

PART 1: OVERVIEW

INTRODUCTION

The Australian economy has performed better than expected since the 2009-10 Budget, with growth now expected to be stronger and unemployment lower. The improved outlook reflects the effectiveness of the significant monetary and fiscal stimulus that has been put in place in response to the downturn, and an expected stronger recovery in the world economy, underpinned by stimulus efforts globally.

Australia has the strongest growing economy in the developed world and this is expected to continue. Forecast GDP growth has been revised up to 1½ per cent in 2009-10 and 2¾ per cent in 2010-11 and the unemployment rate is now expected to peak at 6¾ per cent, well down on the 8½ per cent forecast at Budget.

Nevertheless, with the economy expected to remain below capacity for some time and expected further rises in unemployment, fiscal stimulus is still needed to support domestic activity. It remains appropriate for stimulus to be withdrawn progressively as private demand recovers, as it is designed to do.

The stronger economic outlook has improved the outlook for tax receipts which, under the Government's fiscal strategy, will deliver lower deficits and debt across the forward estimates. Net debt is now expected to peak at 10.0 per cent of GDP, which is around \$50 billion lower than expected at Budget.

However, it will take time for stronger activity to be fully reflected in tax receipts. The forecast underlying cash deficit for 2009-10 is \$57.7 billion (4.7 per cent of GDP). In accrual terms, the deficit is expected to be \$54.4 billion in 2009-10 (4.5 per cent of GDP). Table 1.1 presents the fiscal and underlying cash balances for 2009-10 to 2012-13.

Table 1.1: Summary of budget aggregates

	Estimates			
	2009-10		2010-11	
	Budget	MYEFO	Budget	MYEFO
Underlying cash balance (\$b)(a)	-57.6	-57.7	-57.1	-46.6
Per cent of GDP	-4.9	-4.7	-4.7	-3.6
Fiscal balance (\$b)	-53.1	-54.4	-56.0	-46.5
Per cent of GDP	-4.5	-4.5	-4.6	-3.6
	Projections			
	2011-12		2012-13	
	Budget	MYEFO	Budget	MYEFO
Underlying cash balance (\$b)(a)	-44.5	-31.2	-28.2	-15.9
Per cent of GDP	-3.4	-2.3	-2.0	-1.1
Fiscal balance (\$b)	-41.8	-28.2	-30.3	-18.0
Per cent of GDP	-3.2	-2.1	-2.2	-1.2

(a) Excludes expected Future Fund earnings.

DOMESTIC AND INTERNATIONAL ECONOMIC OUTLOOK

The Australian economy has performed better than expected since Budget and the economic outlook has improved. These good outcomes – supported by the fiscal stimulus and low interest rates – have bolstered confidence by more than expected and set a solid platform for recovery.

Australia has continued to grow despite the global recession and is the only advanced economy to have recorded positive growth – of 0.6 per cent – through the year to June 2009.

After the severe contraction recorded during the December and March quarters, the world economy appears to have stabilised. World output is now expected to decline by 1 per cent in 2009 (previously 1½ per cent), reflecting the contraction that has already taken place during the first half of the year. Global growth in 2010 has been revised up from 2¼ to 3¼ per cent, with slightly stronger growth expected amongst Australia's major trading partners.

A recovery is underway in Australia's Asian trading partners, with key regional economies rebounding strongly over the past six months. China, in particular, has continued to perform better than expected, with domestic demand supported by aggressive monetary and fiscal policy stimulus. After severe contractions in output, there also appear to be signs of a bottoming in GDP in advanced economies including the United States.

Against a more favourable global and domestic backdrop, the current forecasts for the Australian economy have been revised up since the Budget, with growth expected to be stronger, albeit still below trend. Table 1.2 presents the major economic parameters used in preparing the *Mid-Year Economic and Fiscal Outlook 2009-10*.

Table 1.2: Major economic parameters^{(a)(b)}

	Forecasts		Projections	
	2009-10	2010-11	2011-12	2012-13
Real GDP growth	1 1/2	2 3/4	4	4
Employment growth	1/4	1 1/2	2 1/4	2
Unemployment rate	6 3/4	6 1/2	6	5 3/4
Headline inflation	2 1/4	2 1/4	2 1/4	2 1/4
Nominal GDP growth	1 1/4	5 1/2	6 1/4	6 1/4

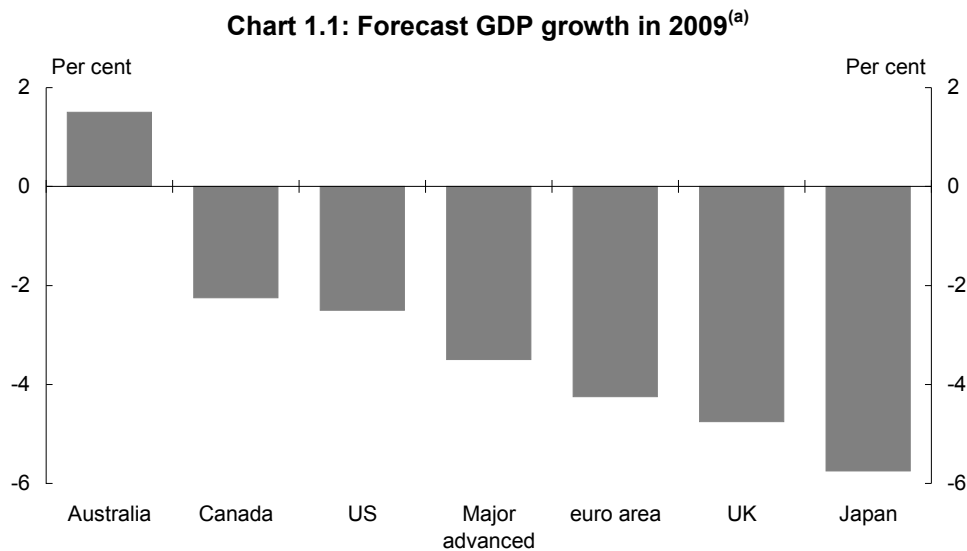
(a) Real and nominal GDP parameters are year average percentage changes. In the forecast period, inflation and employment growth are expressed in through-the-year terms to the June quarter and the unemployment rate is the rate in the June quarter. All projections are in year average terms.

(b) The parameters for 2009-10 and 2010-11 are forecasts, while those for 2011-12 and 2012-13 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 gradually from their 2010-11 forecast levels. The projections of inflation are consistent with the medium-term target band.

Australia is forecast to record the strongest growth of any advanced economy in 2009, with real GDP now expected to grow by $1\frac{1}{2}$ per cent in 2009-10, compared to a $\frac{1}{2}$ per cent contraction forecast at Budget (Chart 1.1). The growth forecast for 2010-11 is also stronger at $2\frac{3}{4}$ per cent.

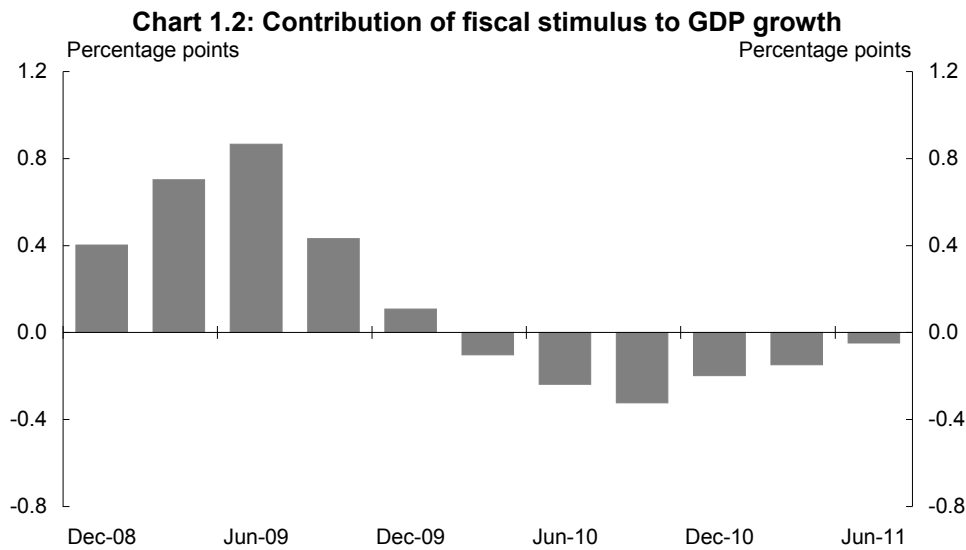
The unemployment rate is now forecast to peak at $6\frac{3}{4}$ per cent in the June quarter 2010. This amounts to an additional 105,000 unemployed persons, on top of the 210,000 rise since the March quarter 2008. Fiscal stimulus is estimated to reduce the peak unemployment rate by $1\frac{1}{2}$ percentage points.

Inflation pressures are expected to remain subdued as the economy continues to operate below capacity and with wages growth expected to be moderate. Headline and underlying inflation are expected to be $2\frac{1}{4}$ per cent through the year to June in both 2009-10 and 2010-11.



(a) Australian data refer to forecasts for 2009-10. Major advanced refers to the G7 economies.
Source: Treasury.

In the near term, fiscal stimulus is expected to add around $2\frac{1}{2}$ percentage points to the level of GDP in 2009-10 and $1\frac{3}{4}$ percentage points in 2010-11, a slight rebalancing compared with Budget. The impact of fiscal stimulus on GDP growth peaked in the June quarter 2009, and is already diminishing. The planned withdrawal of fiscal stimulus is expected to detract from growth from the March quarter 2010 (Chart 1.2).



Fiscal stimulus is estimated to have added around 1 percentage point to GDP growth in 2008-09 and is expected to add 1½ percentage points in 2009-10. These estimates imply that all of the growth in 2008-09, and expected growth in 2009-10 is due to the direct consequences of the fiscal stimulus.

By design, the fiscal stimulus will be withdrawn in line with the gathering pace of the private sector recovery. Some aspects of the stimulus have been recalibrated to allow flexibility in managing the demand for individual programs and to ensure an appropriate level of support is provided to the economy. This gradual withdrawal remains appropriate, with the economy expected to operate below capacity for some time. A gradual withdrawal avoids sudden changes in the profile of government spending that could threaten growth and confidence.

In 2010-11 the gradual withdrawal of stimulus is expected to detract around ¾ of a percentage point from growth. In contrast, withdrawing stimulus completely in 2010-11 would result in employment being lower by around 100,000 persons in that year and a much sharper detraction from growth.

Overall, withdrawing the stimulus at once would detract 2½ percentage points from growth in 2010-11. A sudden withdrawal of public sector activity of this magnitude while the recovery in private sector demand is not yet firmly established would have significant costs in terms of lost output and higher unemployment.

In Australia, incomes remain under pressure. Although the unemployment rate has not deteriorated as much as previously forecast, there has been a substantial reduction in hours worked — equivalent to the loss of over 200,000 full-time jobs — that is weighing down on household incomes. The terms of trade have fallen by 16.9 per cent since September 2008, dragging down business profits.

These factors are reflected in the forecast for nominal GDP growth of 1¼ per cent in 2009-10, which would be the lowest annual rate of growth since 1961-62.

With credit conditions still difficult for many businesses and profits weak, business investment is expected to fall, albeit significantly less sharply than forecast at Budget. Public infrastructure spending will be critical to supporting activity while private investment is weak and to maintaining investment that boosts the economy's capacity. This stimulus will be progressively withdrawn as a more sustained recovery in private sector activity takes hold.

With the downturn now forecast to be shallower, the rate of growth needed to bring the economy back to capacity will be lower than previously projected. GDP growth is now projected to be 4 per cent in both 2011-12 and 2012-13 (compared with 4½ per cent at Budget). In the medium term, the economy will return to its potential growth path in 2014-15, two years earlier than projected at Budget.

Deep downturns can permanently reduce an economy's growth prospects through the erosion of skills and capital. The milder-than-expected downturn in Australia means the long-term output loss is also expected to be smaller. As a consequence, the revised medium-term projections imply a smaller permanent output loss, and higher level of real GDP over the medium term, than projected at Budget. In supporting activity and employment, and moderating the downturn in Australia, stimulus — both monetary and fiscal — is expected to have long lasting benefits.

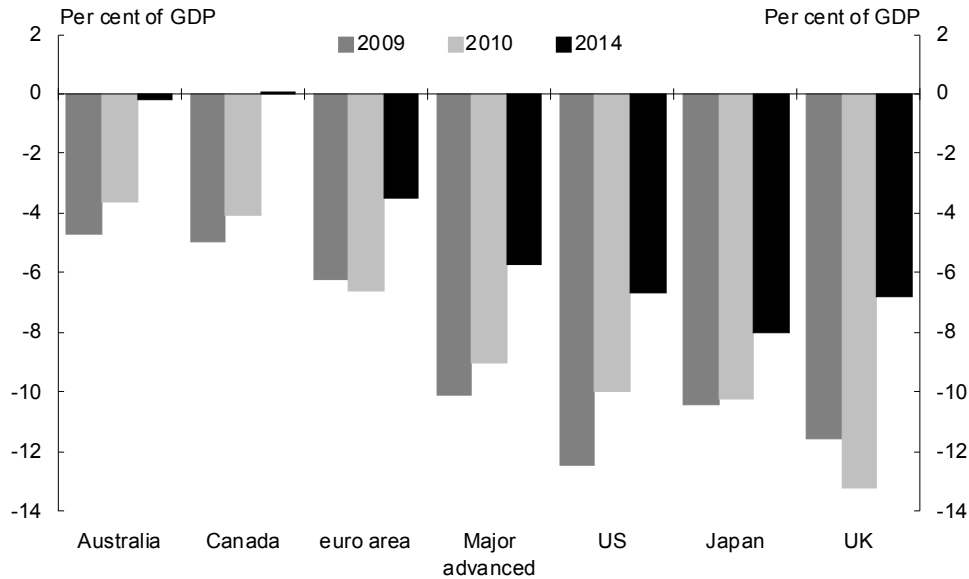
FISCAL OUTLOOK

The stronger economic outlook is expected to result in higher tax receipts relative to the estimates presented in the Budget. Under the Government's fiscal strategy, higher tax receipts will be allowed to flow directly to the budget bottom line to deliver lower deficits and debt. Net debt is now expected to peak around \$50 billion lower than projected at Budget.

However, expected lags between economic activity and tax collections mean that it will take some time for the benefits of stronger economic growth to be fully reflected in the budget position. Tax receipts are largely unchanged in 2009-10 and the fiscal situation will remain challenging in the near term.

The underlying cash deficit is expected to be broadly unchanged in 2009-10 from the estimate presented in the Budget, but substantially lower across the remainder of the forward estimates. The Australian Government budget deficit of 4.7 per cent of GDP in 2009-10, is significantly lower than the 10.1 per cent of GDP deficit expected for the major advanced economies (Chart 1.3).

Chart 1.3: Budget balance positions for selected countries



Source: IMF and Treasury calculations.

Note: Data are as at end of calendar year, except for the Australian Government where data refer to financial years beginning 2009-10.

Variations to tax receipts are the major contributor to the changes to the forecast underlying cash deficit across the forward estimates. However, even with these improvements, estimated taxation receipts for 2008-09 to 2012-13 remain around \$170 billion lower than those presented in the 2008-09 Budget, prior to the onset of the global recession.

Key elements of a sustainable medium-term fiscal strategy

The Government's medium-term fiscal strategy is to achieve budget surpluses on average, over the economic cycle; to keep taxation as a share of GDP, on average, below the level for 2007-08; and to improve the Government's net financial worth over the medium term.

To ensure that growth was supported in a manner consistent with the medium-term fiscal strategy, the Government committed in the February 2009 *Updated Economic and Fiscal Outlook* to a strategy that would support the economy during the global recession and return the budget to surplus as the economy recovered.

The Government has demonstrated its commitment to the fiscal strategy by:

- fully offsetting all new spending since the 2009-10 Budget with savings;
- budgeting for real spending growth of less than 2 per cent in the years in which the economy is projected to grow at above-trend rates; and

- allowing higher tax receipts over the forward estimates to flow through to the budget bottom line.

Continued adherence to the fiscal strategy will ensure that the budget is returned to surplus in a timely fashion as the economy recovers.

Combined with the planned withdrawal of stimulus over the forward estimates, the fiscal strategy will deliver a progressive tightening of the fiscal policy stance over the forward estimates, equivalent to an average of around 1 per cent of GDP a year from 2010-11. The budget deficit is projected to fall from 4.7 per cent of GDP in 2009-10 to 1.1 per cent of GDP in 2012-13. Reflecting the withdrawal of fiscal stimulus, real spending is forecast to contract by 1.3 per cent in 2010-11.

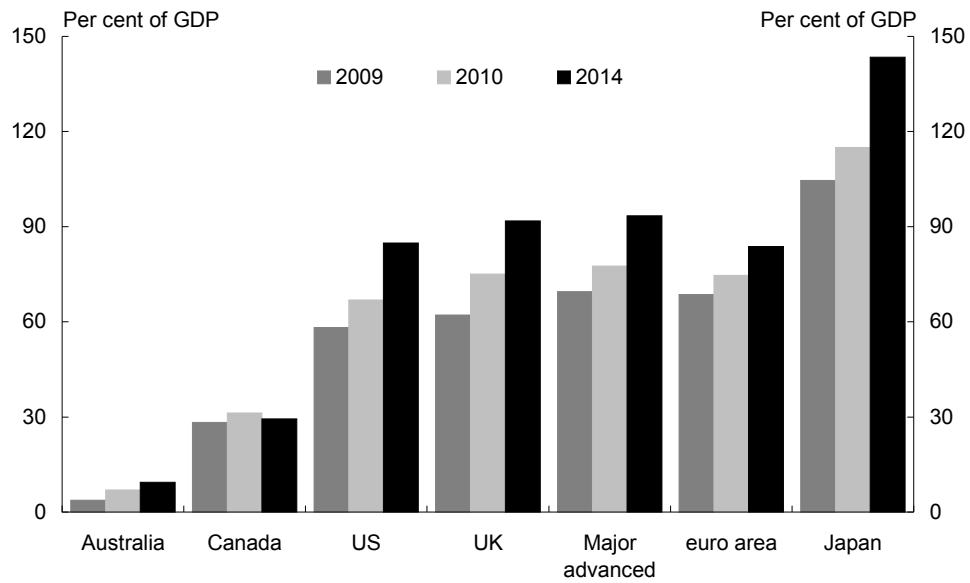
Medium-term fiscal outlook

Medium-term fiscal projections were presented in the 2009-10 Budget. At Budget, the economic slowdown was expected to lower the economy's output potential over the medium term as a result of lower rates of investment and higher unemployment. This impact on the economy's output potential is now expected to be smaller than at Budget, as a result of improvements to the near-term economic outlook.

Higher tax receipts are now expected across the medium term until the economy returns to its potential growth path. Under the Government's fiscal strategy, these higher tax receipts will be banked, resulting in an improved medium-term fiscal position.

The budget is expected to return to surplus in 2015-16, with net debt now expected to peak at 10 per cent of GDP (\$153.2 billion) in 2013-14. This is lower than the peak of 13.8 per cent (\$203.1 billion) projected at the time of the Budget. The Australian Government's net debt position remains low by international standards, and compares to a projected net debt of 93 per cent of GDP for the major advanced economies collectively (Chart 1.4).

Chart 1.4: Government net debt positions for selected countries



Source: IMF *World Economic Outlook* October 2009, Chapter 2 supplemental tables (net Government debt), Treasury calculations.