PART 3: ECONOMIC OUTLOOK

The outlook for the world economy has deteriorated sharply since the *Mid-Year Economic and Fiscal Outlook 2008-09* (MYEFO), with a deep global recession now expected in 2009. Despite intervention to support financial markets and stimulatory monetary and fiscal policies, the global financial crisis has driven almost all major advanced economies into recession. The OECD is predicting the number of unemployed could rise by eight million people in advanced economies over the next two years.

It has also become clear that emerging economies will be more profoundly affected by the crisis than originally thought. In particular, the momentum provided to the world from China's rapid growth has dissipated in recent times. Downward revisions to China's growth prospects have contributed substantially to a weaker outlook for the world economy and to sharp falls in commodity prices.

Against this backdrop, the risk of Australia following the rest of the world into recession has intensified. GDP growth is expected to be weaker than forecast at MYEFO at 1 per cent in 2008-09 and ¾ of a per cent in 2009-10, with very substantial fiscal and monetary policy responses only partially able to offset the impact of the global recession. The unemployment rate is now expected to rise to 7 per cent by June 2010. Without the significant and timely policy stimulus announced by the Government, Australia would face a more severe slowdown than forecast.

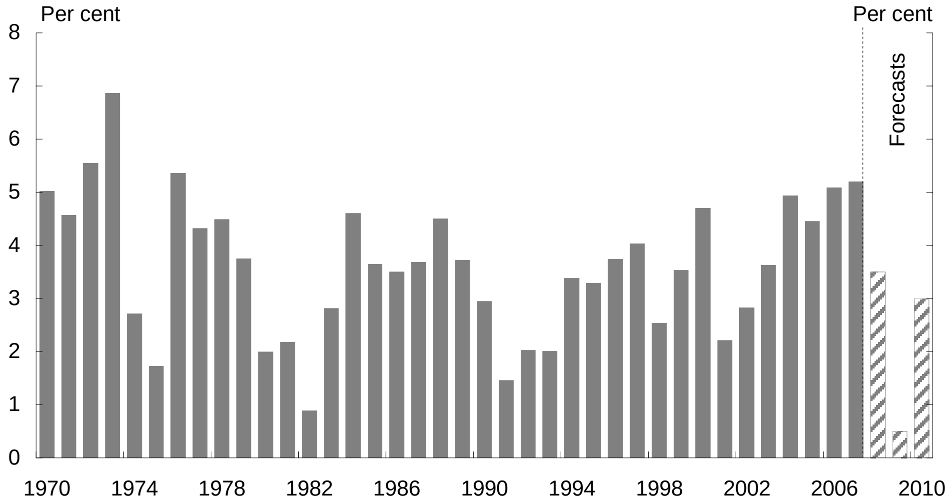
In view of the speed of developments in the global economy, the risk of weaker domestic growth outcomes remains. News of the effects of the global financial crisis on our major trading partners continues to emerge, and we are yet to see the full effect of the financial crisis on the global economy. A deeper or more prolonged recession than expected in the global economy would cause a more severe slowdown in Australia.

Given the pace of developments and the nature of the risks, governments around the world will need to remain vigilant and ready to respond rapidly to changing conditions.

INTERNATIONAL ECONOMIC OUTLOOK

While the global economy has been slowing for some time, it is clear that it is facing a much deeper and more protracted slowdown than many previously anticipated. The world economy is expected to grow by just ½ of a per cent in 2009, the lowest rate of growth in decades (Chart 3.1). Advanced economies are expected to experience the sharpest collective decline in GDP in the post-war period. The key emerging economies of China and India were initially less impacted by the global financial crisis but are now increasingly affected by falls in global trade volumes. As a consequence, China and India are now expected to slow markedly in 2009.

Chart 3.1: World GDP growth



Source: IMF and Treasury.

In the wake of the intensification of the financial crisis in September 2008, the unfolding negative real economy impacts have been broad and rapid, with the December quarter 2008 likely to show the weakest quarterly global GDP performance in the post-war era. Weighted by economic size, around half of the world is already in recession — including the United States, United Kingdom, Euro area and Japan, as well as Hong Kong, Singapore, and New Zealand in our region.

Table 3.1: International GDP growth forecasts[(a)]

	Actual	Estimate	Forecasts	
	2007	2008	2009	2010
United States	2.0	1.2	-1 3/4	1 3/4
Euro area	2.6	0.8	-1 3/4	3/4
Japan	2.4	-0.2	-2 1/2	1
China(b)	13.0	9.0	6 1/2	8 1/4
India(b)	9.3	7.8	5 1/2	6
Other East Asia(c)	5.9	3.2	-1	3 3/4
Major trading partners	5.5	2.9	0	3 1/4
World	5.2	3.4	1/2	3

(a) World and Euro area growth rates 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.
(b) Production-based measures of GDP.
(c) Other East Asia comprises the Newly Industrialised Economies (NIEs), constituting Hong Kong, South Korea, Singapore and Taiwan, and the Association of Southeast Asian Nations group of five (ASEAN-5), constituting Indonesia, Malaysia, the Philippines, Thailand and Vietnam.
Source: National statistical publications, IMF and Treasury.

The magnitude and speed at which the financial shock has fed into the real economy has surprised economic forecasters around the world. The IMF has downgraded its forecasts of global growth three times in four months, bringing its forecast for global growth in 2009 down from just under 4 per cent at the time of the 2008-09 Budget to ½ a per cent in its most recent update.

Half of Australia's top ten major trading partners are already in recession, with seven forecast to contract over 2009. Collectively, Australia's major trading partners are not expected to grow in 2009. Consistent with a modest world recovery next year, only 3¼ per cent growth is forecast for major trading partners in 2010.

Notwithstanding considerable stimulus, very severe contractions are forecast for advanced trading partner economies in 2009. Recessions in the United States, Europe and Japan are set to deepen, with consumers facing falling wealth, restricted access to credit, and rising unemployment. In the United States, the unemployment rate has increased by 2.3 percentage points over 2008, an increase of almost 3.6 million persons.

In the key economies of China and India, growth is projected to slow markedly in 2009. China's economic growth is forecast to slow to 6½ per cent in 2009. The slowdown is expected to be broadly based, with exports contributing significantly less to growth than in previous years. This region has been a key engine for world growth in recent years, and a driver of the commodity price boom from which Australia has benefited. In addition, falling export demand is expected to cause a further sharp GDP contraction in Korea and other Newly Industrialised Economies, further weakening the overall outlook for Australia's major trading partners.

Conditions in financial markets remain very fragile, although the risk of renewed stress and volatility has eased somewhat, aided by government interventions, including interest rate reductions, massive liquidity injections, extended loan facilities, capital injections and banking guarantees. However, ongoing adjustments to tighter credit conditions are proving challenging. Spillovers and contagion from further adverse financial market developments continue to pose significant risks. A further risk is that the gathering economic weakness will feed back into even weaker financial conditions.

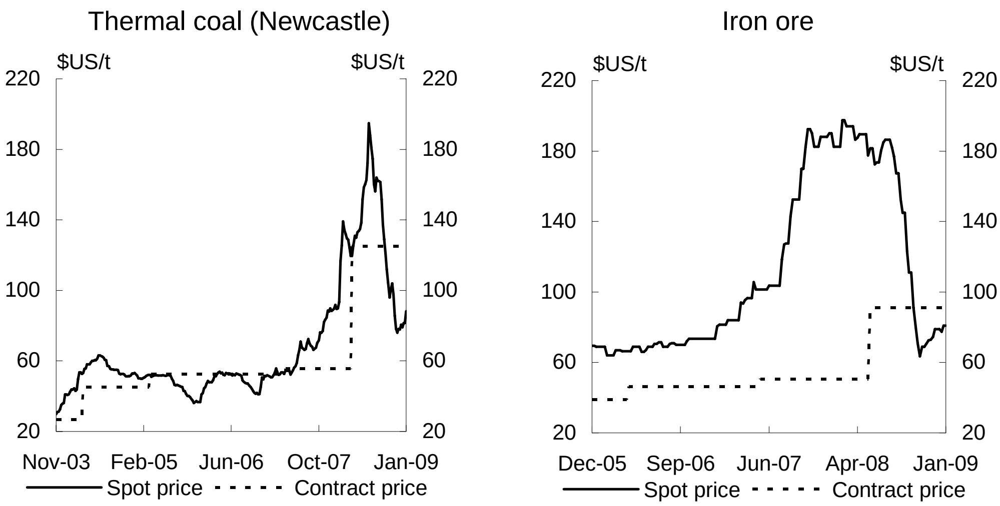
To ameliorate the downturn, many governments have announced aggressive fiscal interventions, including packages aimed at boosting infrastructure, consumer spending and business investment. The aggregate size of these economic packages is large and unprecedented with more stimulus likely to come.

DOMESTIC ECONOMY FORECASTS

The effect of the global recession on Australian economic growth is pervasive, with almost all sectors of the economy facing significant weakness over the forecast horizon. While the Economic Security Strategy was able to provide a well timed boost to growth in recent times, the further deterioration in global conditions has pushed the domestic forecasts down further. Overall the Australian economy is forecast to grow by 1 per cent in 2008-09 and ¾ of a per cent in 2009-10. The key domestic economy forecasts are summarised in Table 3.2.

The adverse effect of the broad-based weakness in the global economy is being reflected in lower commodity prices, which have provided significant stimulus to Australian economic growth and national incomes over recent years. In line with the sharp reduction in global demand, more substantial falls in commodity prices are expected than at MYEFO. Key bulk commodity prices are expected to lose much of their gains of recent years. Prices are expected to remain under pressure until the global economy, and China in particular, begins to recover. The terms of trade are now expected to fall by around 20 per cent over 2009, a much larger fall than expected at MYEFO. The weaker outlook for the terms of trade is reflected in a significantly weaker outlook for national incomes, with corporate profits expected to fall by 9¾ per cent in 2009-10.

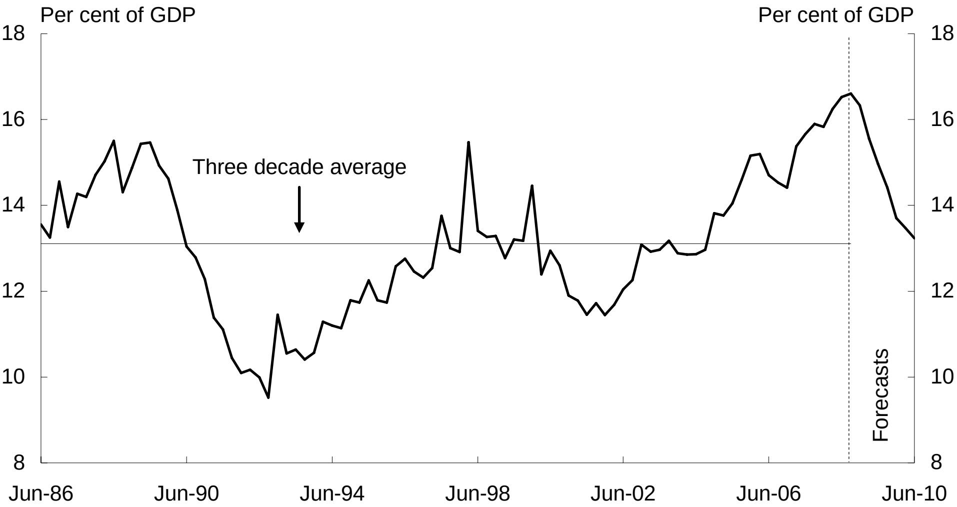
Chart 3.2: Bulk commodity prices



Note: Iron ore spot price is CFR for India/China imports.
Source: Bloomberg and Global Coal.

There has been a marked deterioration in the outlook for business investment since MYEFO. A significantly weaker outlook for global and domestic demand and a weaker profits outlook have reduced much of the stimulus for investment that has prevailed over the last five years. Credit conditions for businesses continue to be tight and the cost of equity funding remains high. Consequently, as current projects are completed few new projects are being added to the pipeline, and a large number of projects have either been cancelled or postponed in light of the deteriorating economic outlook and lower commodity prices. Investment is now expected to fall by 15½ per cent in 2009-10.

Chart 3.3: Business investment



Source: ABS cat. no. 5206.0 and Treasury.

The Nation Building and Jobs Plan aims to counter the effects of falling business investment through measures to support private investors and a well timed boost to public investment which will strengthen the economy's capacity in the future. Incentives to boost private investment will be provided through the Small Business and General Business Tax Break. In addition, the Australian Business Investment Partnership, announced earlier in the year, will help to support investment by providing liquidity support to the commercial property sector. The Nation Building and Jobs Plan adds around $17 billion to Commonwealth and State and local government investment over the forecast period. Public sector investment is providing support to growth over the forecast horizon, with public final demand expected to grow by 5½ per cent in 2008-09 and 7¼ per cent in 2009-10.

The outlook for household consumption has softened further since MYEFO, with household consumption expected to grow by 1¾ per cent in 2008-09. Households are facing significant falls in wealth, with asset values falling sharply over the past year. Australian share markets are down by a further 20 per cent since MYEFO and have halved in value since the peak in late 2007. House prices have also begun to moderate over the past six months. This is being compounded by a high degree of uncertainty around the duration and ultimate effect of the global financial crisis on wealth and employment, which has had a negative effect on sentiment.

In the face of heightened uncertainty, households may increase their savings and rebuild their balance sheets. Strengthening the financial position of households will help bolster confidence and lead to a more rapid recovery in household consumption.

Substantial fiscal and monetary policy stimulus is acting to support consumption. The Government's Economic Security Strategy is boosting household consumption over the December and March quarters particularly, and has been bolstered by substantial monetary policy easing and lower petrol prices. The Nation Building and Jobs Plan will provide an additional $12.7 billion to households in 2009, which will further boost consumption. Nevertheless, it is expected to be some time before household confidence improves and consumption recovers to the levels of recent years. As a result, consumption growth is forecast to be ½ of a per cent in 2009-10.

Dwelling investment is expected to recover somewhat over the forecast horizon, although near-term results are likely to be weak. Building approvals fell sharply at the end of 2008, a legacy of the high interest rates and low levels of confidence which prevailed over much of 2007-08. However, large interest rate cuts, strong underlying demand and the First Home Owners Boost for new houses are expected to support a recovery in dwelling investment in 2009-10, with growth expected to rise to 4 per cent. A downside risk to these forecasts is that confidence in the household sector remains low, exacerbated by uncertainty around unemployment levels.

The outlook for the external sector is weaker in 2008-09 driven by the sharp deterioration in the outlook for world growth. Net exports are expected to detract ½ of a percentage point from growth in 2008-09, before adding ¾ of a percentage point in 2009-10. The outlook for export growth has been revised down sharply to just ½ of a per cent in 2009-10. While some support will be provided by the depreciation of the Australian dollar, the broad based and pervasive weakness in growth across the world economy means that demand for Australia's exports will likewise be weak. Offsetting this in 2009-10 is the significantly weaker outlook for imports, which are expected to fall by 3 per cent in that year. The outlook is driven by the weakness in domestic demand, particularly the sharp slowdown in business investment, which relies heavily on imported capital goods.

In line with the significant slowdown in the domestic economy, employment is expected to contract through 2009 and remain weak in 2010. This will flow through to a substantial rise in the unemployment rate, which is expected to increase to 5½ per cent by June 2009 and 7 per cent by June 2010. The Government's Nation Building and Jobs Plan is expected to provide significant support to employment as the economy weakens. The Plan will support up to 90,000 jobs over the forecast period.

Inflation forecasts have decreased significantly since MYEFO, with both headline and underlying inflation expected to fall to 2 per cent by June 2010. Inflation is expected to ease on the back of weaker global growth and domestic demand, moderating wage pressures and substantially lower oil prices.

DETAIL OF SECTORAL FORECASTS FOR THE AUSTRALIAN ECONOMY

Table 3.2: Domestic economy forecasts[(a)]

	Outcomes(b)	Forecasts		
	2007-08	2008-09		2009-10
		MYEFO	UEFO	UEFO
Panel A - Demand and output(c)				
Household consumption	3.7	2	1 3/4	1/2
Private investment				
Dwellings	1.4	0	-2	4
Total business investment(d)	14.2	5 1/2	1/2	-15 1/2
Non-dwelling construction(d)	11.2	1/2	-2	-18
Machinery and equipment(d)	16.0	8	2	-16 1/2
Private final demand(d)	5.5	2 1/2	3/4	-2 1/2
Public final demand(d)	4.6	3 1/2	5 1/2	7 1/4
Total final demand	5.3	2 3/4	1 3/4	- 1/4
Change in inventories(e)	0.2	- 1/4	- 1/4	0
Gross national expenditure	5.5	2 1/4	1 1/2	- 1/4
Exports of goods and services	4.3	6 1/2	1/2	1/2
Imports of goods and services	12.7	7	2 1/2	-3
Net exports(e)	-1.9	- 1/2	- 1/2	3/4
Real gross domestic product	3.7	2	1	3/4
Non-farm product	3.6	1 3/4	1	1/2
Farm product	8.5	13	11	5
Nominal gross domestic product	8.2	7 3/4	6 3/4	0
Panel B - Other selected economic measures				
External accounts				
Terms of trade	5.1	10 3/4	9	-12 3/4
Current account balance (per cent of GDP)	-6.2	-4 1/2	-3 3/4	-5 1/2
Labour market				
Employment (labour force survey basis)(f)	2.5	1/2	- 1/4	0
Unemployment rate (per cent)(g)	4.3	5	5 1/2	7
Participation rate (per cent)(g)	65.3	65	64 3/4	64 1/2
Prices and wages				
Consumer price index(f)	4.5	3 1/2	2	2
Gross non-farm product deflator	4.4	6	5 3/4	- 1/2
Wage price index(f)	4.1	4 1/4	3 3/4	3 1/4

(a) Percentage change on preceding year unless otherwise indicated.
(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.
(e) Percentage point contribution to growth in GDP.
(f) Through the year growth rate to the June quarter.
(g) Estimate for the June quarter.

Note: The domestic economy forecasts are based on several technical assumptions. The exchange rate is assumed to remain around its recent average level — a trade weighted index of 55 and a United States dollar exchange rate of around 68 US cents. Interest rates are assumed to move broadly in line with market expectations. Oil prices (Malaysian Tapis) are assumed to remain around US$45 per barrel. The farm sector forecasts are based on an assumption of average seasonal conditions in the future, but take into account current low water storage levels.

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