

PART 1: OVERVIEW

INTRODUCTION

Global economic conditions have changed dramatically since the Budget was delivered in May.

The global financial crisis has entered a new and dangerous phase. More than 30 financial institutions around the world have failed or been bailed out and, globally, stockmarkets have suffered significant losses.

These difficulties are affecting global growth, with the economic outlook for advanced economies deteriorating rapidly. All members of the G7 group of advanced economies have experienced negative growth at some time during 2008.

Australia is not immune from the effects of the global financial crisis and the global downturn. But Australia is better placed than most other countries to withstand the fallout.

In light of global developments the Government has taken decisive action to strengthen the economy and support Australians, including guarantees of bank deposits and wholesale funding and the \$10.4 billion Economic Security Strategy.

Notwithstanding the significant challenges arising from the deterioration in the world economic outlook, the Australian economy is expected to continue to grow in 2008-09. The Government is also continuing to budget for surpluses in 2008-09 and across the forward estimates.

An underlying cash surplus of \$5.4 billion is forecast for 2008-09 (0.4 per cent of GDP). In accrual terms, the fiscal balance is expected to record a \$5.8 billion surplus in 2008-09 (0.5 per cent of GDP).

The escalation in the severity of the global financial crisis and associated weaker global economic outlook has, however, seriously impacted on the fiscal outlook, particularly from 2009-10.

Almost all of the decrease in the surplus beyond 2008-09 is due to the significant reduction in revenues associated with the global financial crisis. Policy decisions have had relatively little impact on estimated expenses and revenues in these years.

Expected taxation receipts have been revised down by \$4.9 billion in 2008-09, by \$12.2 billion in 2009-10, \$12.4 billion in 2010-11 and \$7.9 billion in 2011-12.

These downward revisions are largely the result of lower forecasts of capital gains tax (CGT) and company tax. Recent dramatic falls in the value of global equity markets,

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including the S&P ASX 200 index trading around 1500 points lower in late-October than at Budget, has reduced estimated CGT. It is expected that CGT will fall from a peak of almost \$20 billion in 2007-08, to a trough of just under \$12 billion in 2009-10. Company tax estimates have been revised down significantly as profits are expected to be negatively affected by credit market turmoil, weaker global growth and, from 2009-10, falling terms of trade.

Cash payments in 2008-09 are estimated to be \$10.6 billion higher than at the 2008-09 Budget. This largely reflects new policy decisions of \$11.0 billion including \$9.7 billion for the Economic Security Strategy.

Table 1.1 presents the fiscal and underlying cash balances for 2008-09 and the forward years.

Table 1.1: Summary of budget aggregates

	Estimates			
	2008-09		2009-10	
	Budget	MYEFO	Budget	MYEFO
Underlying cash balance (\$b)(a)	21.7	5.4	19.7	3.6
Per cent of GDP	1.8	0.4	1.5	0.3
Fiscal balance (\$b)	23.1	5.8	22.4	7.1
Per cent of GDP	1.9	0.5	1.7	0.6
	Projections			
	2010-11		2011-12	
	Budget	MYEFO	Budget	MYEFO
Underlying cash balance (\$b)(a)	19.0	2.6	18.9	6.7
Per cent of GDP	1.4	0.2	1.3	0.5
Fiscal balance (\$b)	23.3	6.7	22.6	10.1
Per cent of GDP	1.7	0.5	1.6	0.7

Further details on the accrual and cash budget estimates are provided in *Part 4: Fiscal Strategy and Outlook*.

FISCAL STRATEGY

The key elements of the Government's medium-term fiscal strategy, as set out in the 2008-09 Budget, are:

- achieving budget surpluses, on average, over the medium term;
- keeping taxation as a share of GDP on average below the level for 2007-08; and
- improving the Government's net financial worth over the medium term.

The 2008-09 Budget was delivered at a time when strong countervailing forces were affecting the economic outlook.

The fiscal strategy for the 2008-09 Budget year was for a budget surplus of at least 1.5 per cent of GDP; to 'bank' rather than spend revisions to tax receipts; and to reorient spending and taxation arrangements so that new spending was fully offset by savings. This was designed to allow the automatic stabilisers to work.

The Government recognised the risks of deterioration in world economic conditions, and acted prudently to deliver a strong surplus – an important buffer against future uncertainties.

A strong surplus was required in the 2008-09 Budget in order to:

- bear down on the inflationary pressures in the economy by reducing public demand;
- provide funding through current and future budget surpluses for future capital investment in the infrastructure, education, health and hospital needs of the nation; and
- ensure a strong financial position at a time of heightened uncertainty in the international economy.

During September and October it became clear that the flow-through of global financial market developments to the economy was going to be much more severe than previously anticipated.

Accordingly, the Government has responded to these developments by adapting its fiscal policy settings for the 2008-09 Budget year by:

- allowing the 'automatic stabilisers' – the tendency for both revenue and spending to vary in line with economic conditions – to support economic stability;
- targeting a discretionary fiscal stimulus of about 1 per cent of GDP at areas of weakness in domestic demand; and
- maintaining a strong fiscal position, including by continuing to budget for a surplus, in order to provide flexibility to adapt the fiscal stance as needed.

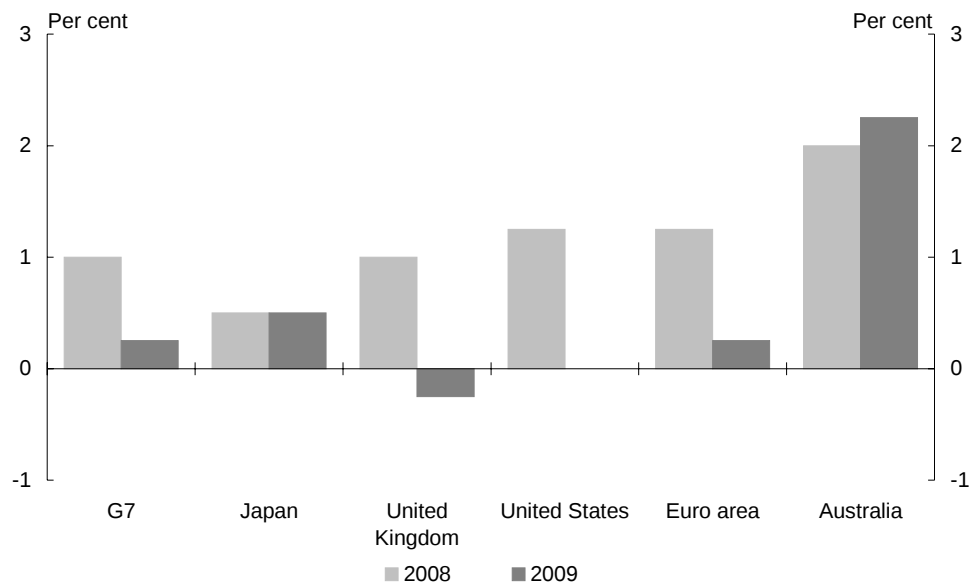
The adapted fiscal policy settings for 2008-09 are consistent with the medium-term fiscal strategy.

DOMESTIC AND INTERNATIONAL ECONOMIC OUTLOOK

The Australian economy is forecast to grow by 2 per cent in 2008-09, $\frac{3}{4}$ of a percentage point lower than expected at Budget. Growth is forecast to remain subdued at $2\frac{1}{4}$ per cent in 2009-10. The downward revision reflects the effects of the global financial crisis on the Australian economy. This crisis represents the most significant upheaval in global financial markets since the Great Depression. The global downturn stemming from the crisis is now expected to be deeper and more widespread, and has seen growth forecasts revised down sharply around the world. The G7 economies are expected to be in recession in 2008. Australia is not immune from these effects, but is better placed than most countries to withstand the fallout.

The world economy is expected to grow by $3\frac{3}{4}$ per cent in 2008, and moderate to 3 per cent in 2009. These forecasts have been revised down since Budget, in particular for 2009, where growth has been revised down by 1 percentage point. Since Budget, there has been a significant deterioration in global financial conditions and confidence. This deterioration intensified in September and October 2008 and is expected to adversely affect global growth. Advanced economies are expected to experience little growth and emerging market economies are forecast to record below trend growth. A gradual recovery in the world economy is expected late in 2009.

Chart 1.1: Forecast economic growth rates for G7, Euro area and Australia in 2008 and 2009



Source: Australian Government Treasury. International data refers to calendar years. Australian data refers to financial years (2008-09, 2009-10). Calculations for G7 and Euro area growth rates use GDP weights based on purchasing power parity. The G7 comprises the US, Japan, Germany, France, Italy, the UK and Canada.

The global financial crisis will increasingly affect growth over the forecast horizon. In Australia, as in other countries around the world, there has been a tightening of credit conditions as banks have passed on higher funding costs and taken a more cautious approach to lending. Share markets have fallen sharply, to be down by around forty per cent since the start of 2008.

Global commodity prices have also fallen sharply, as it has become increasingly likely that emerging economies will be more affected by the crisis than previously expected. The outlook for commodity prices has been revised down and the terms of trade are now forecast to fall by 8½ per cent in 2009-10. As a result, nominal GDP growth in 2009-10 is forecast to grow by only 3 per cent, compared to growth of around 8 per cent over the last two years.

The Australian dollar has also fallen sharply over the past few months, largely as a result of the easing of monetary policy and the changed outlook for global growth and commodity prices. Falls in the Australian dollar have provided crucial support for the Australian economy on previous occasions of severe global weakness, such as during the Asian financial crisis in 1997-98, and the previous US recession in the early 2000s. A lower dollar will again play an important role in helping the economy adjust to weaker world economic growth – by cushioning the effects on exporters and supporting Australian firms competing with imports.

The outlook for household consumption has deteriorated significantly since Budget. Consumers have been weighed down by high interest rates, tighter lending conditions and significant falls in household wealth as a result of the declines in global sharemarkets, and this has been reflected in very low levels of consumer confidence. The fiscal stimulus from the Economic Security Strategy will support consumption growth over the forecast period. Dwelling investment has likewise been weighed down by credit conditions, and will remain subdued in the near-term before recovering in 2009-10, supported by the introduction of the First Home Owners Boost and reductions to official interest rates.

Business investment is expected to remain solid in 2008-09, supported by the large amount of work already underway. Growth is expected to slow as these projects are completed, with investment intentions downgraded on the back of tighter credit conditions, the increased cost of equity funding and a weaker outlook for commodity prices.

High inflation persists, with headline inflation recently reaching 5 per cent. Inflationary pressures are expected to moderate as global growth slows, flowing through to lower global oil and food prices. Inflation is expected to fall to 3 per cent through the year to the June quarter 2010.

The marked deterioration in the global economic outlook, and the resulting fallout for the Australian economy, is forecast to result in more moderate employment growth

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than at Budget. As a consequence, the unemployment rate is forecast to rise to 5 per cent by the June quarter 2009 and 5¼ per cent by the June quarter 2010.

The global financial market crisis continues to present serious risks to the world and domestic outlook. Significant uncertainty remains over the extent and duration of the economic downturn stemming from the crisis, and the effect on Australia. While governments and central banks have acted swiftly with a view to restoring confidence in the financial system and bolstering economic growth, it remains to be seen whether these actions will be sufficient to stabilise global financial markets. Further economic weakness in advanced economies, beyond that currently anticipated, remains a distinct possibility should financial markets fail to stabilise and confidence remain brittle. This presents a downside risk to emerging economies through trade and financial market linkages. Should this risk materialise, this would have further adverse effects on Australia's economic outlook, particularly if it resulted in further weakness in growth in China and lower commodity prices than currently anticipated.

Given the current volatility in financial markets and changing global economic conditions, there will be a higher degree of uncertainty in the forecasts than usual.

Table 1.2 presents the major economic parameters used in preparing the *Mid-Year Economic and Fiscal Outlook 2008-09*. The parameters for 2008-09 and 2009-10 are forecasts, while those for 2010-11 and 2011-12 are projections. The projections of economic growth are based on analysis of underlying trends in employment and productivity. Similar to Budget, the projection years include the assumption that the prices of key non-rural commodities will fall further from their 2009-10 forecast levels. The projections of inflation are consistent with the medium-term target band.

Table 1.2: Major economic parameters^(a)

	Forecasts		Projections	
	2008-09	2009-10	2010-11	2011-12
Real GDP	2	2 1/4	3	3
Employment	1 1/4	3/4	1 1/4	1 1/4
Wage Price Index	4 1/4	4	4	4
CPI	3 1/2	3	2 1/2	2 1/2
Nominal GDP	7 3/4	3	4 1/4	4 1/4

(a) All parameters except the CPI are year average percentage changes. The CPI is through the year growth to the June quarter. As in previous budget documents, projections assume a two-year step down in non-rural commodity prices.