

The **terms of trade** are expected to rise by a strong 16 per cent in 2008-09, from levels that are already the highest in more than 50 years. Australian coal contracts have recently been settled for US dollar price increases in the range from 125 to 240 per cent, while iron ore contract prices are expected to increase by at least 65 per cent in US dollar terms. In contrast, falls in base metal prices are expected, with the slowdown in global growth adding more uncertainty to this outlook. Rural prices and import prices are also expected to support the terms of trade.

The **current account deficit** is forecast to narrow to 5 per cent of GDP in 2008-09, reflecting higher expected national saving as a share of GDP and relatively unchanged national investment. A small trade surplus is forecast given the strong rise in the terms of trade. The net income deficit is likely to widen significantly. This reflects strong growth in corporate profits, particularly mining profits, and rising net interest payments from a higher stock of net foreign debt.

Employment growth is expected to moderate to 1¼ per cent in 2008-09. The participation rate is forecast to average 65¼ per cent, and the unemployment rate is expected to average 4½ per cent. The unemployment rate is forecast to rise to 4¾ per cent by the June quarter 2009, as conditions in the labour market ease. This reflects an easing in non-farm GDP growth due to slower global growth, tighter credit conditions and higher interest rates.

Wages are expected to grow by 4¼ per cent in 2008-09, which is in line with wage price growth in recent times. While wages are expected to grow strongly, they are not forecast to accelerate given the anticipated easing in labour market conditions.

Inflation is forecast to be 4 per cent through the year to the June quarter 2008. Strong demand in the Australian economy, which has not been matched by a commensurate increase in supply capacity, has led to a build-up in underlying inflation. Upward pressure is also expected from the continuing effects of recent increases in oil prices and from specific items such as food and housing costs. Tighter monetary and fiscal policies are expected to gradually ease underlying inflation from 16-year highs. Inflation is forecast to be 3¼ per cent through the year to the June quarter 2009.

Nominal GDP is forecast to grow by 9¼ per cent in 2008-09, which would be its fastest rate of growth since the late 1980s. The growth reflects real GDP growth of 2¾ per cent and growth in broader economy prices — the GDP deflator — of 6¼ per cent, largely due to significant rises in non-rural commodity export prices.

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Table 1: Domestic economy forecasts^(a)

	Outcomes(b)	Estimates	Forecasts	
	2006-07 year average	2007-08 year average	2008-09 year average	Four quarters to June 2009
Demand and output(c)				
Household consumption	3.6	4 1/2	2 3/4	2 1/2
Private investment				
Dwellings	2.4	2 1/2	2	1
Total business investment(d)	6.7	9 1/2	8 1/2	4 1/2
Non-dwelling construction(d)	12.4	8 1/2	5 1/2	3
Machinery and equipment(d)	2.9	9 1/2	11	4 1/2
Private final demand(d)	4.0	5 1/4	4	3
Public final demand(d)	4.3	4 3/4	3	2 3/4
Total final demand	4.1	5 1/4	3 3/4	2 3/4
Change in inventories(e)	0.1	1/4	- 1/4	0
Gross national expenditure	4.2	5 1/2	3 1/2	2 3/4
Exports of goods and services	3.8	3	6	7 1/2
Imports of goods and services	8.9	11	9	7
Net exports(e)	-1.2	-2	-1	- 1/4
Real gross domestic product	3.2	3 1/2	2 3/4	2 3/4
Non-farm product	3.9	3 3/4	2 1/4	2
Farm product	-22.8	2	20	36
Nominal gross domestic product	8.2	7 3/4	9 1/4	6 1/2
Other selected economic measures				
External accounts				
Terms of trade	6.7	4 3/4	16	3 1/4
Current account balance (per cent of GDP)(f)	-5.6	-6 1/4	-5	-5 3/4
Labour market				
Employment (labour force survey basis)	2.7	2 1/2	1 1/4	3/4
Unemployment rate (per cent)(f)	4.5	4 1/4	4 1/2	4 3/4
Participation rate (per cent)(f)	64.8	65 1/4	65 1/4	65
Prices and wages				
Consumer Price Index(g)	2.1	4	3 1/2	3 1/4
Gross non-farm product deflator	4.8	4	6 1/4	4 1/4
Wage Price Index	4.0	4 1/4	4 1/4	4 1/4

(a) The forecasts are based on several technical assumptions. The exchange rate is assumed to be around 93 US cents, with a trade weighted index of around 71. Domestic interest rates are assumed to remain unchanged. World oil prices (West Texas Intermediate) are assumed to be around US\$115 per barrel. Farm sector forecasts assume average seasonal conditions, but account for low water storage levels.

(b) Calculated using original data.

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

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

(e) Percentage point contribution to growth in GDP.

(f) The estimate in the final column is the forecast rate in the June quarter 2009.

(g) Through the year growth rate to the June quarter for 2006-07 and 2007-08.

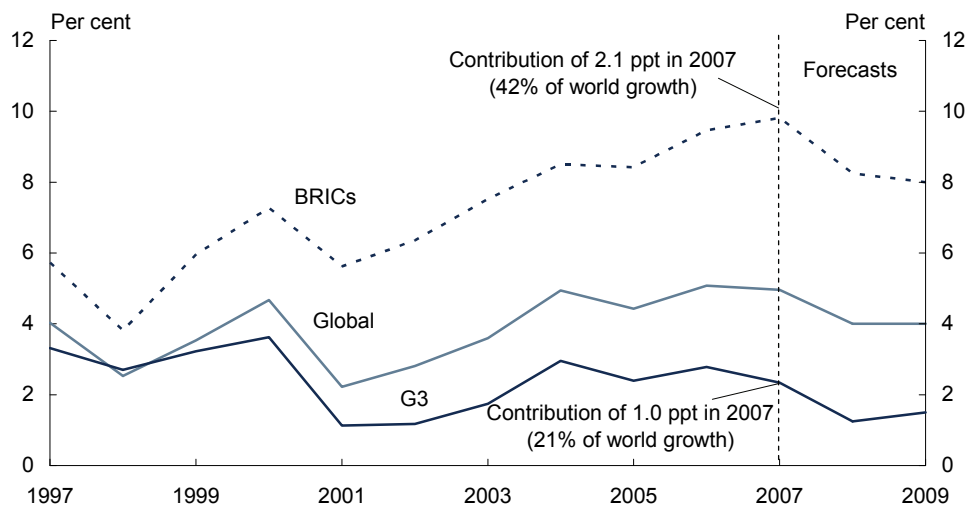
Source: Australian Bureau of Statistics (ABS) cat. no. 5206.0, 5302.0, 6202.0, 6345.0, 6401.0, unpublished ABS data and Treasury.

THE OUTLOOK FOR THE INTERNATIONAL ECONOMY

The outlook for the global economy has deteriorated significantly since last year, as the crisis in the global financial system has deepened and started to hamper economic activity. Complicating the outlook, global inflationary pressures are building, reflecting capacity constraints in some areas and rising energy and food prices.

The global economy is expected to expand by 4 per cent in 2008 and 2009 (Chart 1 and Table 2). Financial market difficulties have been most acute in the US (Box 1), where a severe housing contraction was already slowing growth. In contrast, emerging economies have experienced little impact to date. The contrasting exposure to credit market difficulties is expected to result in a continued large divergence between growth in advanced and emerging economies. The collapse of securitised lending, the increase in borrowing costs, tightening credit standards, and an associated impact on confidence, are expected to significantly constrain advanced economy growth (Box 2), with the US expected to experience a mild recession. Any further escalation in financial market turbulence would represent a significant downside risk to global growth.

Chart 1: Global growth^(a)



(a) Global GDP growth rates are calculated using GDP weights based on purchasing power parity. The BRICs comprise Brazil, Russia, India and China, while the G3 comprises the US, euro area and Japan. Source: International Monetary Fund (IMF) and Treasury.

Despite the forecast for slower global growth, global inflationary pressures remain elevated and represent another key risk to the outlook. High energy and food prices have lifted headline rates of inflation in most countries, and the risk remains that elevated rates of headline inflation could feed into higher inflation expectations. If this risk were to materialise, it could restrict the degree to which global monetary policy might be eased in response to any further deterioration in growth.

Box 1: Global financial market turbulence

Beginning in mid-2007, increasing default rates on US sub-prime mortgages – and associated declines in the value of financial securities backed by these mortgages – led to a fundamental reassessment of the risks inherent in a broad range of structured credit securities. In turn, concerns over the value of structured credit securities offered as collateral quickly led to the almost total evaporation of liquidity in the US asset-backed commercial paper (ABCP) market.

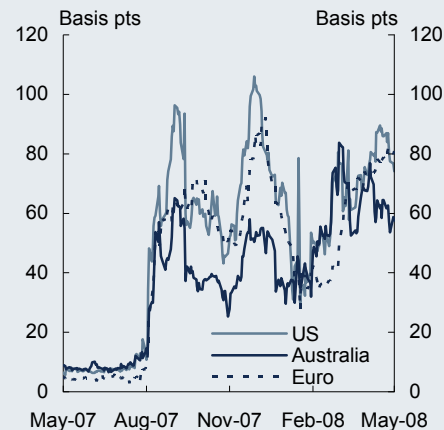
As a result, an array of complex investment vehicles that had previously relied on the ABCP market for much of their funding were unable to rollover their existing liabilities and were forced to call upon emergency lines of credit with their sponsoring banks. Funding demands from these notionally ‘off-balance sheet’ vehicles and direct losses on holdings of structured credit securities have resulted in a significant erosion of banks’ balance sheet positions.

In response, banks have increasingly chosen to shore up their own capital positions by restricting their lending to counterpart institutions. This ‘liquidity hoarding’ has manifested itself in dramatically increased liquidity premiums and a reduction in the availability of funding in inter-bank lending markets. Despite concerted central bank action aimed at alleviating these pressures, spreads in inter-bank markets in most advanced economies remain elevated (Chart A).

More recently, ongoing tightness in funding markets has exposed balance

sheet fragilities amongst institutions whose financial health is important to the stability of the US and international financial systems. For example, a weakening in the balance sheet positions of US ‘mono-line’ bond insurers – who offer insurance against the possibility that bond issuers might default – has raised questions over the soundness of the market for credit default swaps.

Chart A: Inter-bank lending rates (spread over risk-free rates)



Note: Data are as at close 7 May 2008.
Source: Reuters EcoWin.

The virtual collapse of Bear Stearns, a large US investment bank, prompted the US Federal Reserve to take the extraordinary policy action of providing funding for its ultimate purchase by JP Morgan Chase. To limit the potential for another investment bank to suffer a similar liquidity crisis, access to the Federal Reserve’s emergency lending facility has subsequently been extended to include investment banks.

Table 2: International GDP growth forecasts^(a)

	Actual	Estimate	Forecasts	
	2006	2007	2008	2009
United States	2.9	2.2	3/4	1 1/2
Euro area(b)	2.9	2.6	1 1/2	1 1/2
Japan	2.4	2.1	1 1/4	1 1/2
China(c)	11.6	11.9	10	9 1/2
India(c)	9.7	9.1	7 1/2	7 3/4
Other East Asia(d)	5.9	5.8	4 1/4	4 3/4
Major Trading Partners	5.1	5.2	3 3/4	4
World	5.0	5.0	4	4

(a) World and euro area growth rates are calculated using GDP weights based on purchasing power parity. Calculations for Major Trading Partners and Other East Asia use export trade weights.

(b) Euro area numbers are working-day adjusted.

(c) Production-based measures of GDP.

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

Source: National statistical publications, IMF and Treasury.

The US economic outlook has deteriorated significantly since the start of the year. Given deteriorating consumer confidence and continued stress in credit markets, a mild US recession is now expected. For 2008 as a whole, US consumers face the possibility of further house price falls, deteriorating employment prospects, tighter borrowing conditions, lower equity market returns and higher energy costs.

Moreover, tighter credit conditions and weaker business sentiment are likely to restrain business investment over 2008 and into 2009. The housing sector is also likely to continue to detract from growth until at least early 2009. In contrast to the softness in the domestic economy, net exports are expected to remain solid, with exports boosted by solid trading partner growth and a lower exchange rate, while weaker domestic demand should restrain imports. This development should help to reduce the sizable US current account deficit, although the risk of a disorderly adjustment of current account imbalances remains a concern for the US economy and global outlook.

With the deteriorating outlook, US authorities have acted quickly to support growth. The Federal Reserve has aggressively cut interest rates and taken a series of steps to improve liquidity and boost confidence in the financial system. Supporting these monetary policy actions, the US Administration has implemented a fiscal stimulus package (of 1 per cent of GDP) that is targeted at boosting household spending and business investment, with the effects most likely to be seen in the second half of 2008.

Despite weakening advanced economy growth, strength in emerging economies, particularly China and India, has continued. While demand for emerging economy exports will soften, growth is expected to remain robust.

China's growth in 2007, at close to 12 per cent, was its strongest in over a decade. The outlook is for continued strong Chinese growth, albeit at a slightly slower rate than last year. Urbanisation and infrastructure investment are continuing at a brisk pace,

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driving rising demand for energy and raw materials. The rapid economic expansion is generating strong growth in incomes, which will continue to support the momentum in private consumption.

Self-sustaining growth from domestic sources is likely to continue, and the Chinese Government has ample financial resources to support growth should the slowdown in the US have a more serious adverse impact than is currently anticipated. The lack of highly sophisticated financial markets in China, along with the relatively closed capital account, should also limit the impacts arising from the current financial turmoil. However, China will not remain immune from spillovers that arise from trade linkages with the developed world. Export growth is expected to continue to slow, given softer external demand and further appreciation of the Chinese currency.

The main challenge facing the Chinese economy this year is expected to arise from accelerating inflation. Until recently, the increase in inflation has been contained to food prices. However, inflationary pressures have intensified and now appear more broadly based.

In 2007, the Indian economy recorded the third largest contribution to world growth after China and the US. Growth in India's economy is expected to slow, but remain strong, over the next two years reflecting the impacts of tighter monetary conditions and slower global growth. Consumption will be supported through fiscal stimulus in the 2008-09 budget and significant increases to public sector wages.

In the Newly Industrialised Economies (NIEs) and ASEAN-5, growth is expected to ease this year before accelerating slightly in 2009 as advanced economy demand recovers. The moderation in growth in 2008 largely reflects slowing exports.

As mentioned above, other major advanced economies are also expected to slow sharply this year. Following two consecutive years of strong growth, the euro area is forecast to slow in 2008. A key feature of the recent growth performance has been strong export growth – both intra-regional and to emerging economies, particularly emerging Europe. Strong export growth has boosted investment in the region. However, with a deteriorating world growth outlook, export growth is expected to slow significantly while tightening credit conditions are expected to dampen investment and consumption growth.

The Japanese economy finished 2007 on a strong note as it has benefited from strong intra-regional trade. However, while the Japanese financial sector has not been significantly affected by disruptions in the US and euro area financial markets, growth is still expected to slow over the next few years. Consumption growth is expected to only partially offset moderating business investment and exports as global growth slows.

Box 2: Financial and credit market disruptions in advanced economies

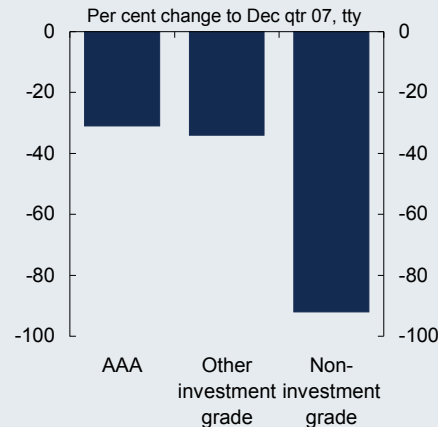
Disruptions in US and euro area financial markets have led to a re-appraisal of the outlook for the global economy. The provision of credit is one of the key functions of financial markets in supporting the real economy.

Dislocations in credit and funding markets can reduce the capacity of the financial system to channel funds from savers to borrowers, raising the overall cost of credit and restricting the access to liquid funds. This can hamper investment and economic growth.

Within a modern financial system, the provision of credit generally occurs either via issuance of debt securities (such as those backed by household and commercial mortgages, and corporate bonds and notes) or via traditional bank intermediation of savings deposits.

Securities markets

The seizing up of markets for a range of financial securities has restricted the ability to raise capital in these markets. An important example of this is the sharp fall in issuance of securities backed by household mortgages in most advanced economies. Total issuance of international debt securities remains well below levels seen prior to the current turmoil, due largely to a decline in issuance by US private financial institutions. Issuance has fallen across all credit ratings, but by more amongst non-investment grade ratings (Chart A).

Chart A: Decline in gross international bond issuance

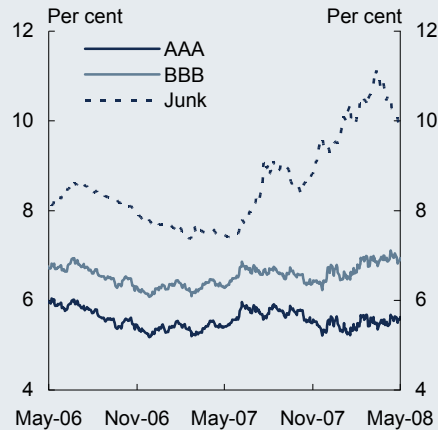
Source: Bank for International Settlements.

In advanced economy corporate bond markets, risk premiums attached to all classes of borrowers have risen, but by proportionally more for higher risk borrowers. At the same time, long-term government bond yields – which form the base, or risk-free, component of most long-term interest rates – have generally declined as investors have sought the relative safety of this asset class. For higher risk corporate borrowers, the increase in risk premiums has more than offset the decline in risk-free interest rates so that borrowing costs have risen substantially. In contrast, increases in the cost of credit for lower risk corporate borrowers have been comparatively muted (Chart B).

Indeed, borrowing costs for lower risk borrowers have fallen in some cases. At shorter maturities, particularly in the US, borrowing costs for investment-grade borrowers have fallen, with aggressive reductions in official US policy rates.

Box 2: Financial and credit market disruptions in advanced economies (continued)

Chart B: US corporate bond yields



Note: Data are as at close 6 May 2008.
Source: Reuters EcoWin.

Bank intermediation

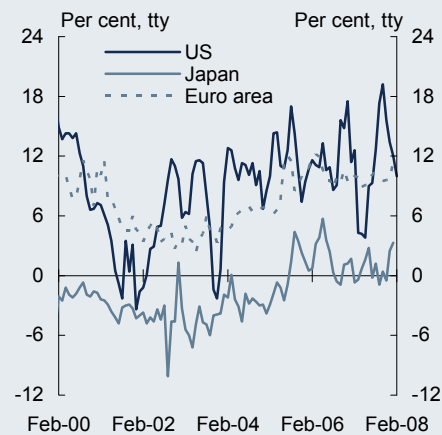
Difficulty raising finance in securities markets has forced borrowers to rely on more traditional bank finance. As a result, business credit growth in most major advanced economies rose in the second half of 2007. Moreover, given their dependence on wholesale short-term funding markets, non-bank finance providers have become a less prominent source of finance for households and a rising proportion of mortgage finance demand has been met by commercial banks.

In aggregate, total loan growth in the US and euro area has remained reasonably robust given the current turmoil (Chart C).

The added demand for credit from banks has put further pressure on their already constrained capital positions. Banks have generally responded by

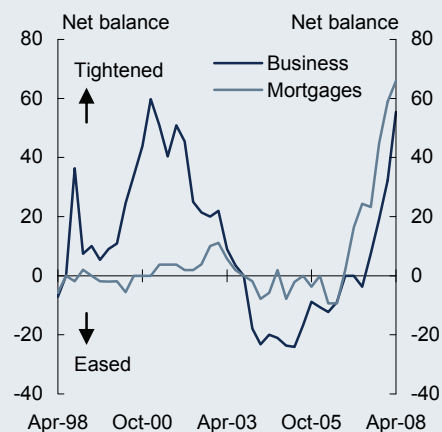
charging higher risk premiums and tightening lending standards, particularly for higher risk household and corporate borrowers. Bank lending surveys in most major advanced economies point to a broad-based tightening in lending standards since mid-2007 (Chart D).

Chart C: Total loan growth



Note: Data are a three-month moving average.
Source: IMF World Economic Outlook April 2008.

Chart D: US lending standards



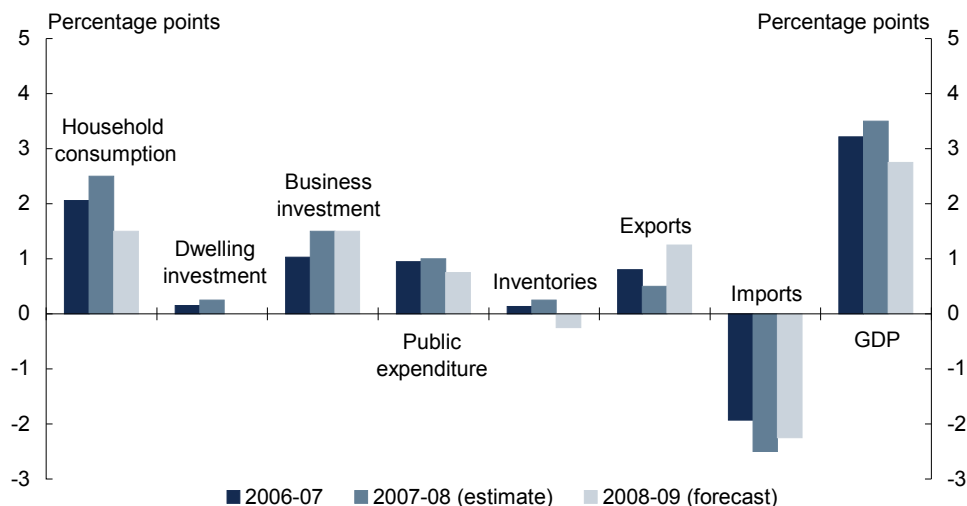
Source: Reuters EcoWin.

THE OUTLOOK FOR THE DOMESTIC ECONOMY

Demand and output

The slowing in global growth, tighter credit conditions and higher interest rates are expected to slow growth in the Australian economy. Real GDP is forecast to grow by $2\frac{3}{4}$ per cent in 2008-09, with growth in domestic final demand slowing to $3\frac{3}{4}$ per cent and net exports subtracting 1 percentage point. The farm sector is forecast to contribute $\frac{1}{2}$ of a percentage point to growth, reflecting a recovery from drought. It is expected that household consumption and business investment will be the main contributors to economic growth (Chart 2). The slowing in growth in the non-farm economy is forecast to result in a moderation in employment growth and a gradual easing of upward pressure on wages and prices. However, price growth is expected to remain elevated over the forecast horizon.

Chart 2: Contributions to GDP growth^(a)



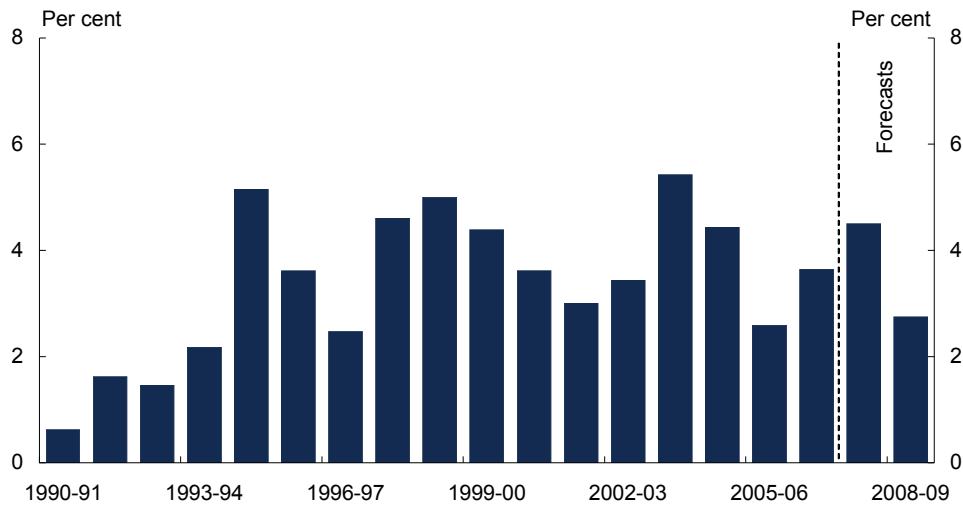
(a) Adjusted for second-hand asset sales and includes the impact of the privatisation of Telstra.
Source: ABS cat. no. 5206.0 and Treasury.

While some industries will be affected by higher interest rates and the higher exchange rate, the mining and construction sectors are expected to grow strongly given the current strength and further expected rises in non-rural commodity prices.

Household consumption

Growth in household consumption is expected to moderate from $4\frac{1}{2}$ per cent in 2007-08 to $2\frac{3}{4}$ per cent in 2008-09 (Chart 3). The moderation reflects the cumulative impact of rising official interest rates, which have risen by 200 basis points since March 2005, and an easing in labour market conditions. It also reflects tighter credit conditions and increased uncertainty from global financial market developments.

Chart 3: Growth in household consumption



Source: ABS cat. no. 5206.0 and Treasury.

In addition to increases in official interest rates, commercial banks have increased their average standard variable mortgage rates by around a further 40 basis points. Increased interest rates are constraining household consumption directly and, in the current environment, households are likely to reassess their financial positions and reduce debt accumulation. Cumulative interest rate rises and the uncertainty around the global environment have led consumer sentiment to weaken sharply in recent months. This is expected to weigh on consumption in the period ahead.

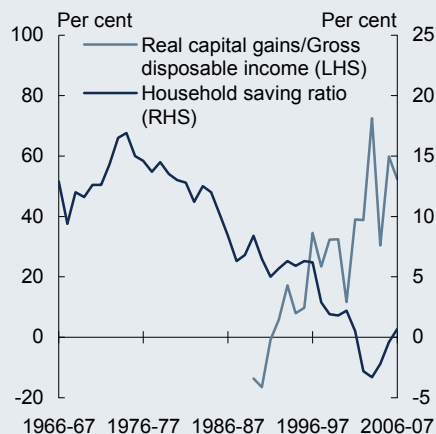
The current turbulence in global financial markets has also reduced growth in household wealth. Australian share prices fell by almost 10 per cent from the end of July 2007 (when the turbulence in financial markets began) to the end of April 2008. Lower returns and instability in the stock market will also increase people's desire to save for precautionary reasons, leading to a continued rise in the household saving ratio over the forecast horizon (Box 3). Growth in housing wealth is expected to slow as house price growth moderates.

Over the past 15 years, households have become much more indebted. This increases the impact of any given rise in interest rates. In the current circumstances, where interest rates have risen considerably over a long period of time, there has been an increase in the number of individuals experiencing financial stress.

Box 3: The household saving ratio

Australia's household saving ratio is expected to rise in 2008-09, continuing the recent reversal of its previous 30-year decline since the mid-1970s (Chart A).

Chart A: Household saving ratio and capital gains as a share of income



Source: ABS cat. no. 5204.0 and 5206.0.

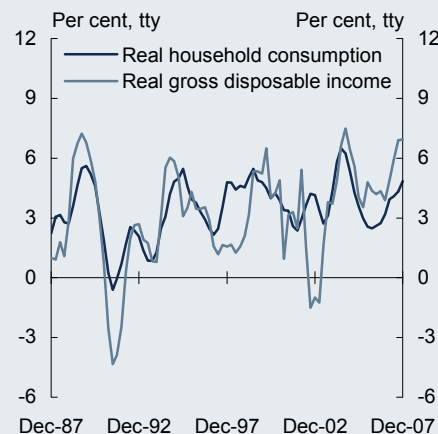
The long-term decline in the saving ratio is largely attributable to three factors. First, financial innovation and deregulation have improved access to credit, reducing the need to save to meet large expenditures or for precautionary reasons. Second, the increasing trend towards incorporation has meant that some small business saving is now reflected in corporate saving rather than household saving.

Third, substantial capital gains have allowed wealth to be built without the need to forgo current consumption. The decline in the saving ratio between 1995-96 and 2003-04 corresponds to a period of increasing capital gains (Chart A). Since 2003-04 there has been

some moderation in capital gains, which might have contributed to the turn-around in the saving ratio.

This turn-around has also occurred at a time of strong growth in disposable income, largely due to the terms of trade boom. Another possible explanation for the rise in the saving ratio is that this strong income growth is perceived to be temporary, inducing households to increase saving to smooth consumption over time. Consistent with this hypothesis, consumption growth is normally less variable than income growth (Chart B).

Chart B: Household consumption and income growth



Note: Data are a two-quarter moving average and are not adjusted for the effects of *The New Tax System*.

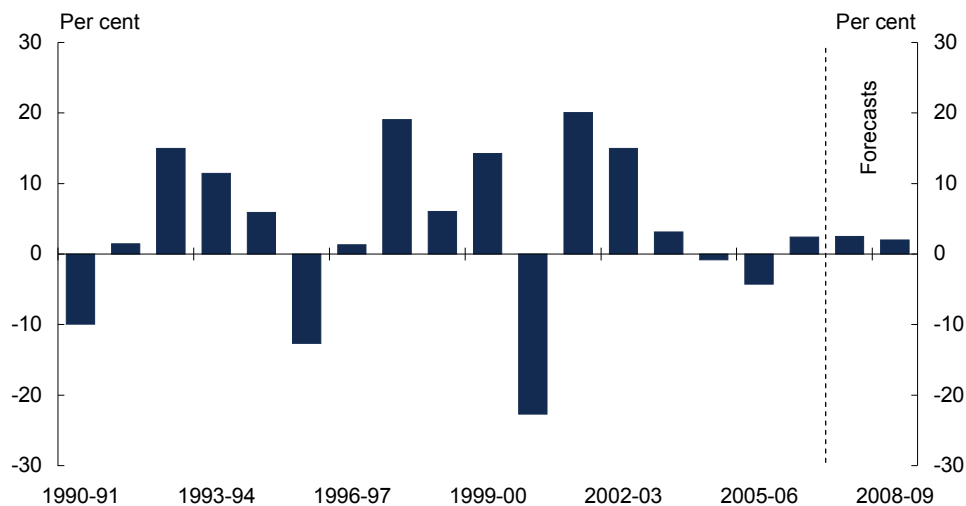
Source: ABS cat. no. 5206.0 and Treasury.

Another possible explanation relates to the precautionary motive to save. Given high levels of indebtedness, rises in interest rates in recent years may have prompted households to increase saving in order to protect against adverse shocks.

Dwelling investment

With dwelling investment mainly funded by mortgages, this sector is particularly sensitive to increases in interest rates. Growth in dwelling investment is forecast to be a subdued 2 per cent in 2008-09 (Chart 4), with growth largely expected to come from alterations and additions.

Chart 4: Growth in dwelling investment



Source: ABS cat. no. 5206.0 and Treasury.

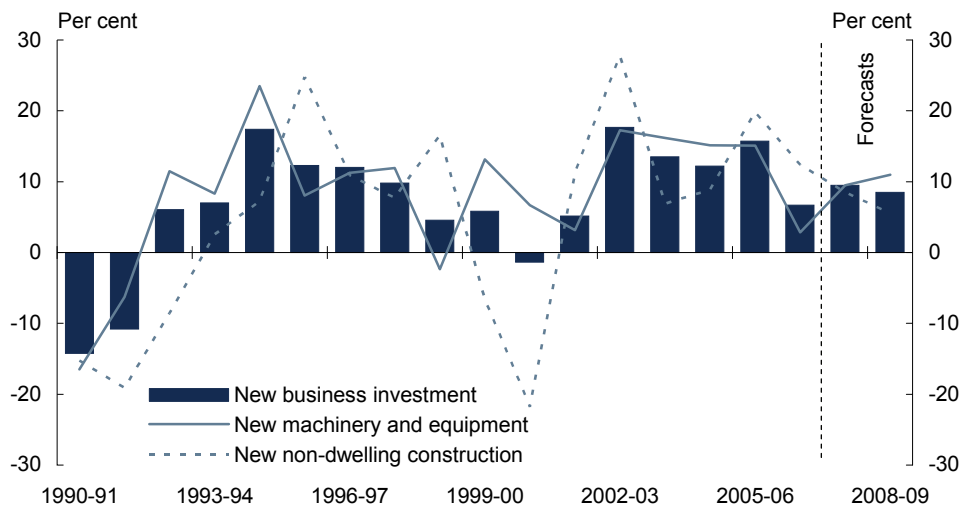
Alterations and additions have grown more strongly than new dwelling investment over the past four years. Alterations and additions grew by 5.3 per cent over the first half of 2007-08, while new dwelling investment fell by 0.9 per cent.

Over the forecast period, the cumulative effects of increases in interest rates and tighter credit conditions are expected to have a moderating impact on growth in house prices. There is also a risk that lower levels of investor activity could put additional pressure on an already stretched rental market. Rental vacancy rates are currently at very low levels across Australia. The rental prices component of the Consumer Price Index rose by 7.1 per cent through the year to the March quarter 2008.

Business investment

New business investment has grown at well-above-average rates over the past five years, bringing investment as a share of GDP to around 33-year highs in nominal terms. Strong rates of growth are expected to continue, although higher interest rates, tighter credit conditions and uncertainty in world equity and debt markets will have a dampening effect. New business investment is forecast to increase by 9½ per cent in 2007-08 and 8½ per cent in 2008-09 (Chart 5).

Chart 5: Growth in new business investment



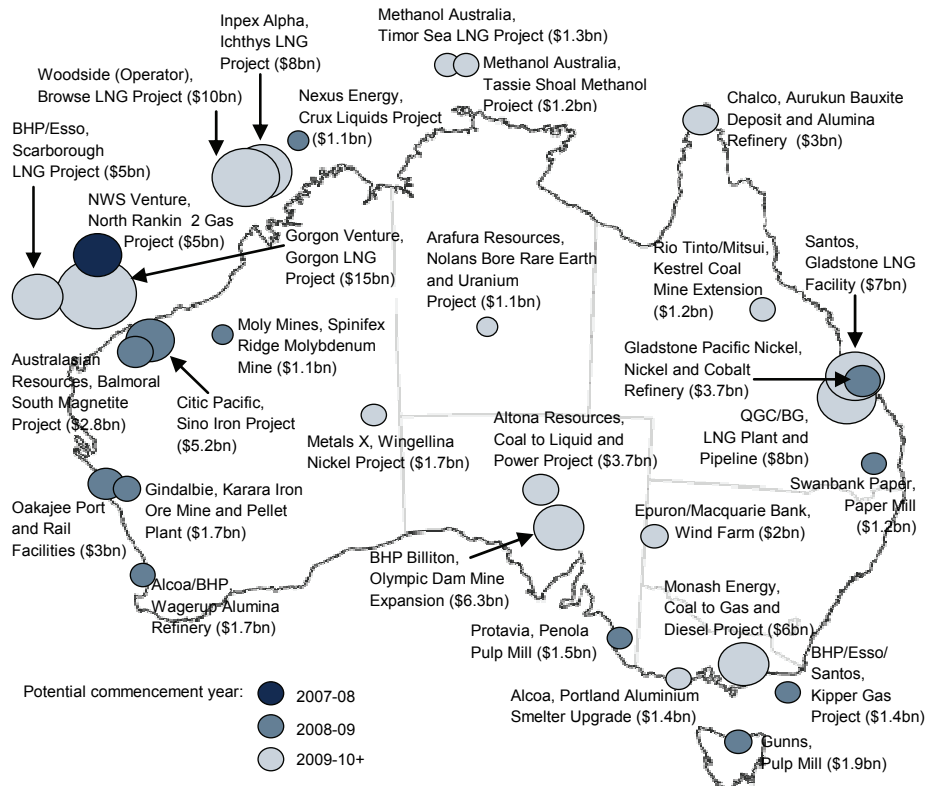
Note: Includes the impact of the privatisation of Telstra.

Source: ABS cat. no. 5206.0 and Treasury.

New machinery and equipment investment is forecast to increase by 11 per cent in 2008-09. The latest Australian Bureau of Statistics *Survey of Private New Capital Expenditure and Expected Expenditure* (CAPEX) implies strong rates of machinery and equipment investment. The construction, property and business services, and transport and storage sectors show particularly strong investment intentions. The mining industry will also continue to be a positive contributor, with further rises in non-rural commodity prices supporting mining profits and investment. The strong Australian dollar is expected to further support machinery and equipment investment, as a large proportion of this investment is imported. Agricultural machinery and equipment investment, which is not included in the CAPEX, is also likely to be solid as the farm sector recovers from drought.

Total new non-dwelling construction is forecast to grow by 5½ per cent in 2008-09. Engineering construction is expected to be supported by a large number of projects, particularly mining projects, currently under construction. The amount of engineering construction work commenced but not yet completed remains at around record highs. Large projects currently in the construction phase include the Pluto liquefied natural gas (LNG) project, the North West Shelf LNG expansion, the Rapid Growth Project 4 iron ore expansion, the Pyrenees oil field and the Boddington gold mine expansion. There are also a large number of projects planned to begin construction over the next several years (Chart 6). However, there remains a risk that increased costs and labour supply constraints will delay some of this construction. Investment in non-residential buildings is expected to be solid, with strong approvals for the construction of office, retail and other business premises.

Chart 6: Selected upcoming engineering construction projects



Note: All the projects shown are planned, but are yet to begin construction. The size of the circle indicates the estimated size of the project.

Source: March 2008 Access Economics Investment Monitor and Treasury liaison.

Notwithstanding the forecast for strong growth in business investment, there will be some dampening effect from higher interest rates, tighter credit conditions and global financial market uncertainty. These developments have seen business sentiment weaken considerably. Further volatility in global financial markets poses a risk to the business investment outlook.

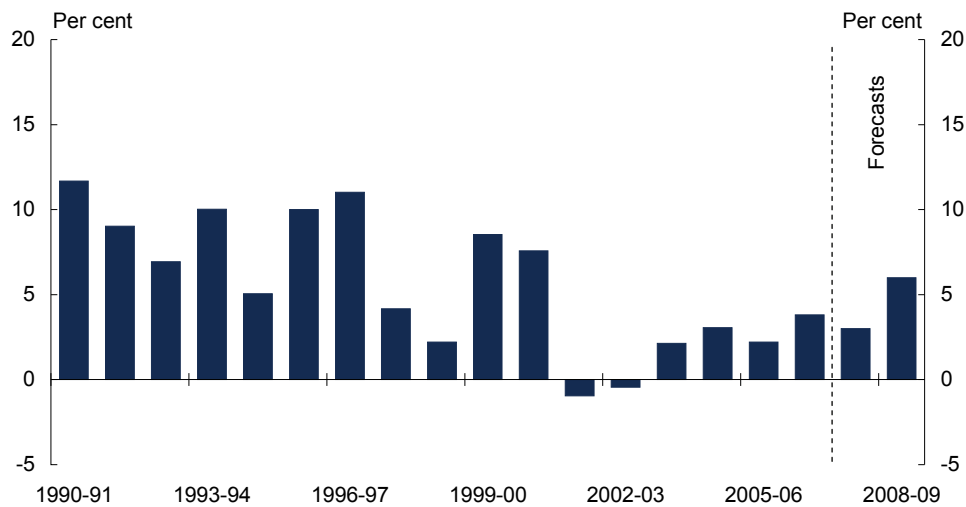
Public final demand

Growth in public final demand is expected to slow from 4¾ per cent in 2007-08 to 3 per cent in 2008-09. Australian Government consumption and State and local government investment growth is forecast to slow. However, some of the expected State and local government investment in 2007-08 may carry over into 2008-09, given competing demands on construction resources from the private sector.

Exports and imports

Slower global growth and the higher exchange rate are expected to subdue exports of elaborately transformed manufactures and services in 2008-09. However, rural exports are forecast to grow strongly given the assumed recovery from drought, and non-rural commodity exports are expected to grow as mining projects expand or commence production. Overall, exports are forecast to grow by 3 per cent in 2007-08 and 6 per cent in 2008-09 (Chart 7). Commodity exports account for more than three quarters of the growth in exports in 2008-09.

Chart 7: Growth in export volumes



Source: ABS cat. no. 5302.0 and Treasury.

Rural exports fell by 3.3 per cent in 2006-07, reflecting a significant fall in farm production due to drought. The continuation of drought conditions is likely to result in rural exports falling even more in 2007-08, reflecting no recovery in farm production and low levels of inventories. Rural exports are expected to rebound strongly in 2008-09 with the assumption of average seasonal conditions, but are forecast to remain slightly below their pre-drought levels (Box 4).

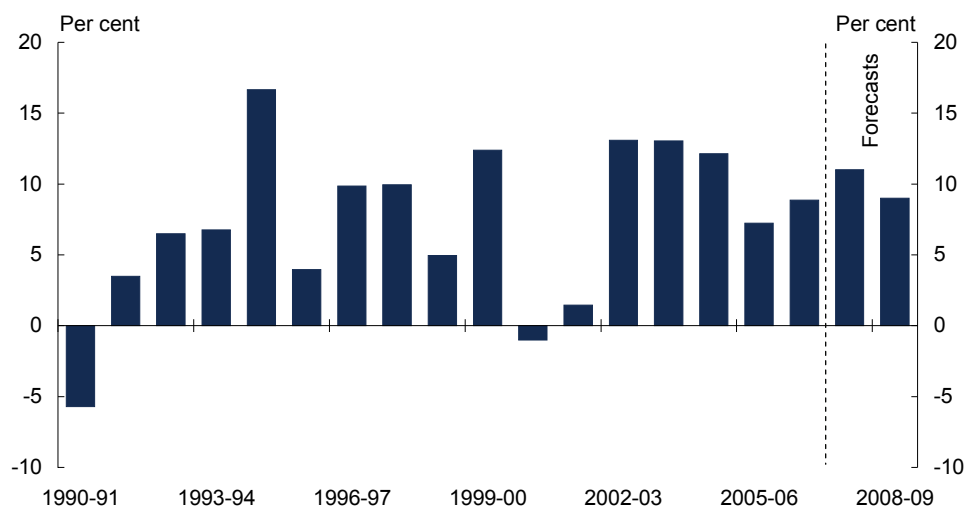
Growth in non-rural commodity exports continues to show volatility and divergences between components. The overall outlook for these exports remains positive as investment projects continue to come on line. However, for some key commodities, particularly coal, export volumes will be constrained by the capacity and efficiency of transport infrastructure (see Budget Statement No. 4). Iron ore and mineral fuel exports are forecast to grow particularly strongly. Since the beginning of 2006, over \$20 billion worth of iron ore, oil and gas mining and related infrastructure projects have begun production. In 2006-07, mineral fuel exports grew by 20.5 per cent after recording average annual falls of 5.8 per cent over the preceding four years.

Statement 2: Economic Outlook

Growth in exports of elaborately transformed manufactures has recently been driven by pharmaceutical and road vehicle exports, while services exports have recorded strong growth in education-related services. However, the higher exchange rate and a slowing in global growth are expected to weigh on these exports in 2008-09.

Import volumes are forecast to grow by 11 per cent in 2007-08 and 9 per cent in 2008-09 (Chart 8). The slight moderation in 2008-09 largely reflects the outlook for the domestic economy, partly offset by the higher exchange rate which makes imports cheaper. Consumption and services imports are anticipated to slow in line with the moderation in household consumption, while intermediate imports will ease with the slowing in domestic production. Capital imports are expected to be solid, consistent with strong growth in business investment.

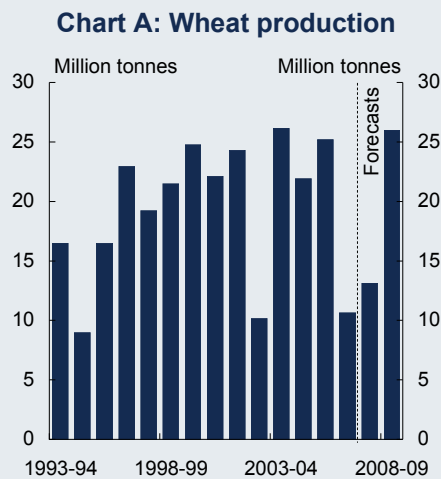
Chart 8: Growth in import volumes



Source: ABS cat. no. 5302.0 and Treasury.

Box 4: The outlook for farm production

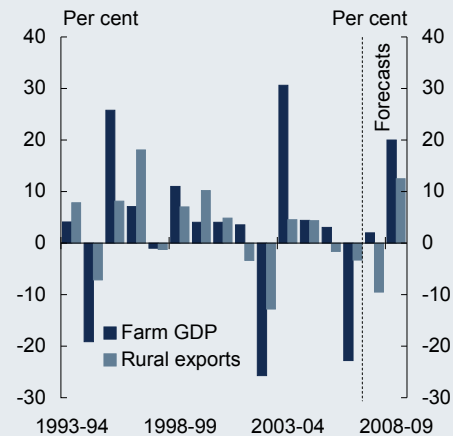
Farm production is forecast to increase by 20 per cent in 2008-09 following two consecutive drought years. The recovery is underpinned by a rebound in the production of cereal crops such as wheat and barley. The Australian Bureau of Agricultural and Resource Economics (ABARE) is forecasting a near doubling in wheat production in 2008-09 (Chart A).



Source: ABARE.

High world wheat prices and widespread summer rainfall are likely to encourage increased crop plantings, particularly as farmers aim to recover lost earnings from two poor seasons. This increased production is expected to translate into a significant increase in rural exports (Chart B).

Growth in livestock production is expected to remain subdued over the forecast horizon. While the improved seasonal conditions are expected to result in increased herd rebuilding, the number of livestock slaughtered is expected to fall.

Chart B: Growth in rural production and export volumes

Source: ABS cat no. 5206.0, 5302.0 and Treasury.

While wheat production is expected to recover significantly, the recovery in total farm GDP is forecast to be weak by historical standards due to low water storage levels.

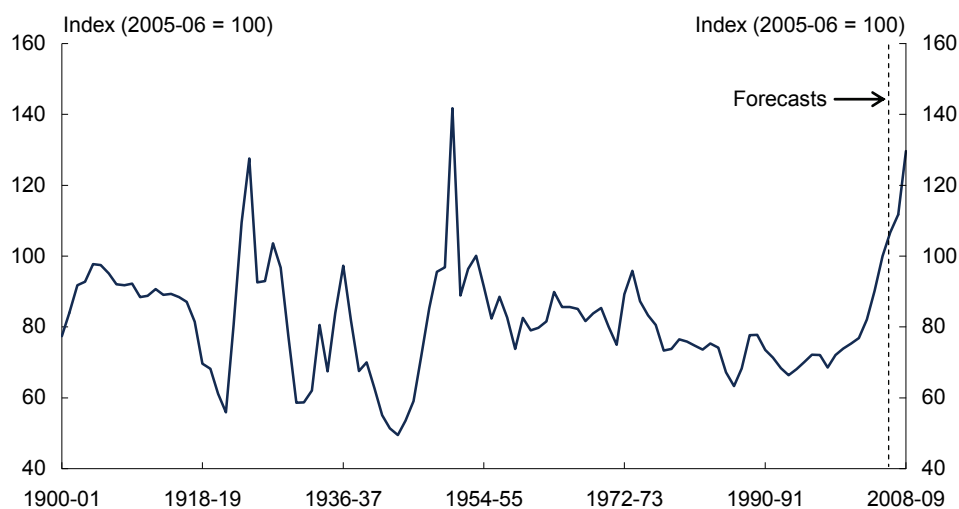
Despite good rainfall over large parts of Australia during summer, low water storage levels still persist in some of Australia's key farming regions. This is particularly the case for the Murray-Darling Basin, which accounts for around 40 per cent of Australia's gross value of agricultural production. Constrained growth in this region will weigh on aggregate farm production.

The outlook for the farm sector assumes average seasonal conditions and remains subject to considerable downside risk. The success of the 2008-09 crop is contingent on further timely rainfall. Failure to receive sufficient rain during the critical spring period would greatly reduce the size of the harvest.

Terms of trade

Robust growth in the emerging economies is supporting further large rises in Australia's terms of trade from levels that are already the highest in more than 50 years. This will lead to an acceleration in domestic incomes, which will contribute to already heightened price pressures. The terms of trade are forecast to increase by 4¾ per cent in 2007-08 and 16 per cent in 2008-09 (Chart 9). Over the 2008 calendar year, the terms of trade are forecast to rise by over 20 per cent which, if realised, would be the largest increase in a generation.

Chart 9: Terms of trade



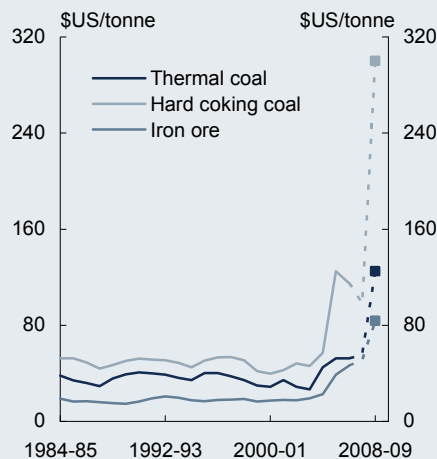
Source: ABS cat. no. 5302.0, Reserve Bank of Australia and Treasury.

World markets for iron ore and coal remain exceptionally tight, driven by both demand and supply factors (Box 5). Recently settled Australian coal contracts have seen US dollar prices rise by between 125 and 240 per cent for the 2008-09 Japanese fiscal year (1 April 2008 to 31 March 2009). For iron ore, negotiation of contract prices between some overseas producers and steelmakers has resulted in US dollar price increases of at least 65 per cent for the same period. While a slowdown in global growth would be expected to dampen demand and therefore world prices, this has been overshadowed in the current market for bulk commodities, where a large shortfall of supply is supporting higher prices. In contrast, base metal prices are expected to fall, reflecting increased supply in these markets and slower world growth.

Strong rural prices and falling import prices are also expected to support Australia's terms of trade. Rural prices have risen in recent times, driven by temporary supply-side factors such as drought, as well as rising demand from emerging economies and increased biofuel production. Australian dollar import prices are expected to continue to fall, but at a slower rate given some upward pressure from higher world inflation.

Box 5: World bulk commodity markets

Strong growth in world demand for coal and iron ore has rapidly outstripped supply in recent years. This has driven bulk commodity prices to record highs (Chart A).

Chart A: Bulk commodity prices

Source: ABARE and Treasury.

Prices for thermal and metallurgical coal have surged due to strong demand in China for coal used in electricity generation and steelmaking. Benchmark US dollar prices for the current contract period (the 2008-09 Japanese fiscal year (JFY)) for hard coking coal are 550 per cent higher than five years ago, and for thermal coal are 365 per cent higher.

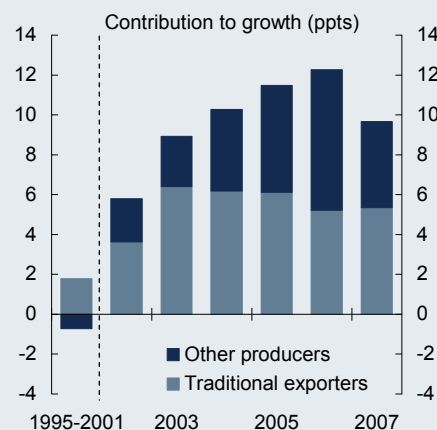
A fall in China's net exports of coal provides an indication of their increase in demand. Chinese exports of coal fell by almost 40 million tonnes over the past four years.

While the fall in China's net supply to international markets represents only a small share of world coal output, it has

had a large price impact due to the inability of other exporters to expand supply in the near term. Recent tightness in world coal markets has been exacerbated by flooding in Australia and Indonesia, infrastructure constraints in Australia and South Africa, and world shortages of mining materials and personnel, which have put further upward pressure on prices.

Iron ore contract prices have also risen significantly. Expected \$US contract prices for the 2008-09 JFY are almost five times higher than in 2002-03.

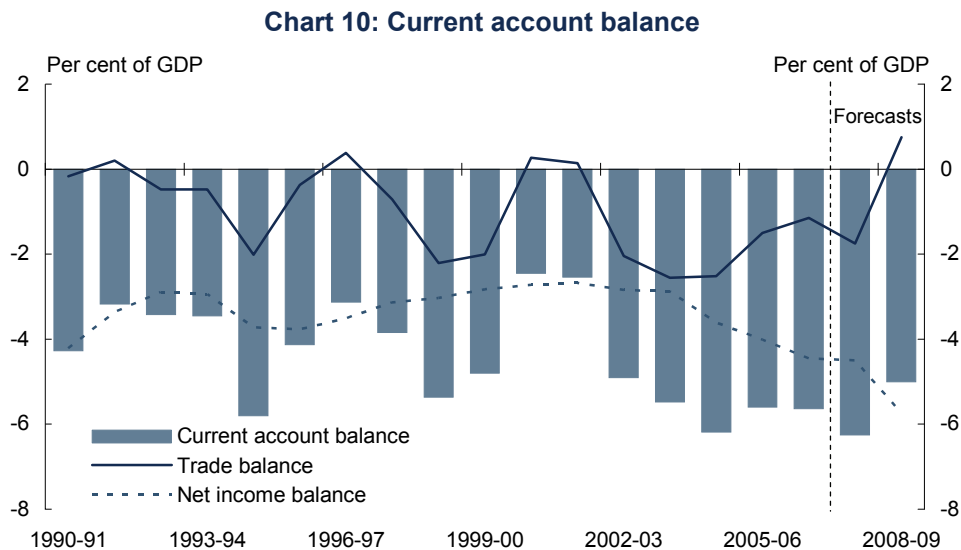
As with coal, the large price rises reflect strong demand and the limited ability of traditional iron ore exporting nations (Brazil, Australia, India, South Africa, Canada and Sweden) to meet this demand. The lack of supply from traditional exporters has meant that some of the increase in demand has come from non-traditional, higher-cost producers, especially China (Chart B).

Chart B: World iron ore production

Source: International Iron and Steel Institute, ABARE and Treasury.

Current account balance

The strong rise in the terms of trade is forecast to result in a small trade surplus in 2008-09. However, the net income deficit is forecast to widen significantly, reflecting robust growth in corporate profits, particularly mining profits, and rising net interest payments from a higher stock of net foreign debt. Overall, the current account deficit is forecast to narrow to 5 per cent of GDP in 2008-09 (Chart 10).



Source: ABS cat. no. 5302.0, 5206.0 and Treasury.

The turbulence in world debt and equity markets is affecting the outlook for the net income deficit. In the nine months to the end of April 2008, the US Federal Reserve cut its target interest rate by 325 basis points while, at the same time, corporate spreads in both the US and Australia widened substantially. This is making the outlook for future world interest rates particularly uncertain.

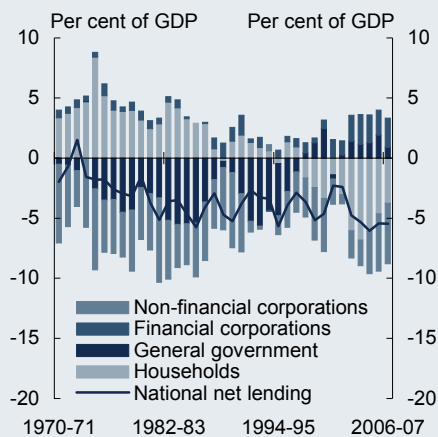
The outlook for the net income deficit is also heavily dependent on the relative performance of domestic and foreign profits, particularly US corporate profits. While further strength in the terms of trade is expected to support growth in Australian profits, the range of possible outcomes has widened. This is particularly the case in the US, where the extent of losses suffered by financial institutions from the recent sub-prime mortgage crisis is still being uncovered.

From a saving and investment perspective, the narrowing of the current account deficit reflects expected higher national saving as a share of GDP and relatively unchanged national investment (Box 6).

Box 6: Net lending and the current account balance

Historically, investment in Australia has been greater than domestic saving. This has been reflected in persistent current account deficits, as Australia draws on foreign saving to fund that portion of national investment that is not funded by domestic saving.

Chart A decomposes Australia's net lending position – the difference between national gross saving and investment – into each of the sectors of the economy. The national net lending position represents the balance on the current and capital accounts.

Chart A: Net lending by sector

Source: ABS cat. no. 5204.0 and 5206.0.

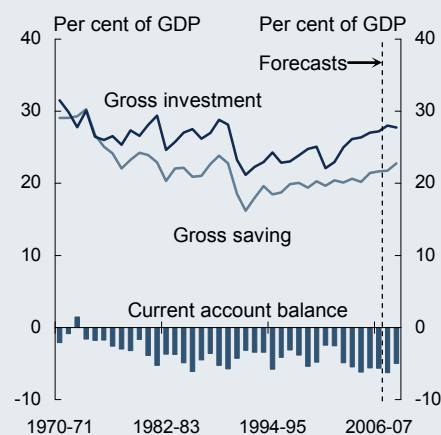
For much of the past 50 years, households have been net lenders. However, over the 1980s and 1990s, households shifted to a net borrowing position in part due to financial deregulation and innovation. In the early-2000s, there was a rapid expansion of household borrowing for housing, particularly in 2002-03. However, the past three years have seen a fall in household net borrowing.

The household saving ratio is expected to continue to rise over the forecast horizon (Box 3).

The government sector has increasingly become a net lender, with general government saving more than offsetting general government investment.

Despite strong growth in non-financial corporate profits over the past five years, the non-financial sector has remained a net borrower, reflecting high rates of investment during this time. Gross investment as a share of GDP by the non-financial corporate sector has increased by 3.8 percentage points over this period.

Business investment is forecast to remain strong. Nevertheless, the combined effect of higher household and government saving is expected to result in a narrowing of the current account deficit in 2008-09 (Chart B).

Chart B: Saving and investment

Source: ABS cat. no. 5206.0 and Treasury.

Labour market, wages and consumer prices

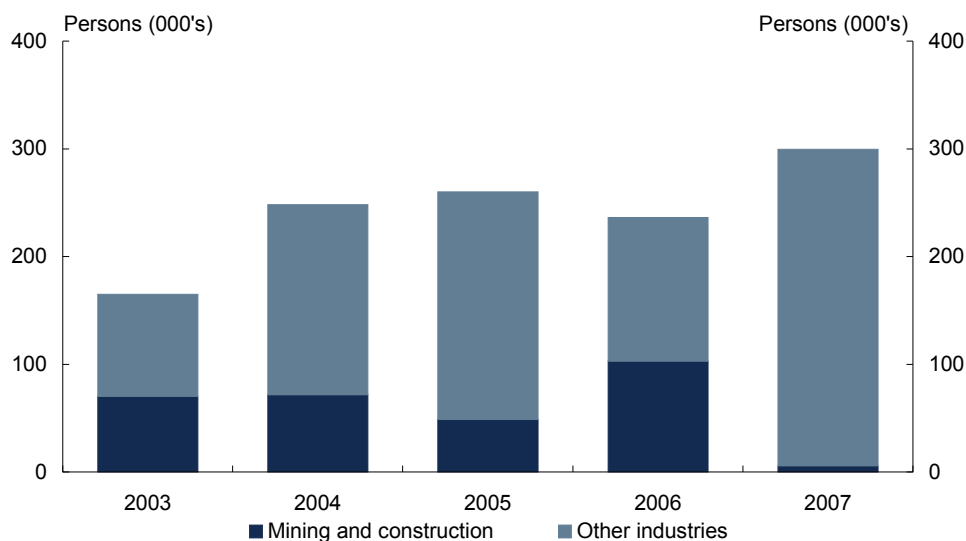
Labour market

The expected slowing in non-farm GDP growth from slower global growth, tighter credit conditions and higher interest rates is expected to see employment growth ease to 1¼ per cent in 2008-09, resulting in a gradual rise in the unemployment rate to 4¾ per cent by the June quarter 2009. The participation rate is forecast to fall slightly to 65 per cent.

The strong rise in the terms of trade to date has driven strong labour market outcomes. Since the beginning of 2004, employment has grown at an average annual rate of 2.7 per cent, while the unemployment rate has fallen from 5.6 per cent in January 2004 to 4.2 per cent in April 2008. The participation rate has also risen, and immigration has become an increasingly important source of labour supply (Box 7).

Consistent with the strong rise in non-rural commodity prices, employment growth in the mining and construction sectors has contributed solidly to total employment growth (Chart 11). Around 30 per cent of the rise in employment between 2004 and 2006 occurred in these industries, despite their share of total employment being only around 10 per cent. During 2007, however, almost all employment growth came from a range of other industries, reflecting higher incomes from the terms of trade rises flowing back through the economy, as well as capacity constraints in the mining and construction sectors. While further rises in the terms of trade will provide ongoing support for employment growth, the slowing in real economic activity is expected to have an offsetting impact over the forecast horizon.

Chart 11: Increase in employment by industry



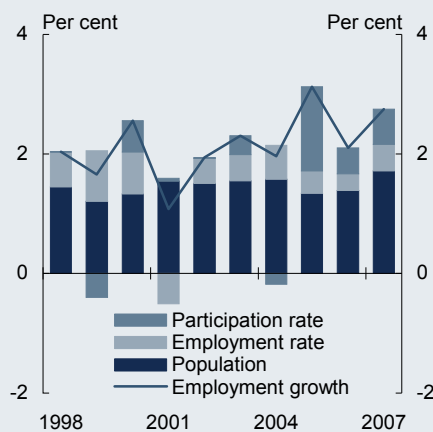
Note: Data are through the year to December.
Source: ABS cat. no. 6291.0.55.003.

Box 7: Skilled immigration and the labour market

Employment growth can have three sources — increases in the population (from either immigration or natural increase); increases in the participation rate; and reductions in the unemployment rate.

Between 2004 and 2007, employment in Australia rose at an annual average rate of nearly 270,000 persons, of which 56 per cent was due to population growth, 30 per cent to increases in the participation rate and 14 per cent to reductions in the unemployment rate (Chart A).

Chart A: Sources of employment growth



Source: ABS cat. no. 6202.0 and Treasury.

There are clearly limits to which employment can be increased through participation. In addition, as baby boomers reach retirement age, the proportion of the population of traditional working age (15 to 64 years) will decline. And with the unemployment rate currently around its lowest level in 33 years, immigration will play an important

role in driving further growth in employment.

Immigration has been an important contributor to Australia's recent strong labour market outcomes. Employment increased by 290,000 persons over the year to February 2007, with almost 40 per cent of these people being recent migrants (those who arrived in Australia in 2003 or later).

The participation and unemployment rates of migrants depend on a variety of factors, including age, skill level, English language proficiency and length of time in Australia. For example, migrants who enter via skilled programs tend to have better labour market outcomes. In 2004, permanent skilled migrants had a participation rate of 82.4 per cent, higher than the general population, and an unemployment rate of 4.2 per cent, below the national average at that time.

Immigration will also remain important to meet areas of skill shortages in the economy. Skilled migrants and their dependants accounted for 66 per cent of immigrant visas in 2006-07.

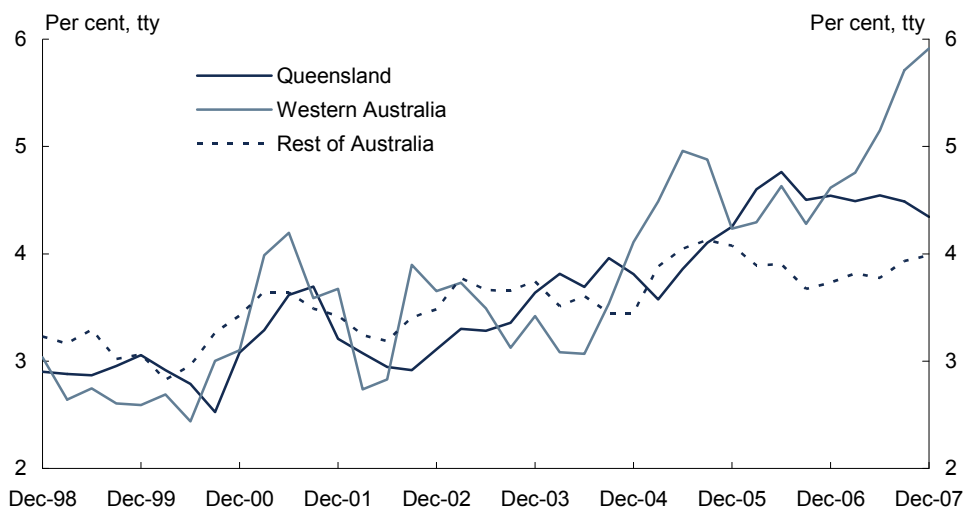
The Government is committed to meeting skill shortages in the economy through a carefully targeted skilled migration program. The Government will increase the skilled stream of the Migration Program by 31,000 places from 2008-09 and is intending to improve the integrity and responsiveness of temporary business long-stay visas.

Wages

Wages are expected to grow strongly, but are not forecast to accelerate given the anticipated easing in labour market conditions. The Wage Price Index is forecast to grow by $4\frac{1}{4}$ per cent in 2007-08 and 2008-09, with growth also $4\frac{1}{4}$ per cent through the year to the June quarters in both 2008 and 2009.

In recent times, wage growth has been strongest in the resource-rich States, a trend that is likely to be reinforced by further rises in non-rural commodity prices. Wage growth over the past two years has averaged 5.3 per cent per annum in Western Australia, 4.4 per cent per annum in Queensland, and 3.9 per cent per annum in the rest of Australia (Chart 12). This partly reflects strong wage growth in the mining and construction industries.

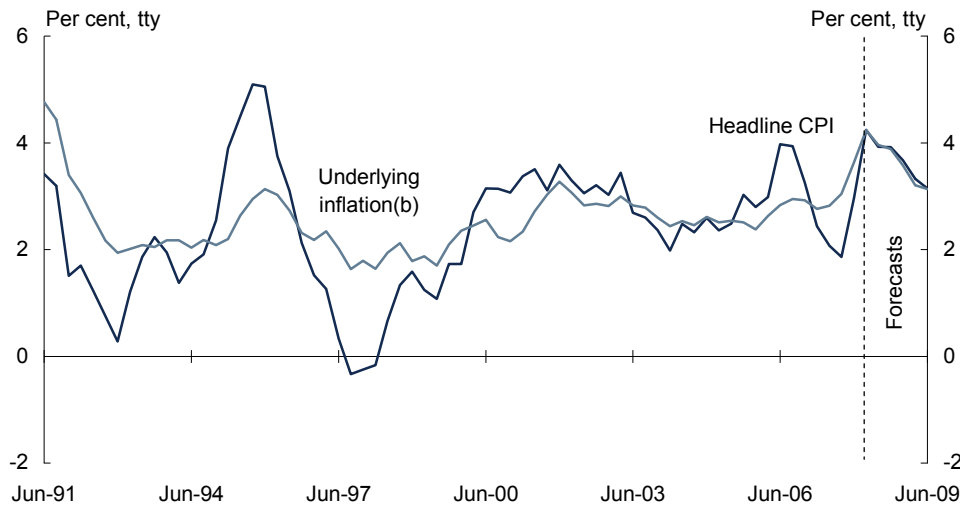
Chart 12: Growth in the Wage Price Index



Source: ABS cat. no. 6345.0.

Consumer prices

Several years of strong demand in the Australian economy has not been matched by a commensurate expansion in supply. This has led to a significant build-up in underlying inflationary pressures (Box 8). The Consumer Price Index is forecast to increase by 4 per cent through the year to the June quarter 2008 and by $3\frac{1}{4}$ per cent through the year to the June quarter 2009 (Chart 13). The corresponding figures for underlying inflation are also 4 per cent and $3\frac{1}{4}$ per cent. The current broad-based strength in price pressures reflects an economy that has been running at close to full capacity. Inflation has also been exacerbated by high energy and food prices, and specific pressures from housing costs.

Chart 13: Headline and underlying inflation^(a)

(a) Adjusted for the effects of *The New Tax System*.

(b) The underlying inflation measure is the average of the RBA trimmed mean and weighted median.

Source: ABS cat. no. 6401.0, Reserve Bank of Australia and Treasury.

Growth in nominal unit labour costs has been strong over the past three years, reflecting a slowdown in productivity growth and a modest pick-up in wages. As capacity constraints gradually ease, growth in nominal unit labour costs will moderate, helping to ease inflationary pressures.

Adverse supply conditions, including in Australia, have placed upward pressure on food prices both domestically and globally. Food prices rose by 5.7 per cent through the year to the March quarter 2008. There has also been strong world demand for agricultural food products. The expected recovery in Australia's farm sector may place some downward pressure on prices, although strong global demand pressures remain.

Housing costs are also expected to contribute to inflation over the forecast period. While house price growth is forecast to moderate, rising rental costs will continue to place upward pressure on inflation.

Incomes

In contrast to the slowing in real GDP growth, nominal GDP growth is forecast to pick-up. Nominal GDP is forecast to grow by 9¼ per cent in 2008-09 which, if realised, would be the fastest rate of growth recorded since the late 1980s. The divergence between nominal and real growth reflects strong growth in Australia's terms of trade, as well as elevated domestic price pressures that are reflected in the gross national expenditure (GNE) deflator (Chart 14).

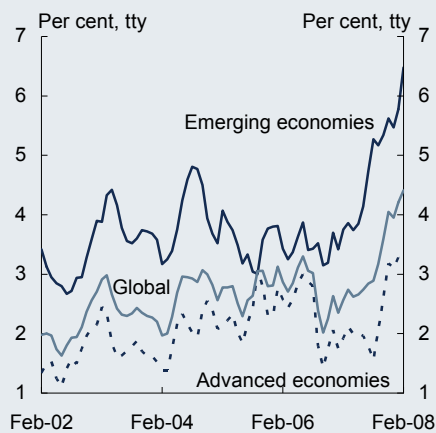
Box 8: The emergence of inflationary pressures

Underlying inflationary pressures have been building in Australia. While the risks of higher inflation have been identified for some time, recent data have revealed the extent of these pressures.

Underlying inflation picked up from 2.4 per cent over 2005 to 2.9 per cent over 2006 and 3.6 per cent over 2007. It is currently running at 4.2 per cent, its highest rate in over 16 years.

In common with other countries, Australia has experienced higher prices for energy and, more recently, food. These price pressures have seen inflation rise around the world (Chart A).

Chart A: Global inflation



Source: IMF WEO April 2008.

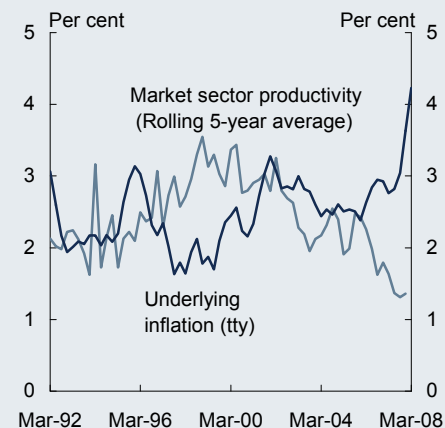
However, in contrast to the experience of other advanced economies, Australia has also faced strong domestic demand pressures. A long period of economic expansion, supported in recent years by the terms of trade boom, has absorbed much of the economy's spare capacity.

Demand growth has been broadly based, with particular strength in business investment. The labour market has tightened, with record-high participation and the unemployment rate at around 33-year lows.

The tight labour market, combined with shortages of skills in many industries, has led to stronger growth in wages as firms compete for suitably skilled staff.

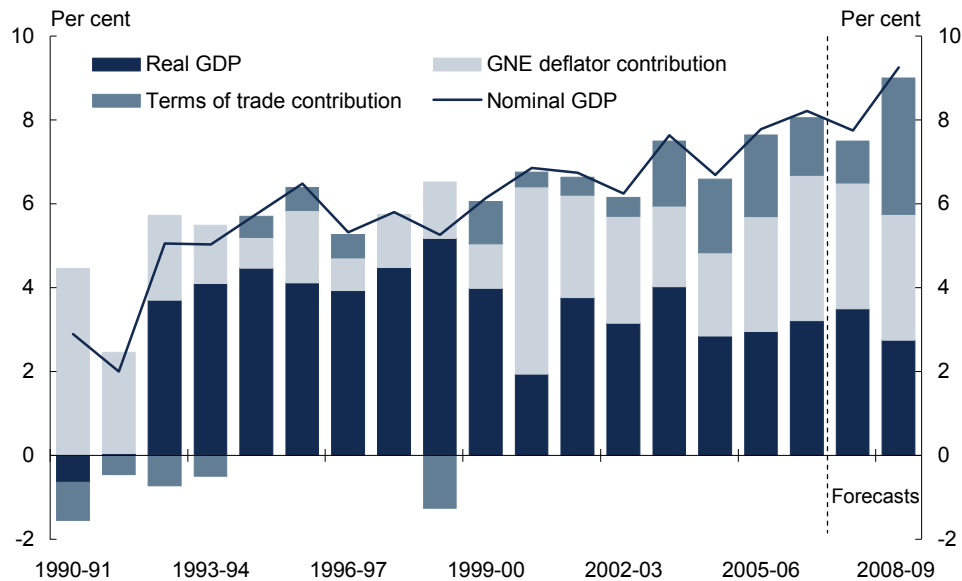
Stronger growth in wages has occurred at the same time that productivity growth has slowed. Market sector productivity growth over the past five years averaged 1.4 per cent per annum; lower than in any five-year period since the early 1990s (Chart B). This has increased price pressures as firms seek to recover higher input costs.

Chart B: Inflation and productivity



Source: ABS cat. no. 5206.0 and RBA.

Inflation is forecast to remain elevated, but to gradually ease with an increase in the economy's supply capacity and a slowing in demand.

Chart 14: Decomposition of nominal GDP growth

Note: The small discrepancy between nominal GDP and the sum of its components is due to interactions which cannot be attributed to individual components.

Source: ABS cat. no. 5206.0 and Treasury.

Broadly, nominal GDP is distributed throughout the economy as compensation of employees, gross operating surplus and gross mixed income. Compensation of employees reflects the total salary and wages paid to employees. It is forecast to grow by 8 per cent in 2007-08 and 6¼ per cent in 2008-09. The moderation in growth reflects the easing in labour market conditions, with wage growth expected to remain strong.

Gross operating surplus is a broad measure of profits. Corporate profits are expected to grow strongly over the forecast horizon, reflecting further strong rises in non-rural commodity prices. The profits of private non-financial corporations are forecast to rise by 8¼ per cent in 2007-08 and 18¾ per cent in 2008-09, with the sharp acceleration primarily due to strong profit growth in the mining sector.

Gross mixed income, which includes the wages and profits of farm and other unincorporated enterprises, is also forecast to increase strongly. Profits in the farm sector are expected to be strong, consistent with a recovery in farm production and high world prices for rural commodities.

The nominal economy has grown at an average annual rate of 7.6 per cent over the past three years, compared to an average annual rate of 6.2 per cent over the preceding decade. It is estimated that the cumulative addition to nominal GDP from the rise in the terms of trade is around \$260 billion over the five years to 2008-09 (Box 9).

Box 9: The impact of the terms of trade boom on the economy

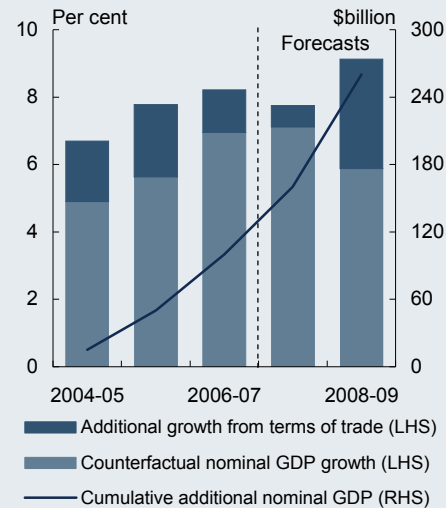
Rapid growth in the terms of trade since 2003-04 has boosted nominal incomes. As a result, aggregate real incomes have grown considerably faster than real GDP. Over the past three years, average annual growth in real gross domestic income has been 1.7 percentage points higher than growth in real GDP.

Quantifying this impact on nominal incomes depends on views as to how the economy would have evolved in the absence of the terms of trade rise.

The simplest approach is to recalculate nominal GDP with the terms of trade held constant at their average 2003-04 level. This captures the direct effect of higher export prices on nominal incomes. On this basis, nominal GDP is expected to be around 9 per cent, or \$100 billion, higher in 2008-09 than it would have been had the terms of trade remained at their 2003-04 level (Chart A). Over the five years to 2008-09, the cumulative nominal GDP gain is estimated to be around \$260 billion.

This approach assumes that the growth path of real variables, such as employment, is unaffected by the rise in the terms of trade. An alternative approach is to assume that key variables would have grown in line with their previous trends had the terms of trade not risen rapidly. Any divergence from trend is assumed to be due to terms of trade effects.

Chart A: Nominal GDP



Source: ABS cat. no. 5206.0 and Treasury.

Using this approach, total factor incomes are estimated to be 11 per cent higher in 2008-09 than in the counterfactual. This approach also provides an indication of effects on components of GDP.

The largest income boost is to corporate profits, which are estimated to be 20 per cent higher in 2008-09. Employees are also estimated to have benefited significantly from the terms of trade boom. Labour income is estimated to be 9 per cent higher in 2008-09 than in the counterfactual. Part of the increase in labour income is due to stronger growth in employment. The level of employment in 2008-09 is estimated to be 2 per cent, or 200,000 persons, higher than in the counterfactual.