PART 2: ECONOMIC OUTLOOK

The Australian economy has performed better than expected since the Budget but continues to face challenges. The economy grew by 1 per cent in 2008-09 (in year average terms), a remarkably good outcome at a time of profound global financial instability and macroeconomic weakness. The Australian economy has proven to be one of the most resilient economies in the developed world, continuing to grow at a time when most advanced economies were falling into recession.

The MYEFO GDP forecasts are for stronger growth of 1½ per cent in 2009-10 and 2¾ per cent in 2010-11. These are significant upgrades from the Budget forecasts of -½ per cent and 2¼ per cent. Risks around these forecasts appear balanced. Stronger outcomes could eventuate if the global recovery gains traction and domestic conditions continue to gather momentum. However, at this stage downside risks remain, particularly in the major advanced economies, and while the domestic outlook is looking much better, there is only tentative evidence that a more solid, self-sustaining recovery in private sector demand is underway.

The improved outlook reflects the success of stimulus measures undertaken by the Government and the Reserve Bank of Australia, a stronger than expected world recovery — particularly in China, and the resilience of the Australian economy — particularly the strength of the financial sector.

The fiscal and monetary stimulus appears to have been more effective than expected at Budget, not only directly supporting spending, but also boosting business and consumer confidence to a larger than expected degree (Box 1). The boost to confidence will encourage spending in the economy above and beyond the direct effects of Government stimulus payments.

Global financial conditions have stabilised and the world economy appears to be starting to recover, albeit slowly and from a low base. Financial conditions have stabilised and asset prices have started to rise again. The Australian financial system, supported by government guarantees, has continued to function well although international pressures continue to affect the price and availability of credit.

While outcomes have been more positive than expected, the economy is still facing significant adjustments. Private final demand is forecast to contract in 2009-10. The unemployment rate has deteriorated by less than expected but there has been a significant decline in hours worked in the economy — the equivalent of a loss of more than 200,000 full-time jobs. This translates into weaker average earnings, with flow-on effects to the rest of the economy.

Falls in export prices have seen the largest terms of trade fall since the mid-1970s, impacting on profits, which have declined significantly. Weaker profits and ongoing financing constraints in some sectors will weigh on business investment in the short term.

Despite the improved outlook, growth is still expected to be subdued in the near term, with the economy growing at rates not sufficient to avoid further rises in unemployment.

The unemployment rate is now expected to peak at 6¾ per cent in mid 2010, well down on the Budget forecast of 8½ per cent. The unemployment rate rose 1.5 percentage points in the year leading up to the Budget, but has proven remarkably resilient since that time, remaining broadly unchanged since Budget. This in part reflects a greater preparedness of employers to reduce hours rather than shed staff. A risk to these forecasts is that future labour market weakness is reflected more in higher numbers of unemployed than has been the case in recent months.

The fiscal stimulus has played, and will continue to play, a key role in supporting the economy. Without the fiscal stimulus, it is estimated that the economy would not have grown in 2008-09 and would not grow in 2009-10 — a period of weakness that would have been comparable with the early 1990s recession. The planned staged withdrawal of the fiscal stimulus will begin to detract from economic growth in 2010 as an expected broad-based recovery in private demand takes hold in 2010-11.

Over time the economy is expected to return to close to its former growth path. Where potential output in many other countries has been severely damaged by the global financial crisis, the shallower downturn in Australia means that there will be much less erosion of skills and capital. This will moderate any adverse impact of the slowdown on the economy's level of potential output when we emerge from the downturn. In supporting activity and employment in Australia during the global recession, the stimulus — both fiscal and monetary — is expected to have long-lasting benefits.

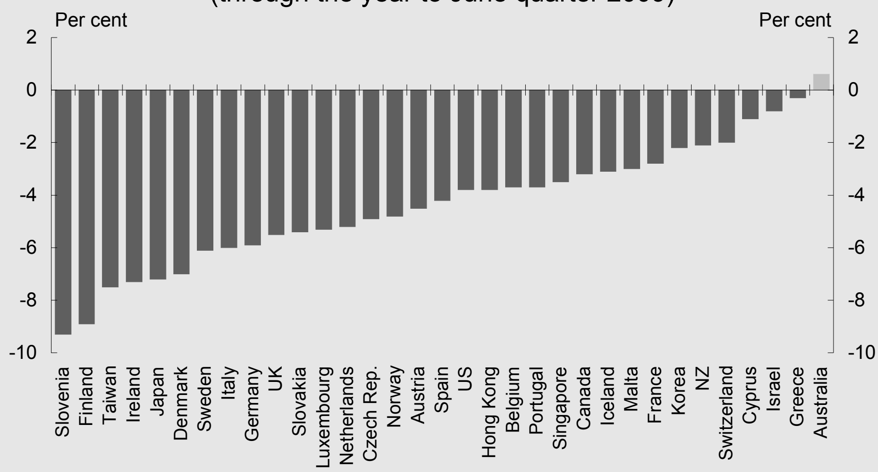
The medium-term economic projections have been updated to reflect the better-than-expected outcomes. Since the downturn is now expected to be shallower than originally forecast, it will take a lower rate of above-trend growth than previously projected to return the economy to capacity and it is expected to return to that point about two years sooner than expected at Budget.

Box 1: The impact of fiscal stimulus

The Government's fiscal stimulus, combined with historically low interest rates, has provided timely support to the Australian economy during the global recession. Australia's economy grew by 0.6 per cent through the year to June 2009 — the only advanced economy to have expanded over this period, and one of four advanced economies to have avoided consecutive quarterly contractions. Without the fiscal stimulus, it is estimated that the economy would have contracted in each of the last three quarters, and by 1.3 per cent over the year to June.

International comparison of GDP growth

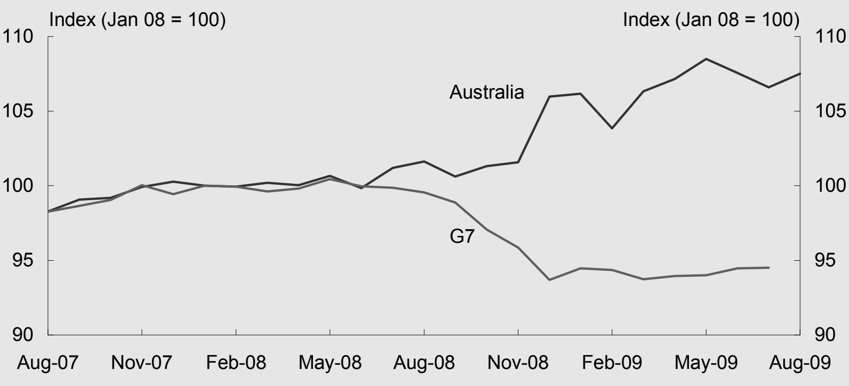
(through the year to June quarter 2009)



Source: ABS cat. no. 5206.0 and national statistical publications.

The stimulus was timed to provide support when the economy would be at its weakest. Direct payments to households, and lower interest rates, have helped retail sales remain buoyant in Australia. In August 2009, retail turnover was 5.8 per cent higher than the pre-stimulus levels of November 2008, having remained largely flat throughout 2008.

Retail trade in Australia and major advanced economies



Source: ABS cat. no. 8501.0, EcoWin and Treasury.

Box 1: The impact of fiscal stimulus (continued)

Combined with lower interest rates, the introduction of the First Home Owners Boost (FHOB) in October 2008 has seen loan approvals for first home buyers rise by 48.5 per cent. The take-up of the FHOB was more than 150,000 to the end of August 2009.

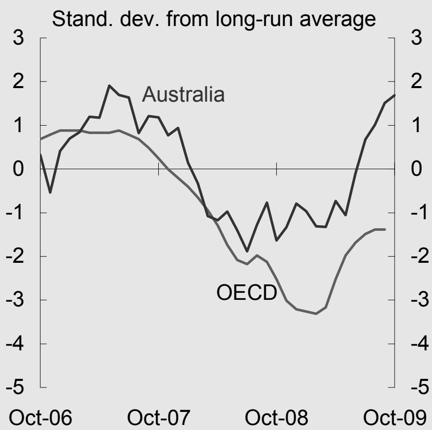
For owner occupiers, the number of finance commitments for new dwellings has increased by 60.9 per cent since October 2008, while total residential building approvals have risen 29.0 per cent since their recent lows in January 2009. As financing activity translates into building approvals and construction activity with a lag, this will sustain the economic impact of the FHOB into 2010.

The Government's stimulus packages have also helped underpin Australia's relatively strong economic performance by supporting business and consumer confidence.

Consumer confidence is now nearly 50 per cent higher than the pre-stimulus levels of October 2008. Business confidence is near six-year highs. Business conditions have rebounded strongly from their lows over recent months, in contrast to the sharp falls experienced in late 2008 and early 2009.

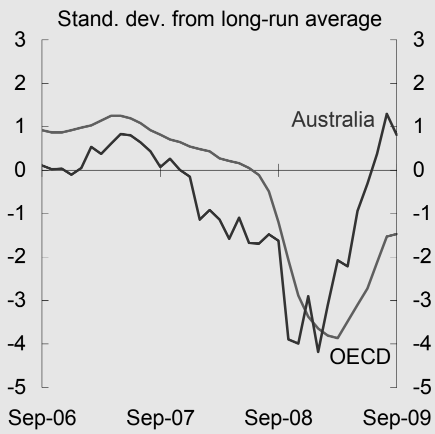
Consumer and business confidence

Consumer sentiment



Source: Westpac-Melbourne Institute, OECD and Treasury.

Business confidence



Source: National Australia Bank, OECD and Treasury.

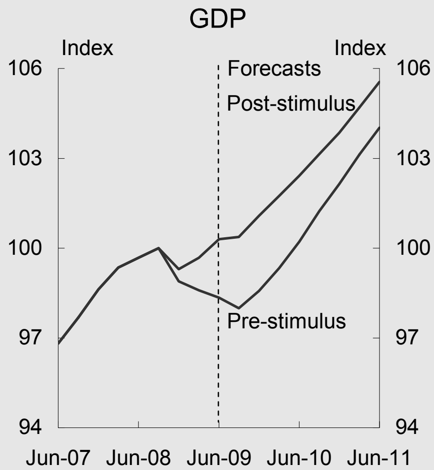
Box 1: The impact of fiscal stimulus (continued)

The stimulus measures have helped to soften the impact of the global recession on unemployment. The unemployment rate has remained low compared with other advanced economies and is now expected to peak at 6¾ per cent, around 1½ percentage points lower than in the absence of fiscal stimulus.

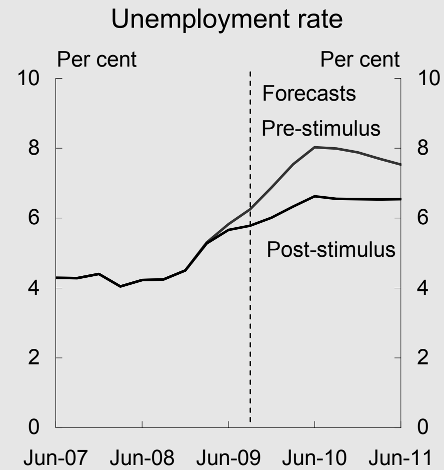
The effects of the first phase of the stimulus packages, involving direct payments to households, are now abating. The second and third phases of stimulus, involving significant investment in social infrastructure and nation building projects, are now underway. The scale of these projects is already evident in non-residential building approvals, and they will help to offset significant weakness in private building activity.

The stimulus measures are temporary and designed to be withdrawn as private demand begins to recover. With its impact on GDP growth having peaked in the June quarter 2009, gradual withdrawal of stimulus will begin to detract from economic growth over the forecast horizon.

Forecast impact of fiscal stimulus



Source: ABS cat. no. 5206.0 and Treasury.



Source: ABS cat. no. 6202.0 and Treasury.

INTERNATIONAL ECONOMIC OUTLOOK

The world economy has begun to emerge from a deep recession, backed by unprecedented macroeconomic stimulus and financial sector support. Equity markets have rebounded and credit spreads have narrowed, reflecting a perceived decline in system-wide risks and firming expectations of a global recovery. Confidence has improved, and production and trade are rising around the world. Nonetheless, risks remain for recovery, particularly for the major advanced economies.

Against this backdrop, growth forecasts have been upgraded across all major economies (Table 2.1). The economies of the United States, euro area and Japan are still expected to suffer deep contractions this year and face the prospect of a slow and uncertain recovery. However, supportive policy stances are expected to underpin the recovery into 2010. Trade-dependent economies of East Asia, which recorded the steepest falls in GDP at the onset of the global recession, are now bouncing back the most rapidly (Box 2). China remains crucial to regional growth prospects but, despite upward revisions to forecasts, it is still expected to grow at a slightly below-trend pace in 2009.

Table 2.1: International GDP growth forecasts[(a)]

	Actual	Forecasts		
	2008	2009	2010	2011
United States	0.4	-2 1/2	1 1/2	1 3/4
Euro area	0.6	-4 1/4	1/2	1 1/4
Japan	-0.7	-5 3/4	1 1/2	1
China(b)	9.0	8 1/4	9 1/4	9 1/2
Other East Asia(c)	2.6	-1 3/4	4	4 1/4
India	7.3	5 1/2	6	6 1/4
Major trading partners	2.6	-1	3 1/2	3 3/4
Advanced economies(d)	0.6	-3 1/4	1 1/2	1 3/4
World	3.0	-1	3 1/4	3 1/2

(a) World, euro area and advanced economies growth rates are calculated using GDP weights based on purchasing power parity (PPP), 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 is Korea, Taiwan, Hong Kong, Singapore, Indonesia, Malaysia, Thailand, Vietnam and the Philippines.
(d) Composed of the 33 industrialised economies classified as advanced by the IMF.
Source: National statistical publications, IMF and Treasury.

A number of the upside risks identified at Budget have been realised, underpinning the near-term rebound in the global economy. These include the improved stability in financial markets and rapid implementation of fiscal stimulus, especially in Asia. Much of the improvement in conditions during the first three quarters of 2009 can be attributed to the large amount of policy stimulus around the world.

Over the medium to longer term, a number of risks remain around achieving a sustained global recovery. Since much of the recent improvement has been stimulus-induced and may relate to temporary, cyclical factors such as the rebuilding of inventories, there are questions about how durable the current drivers of growth will prove to be. As yet there is limited evidence of a sustained recovery in private sector activity.

Significant risks to financial stability remain over both the short and medium term. Most immediately, increasing default rates among household and corporate borrowers and likely further write-downs in asset values will continue to impact on bank balance sheets and restrict credit growth, particularly in the US and Europe. This reinforcing effect between income and credit presents as a risk that could weaken the recovery. Looking further ahead, the withdrawal of government interventions in financial markets, while necessary, entails significant risks to financial stability over the medium term.

A recovery in private sector demand in the advanced economies is yet to take place. Financial deleveraging by firms and households will persist in the major advanced economies, which, together with rising unemployment, will act to dampen demand. As deleveraging in advanced economies will act to temper consumption and bolster savings, the strength and sustainability of the global recovery will rely to a significant extent on emerging economies successfully growing their domestic demand. This is a key long-term challenge facing the world economy and one in which the G-20 has an important ongoing role to play by helping coordinate policy actions across the world's major economies through its *Framework for Strong, Sustainable and Balanced Growth*.

In view of these ongoing challenges, growth in the major advanced economies, while expected to be stronger, is still forecast to be subdued. The **United States** economy is expected to grow by 1½ per cent in 2010, a 1¼ percentage point upward revision since Budget, reflecting the impacts of fiscal stimulus, a stabilisation in financial and housing market conditions, and a moderating rate of decline in investment. The strength of the recovery in private demand, and the success of the extraordinary policy measures and their eventual withdrawal will be key determinants of the outlook in 2010 and beyond.

The improved outlook for the **euro area** reflects accommodative monetary and fiscal policy, a rebound in confidence, the progressive ending of the destocking process, and stabilisation in the manufacturing sector from increased global demand. However, the recovery will be constrained by the factors outlined above.

Similarly, **Japan**'s economy is showing signs of a moderate recovery, albeit from a very low base. Industrial production and exports have improved, and there has been progress in inventory adjustment. Production has also been supported by government programs to encourage the purchase of environmentally friendly cars and household appliances. However, sharp falls in corporate profits and high levels of excess capacity mean that business investment is likely to remain depressed. Support for consumption from fiscal stimulus will be partially offset by historically high rates of unemployment.

Stronger growth is expected in the emerging economies. On the back of aggressive monetary and fiscal stimulus, **China**'s economy is expected to grow by 8¼ per cent in 2009, below its average annual growth rate of around 10 per cent over the past 10 years. China's growth is expected to accelerate to 9¼ per cent in 2010 and 9½ per cent in 2011. Record high loan growth and strong fiscal stimulus have supported a surge in fixed asset investment, particularly by state-owned enterprises. Infrastructure-related investment is expected to be the main driver of growth, with private investment expected to make a modest recovery as fiscal stimulus winds down in late 2010. Consumption growth is expected to be robust, despite the investment focus of China's fiscal stimulus. Exports are expected to gradually strengthen in line with the improved outlook for China's major trading partners.

Key watch points for China include whether the private sector will recover sufficiently to sustain solid growth once stimulus winds down, and the extent to which the surge in bank lending in the first half of 2009 leads to increases in non-performing loans or unsustainable rises in asset prices.

India's economy remains resilient, in part due to its services sector putting a floor under domestic demand. Falls in industrial production have ended as demand for India's manufactured exports has stabilised. With much of the country now in drought, the agricultural sector, which accounts for around one-fifth of GDP, is a key downside risk.

The economic outlook for the rest of **East Asia** has improved markedly. The recovery in the Newly Industrialised Economies will be influenced heavily by China's economic performance and the pace of recovery in advanced economies. In Southeast Asia, accommodative monetary policy and temporary fiscal measures are expected to support consumption in the near term, while a recovery in capital inflows and an easing of financial market constraints is expected to support investment. Potential obstacles to the recovery in the region include the risk of drought and exposure to rising oil prices.

Box 2: Economic performance of major Asian economies

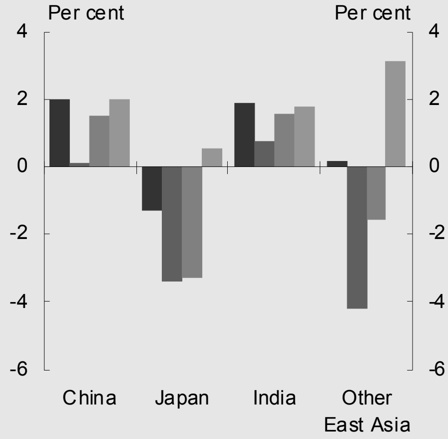
Major Asian economies account for two-thirds of Australia's trade. The shockwaves from the global financial crisis impacted severely on these economies, despite them being far from the epicentre of the global financial crisis and having financial institutions with only limited exposure to US subprime securities. As external demand collapsed, production and trade suffered heavy setbacks.

The region has, however, rebounded quickly. Aggressive monetary and fiscal stimulus targeted at boosting domestic demand played a key role. In addition, the region's trade dependence made it a key beneficiary of measures such as cash handouts, tax cuts, and 'cash for clunkers' programs implemented worldwide. Rebounding equity markets, resumed capital inflows, and a reduction in spreads for corporate debt are providing further support.

Sound corporate balance sheets, strong supply-side fundamentals, and public finances — which have generally been less damaged by the crisis than in the advanced world — will help provide further impetus to the recovery.

Nonetheless, the region remains vulnerable to external factors. The recession hit the export-dependent economies the hardest, and these economies are the ones experiencing the fastest rebound with the recovery in world trade (see chart).

Quarterly GDP growth
(Sept 2008 to June 2009)



Other East Asia: Korea, Singapore, Taiwan, Hong Kong, Indonesia, Thailand, Malaysia, Vietnam and the Philippines.
Source: CEIC, Chinese National Bureau of Statistics unofficial estimates and Treasury.

The region is particularly dependent on US consumers, who are responsible for around a quarter of its export value added in recent years. Deleveraging by US households could therefore have a sizeable impact on Asia, requiring significant adjustment in the region's sources of growth. For example, private consumption in China will need to halt, and perhaps reverse, its decade-long decline relative to GDP.

Macroeconomic stimulus can support growth in the near term, but sustained growth in the medium term will require policies to rebalance growth away from external to domestic demand. Such policies include better social safety nets to boost private consumption. In addition, structural reforms to raise productivity could improve domestic incomes and spending and offset the lost growth impetus from exports.

DETAILED DOMESTIC FORECASTS

The forecasts for the domestic economy are underpinned by several technical assumptions. The exchange rate is assumed to remain around levels seen at the time the forecasts were prepared (a trade-weighted index of around 69 and a US$ exchange rate of around 90c). Interest rates are assumed to rise in line with market expectations over the forecast period. World oil prices (Tapis) are assumed to remain at around US$69 per barrel. The farm sector forecasts are based on an assumed return to average seasonal conditions over the remainder of the forecasting period. The detailed forecasts are presented in Table 2.2.

Table 2.2: Domestic economy forecasts[(a)]

	2008-09	2009-10		2010-11	
	Outcomes(b)	Forecasts			
		Budget	MYEFO	Budget	MYEFO
Panel A - Demand and output(c)					
Household consumption	1.4	- 1/4	3/4	1 3/4	2 3/4
Private investment					
Dwellings	-1.9	0	1 1/2	11 1/2	12
Total business investment(d)	6.7	-18 1/2	-6 1/2	3 1/2	5 1/2
Non-dwelling construction(d)	7.5	-26	-9 1/2	3	5
Machinery and equipment(d)	5.2	-16 1/2	-6	4	7
Private final demand(d)	2.0	-4	- 3/4	2 3/4	4
Public final demand(d)	4.6	7 3/4	7 3/4	- 1/2	1/2
Total final demand	2.5	-1 1/4	1 1/4	2	3 1/4
Change in inventories(e)	-1.3	1/4	3/4	3/4	1/2
Gross national expenditure	1.3	-1 1/4	1 3/4	2 1/2	3 1/2
Exports of goods and services	1.8	-4	1 1/2	4 1/2	4 1/2
Imports of goods and services	-2.5	-6 1/2	2 1/2	6 1/2	8
Net exports(e)	1.0	3/4	- 1/4	- 1/2	- 3/4
Real gross domestic product	1.0	- 1/2	1 1/2	2 1/4	2 3/4
Non-farm product	0.7	- 1/2	1 1/2	2 1/4	2 3/4
Farm product	13.6	1	3	0	3
Nominal gross domestic product	6.1	-1 1/2	1 1/4	3 3/4	5 1/2
Panel B - Other selected economic measures					
External accounts					
Terms of trade	7.6	-13 1/4	-9 3/4	0	3 1/2
Current account balance (per cent of GDP)	-3.2	-5 1/4	-5 1/2	-5 3/4	-5 1/4
Labour market					
Employment (labour force survey basis)(f)	0.1	-1 1/2	1/4	1/2	1 1/2
Unemployment rate (per cent)(g)	5.7	8 1/4	6 3/4	8 1/2	6 1/2
Participation rate (per cent)(g)	65.4	64 3/4	65	64 1/4	65
Prices and wages					
Consumer Price Index (headline)(f)	1.5	1 3/4	2 1/4	1 1/2	2 1/4
Gross non-farm product deflator	5.4	-1	- 1/4	1 1/2	2 3/4
Wage Price Index(f)	3.8	3 1/4	3 1/4	3 1/4	3 1/2

(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.
Source: ABS cat. no. 5206.0, 5302.0, 6202.0, 6345.0, 6401.0, unpublished ABS data and Treasury.

Household consumption is expected to grow by ¾ of a per cent in 2009-10, surpassing Budget expectations of a ¼ per cent contraction. The improvement largely reflects a strong rebound in consumer confidence, which, bolstered by stimulus, is over 36 per cent higher than in May; and the recent rise in asset values. Offsetting these effects in the short term is an unwinding of the temporary impact of fiscal stimulus payments on household consumption.

A more benign outlook for the labour market and recovering asset prices are lending support to the stronger outlook for 2010-11. Household consumption is expected to grow by 2¾ per cent in 2010-11, revised up from 1¾ per cent at Budget.

Dwelling investment prospects have improved, with growth of 1½ per cent now expected in 2009-10 compared with zero growth forecast at Budget. Housing finance and building approvals data are indicating a likely resurgence in dwelling investment activity in late 2009 carrying into 2010, with the impetus provided by the First Home Owners Boost, improved confidence and low mortgage interest rates. However, tight credit conditions, particularly in relation to medium and high density developments, are restricting developer activity. Strong population growth and relatively high rental yields point to more robust investor-led outcomes in 2010-11, with forecast growth of 12 per cent. The prospect of higher interest rates and the withdrawal of the First Home Owners Boost could moderate the strength of this recovery somewhat.

New business investment is forecast to contract by 6½ per cent in 2009-10, followed by a modest rebound of 5½ per cent in 2010-11. These forecasts are stronger than at Budget but still reflect significant weakness in the near term. The forecast contraction in 2009-10, if realised, would be the weakest outcome in business investment since the early 1990s recession. While the outlook for the mining sector has improved, underlying private sector investment intentions for the current year remain weak in other sectors.

While the Small Business and General Business Tax Break has provided support to plant and equipment investment in recent times, investment in new machinery and equipment is forecast to decrease by 6 per cent in 2009-10, as firms defer discretionary spending in the face of lower capacity utilisation and weaker profits. Investment in new machinery and equipment is expected to recover lost ground in 2010-11, growing by 7 per cent, supported by a stronger outlook for corporate profits and global and domestic demand.

Total non-dwelling construction is forecast to fall by 9½ per cent in 2009-10 before growing by 5 per cent in 2010-11. The new forecasts reflect the recent approval of the Gorgon LNG project, and a higher probability than was the case at Budget of several other major engineering construction projects proceeding. The pace of construction could be faster than expected, resulting in upside risks. Any delay or deferral of individual projects also could impact on the profile of investment growth over the forecast horizon. The forecasts reflect an increasing role of engineering construction in the economy in the medium term.

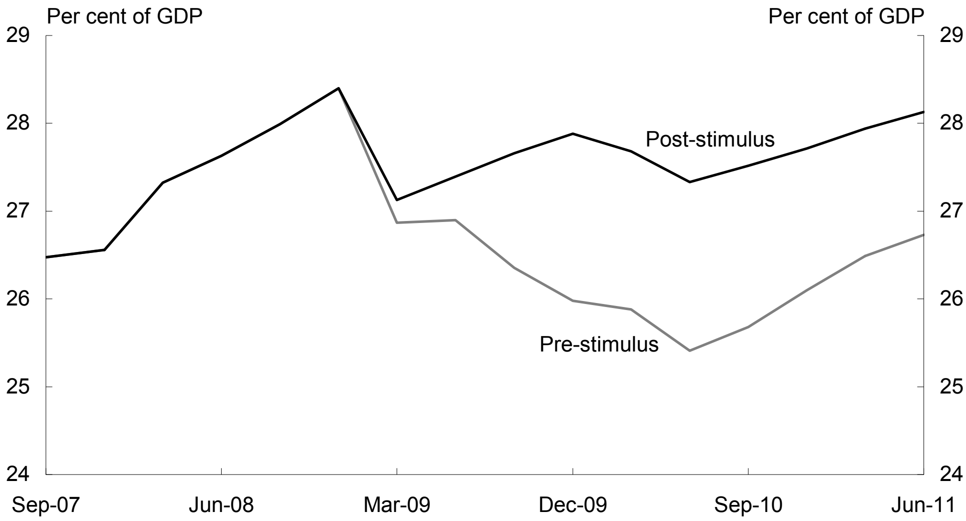
The relative strength in engineering construction investment is being offset by a depressed outlook for non-residential building investment, particularly in 2009-10. Non-residential building investment is still expected to fall sharply in 2009-10 and contract further in 2010-11. This pessimistic outlook stems from a combination of extremely weak private non-residential building approvals, ongoing credit constraints and rising vacancy rates exacerbated by new supply continuing to come on line.

Public final demand is expected to grow by 7¾ per cent in 2009-10, contributing 1¾ percentage points to growth, but will make virtually no contribution to growth in 2010-11. The strong growth in 2009-10 reflects the major components of the Nation Building and Jobs Plan reaching peak activity levels. The 2010-11 forecast reflects the staged withdrawal of stimulus.

The Nation Building and Jobs Plan and other stimulus packages contribute around $30 billion to Australian Government and state and local government investment over the forecast period. Total new public investment is expected to grow by 24¼ per cent in 2009-10, the largest increase on record.

Public investment will help to offset the anticipated weakness in private investment. Total investment as a share of GDP (business investment, dwelling investment and public investment) is expected to remain elevated over the forecast period underpinned by the substantial fiscal stimulus (Chart 2.1). A decline in the ratio of business investment to GDP of around 1.4 percentage points in 2009-10 is expected to be offset by a 1.1 percentage point increase in public investment. As the economy strengthens in 2010-11, public investment will fall as a per cent of GDP as the stimulus is withdrawn and stronger private investment supports the recovery.

Chart 2.1: Total investment



Source: ABS cat. no. 5206.0 and Treasury.

The outlook for **export volumes** has improved, although there are significant divergences at a sectoral level and export values are weak. Commodity exports are expected to grow in both 2009-10 and 2010-11, reflecting a stronger outlook for world commodity demand and an expected increase in Australian production capacity. In contrast, exports of elaborately transformed manufactures (ETMs) are expected to fall in 2009-10, before staging a gradual recovery in 2010-11.

The **terms of trade** are forecast to fall by 9¾ per cent in 2009-10, a smaller fall than forecast at Budget, supported by stronger world spot commodity prices and lower import prices. Contract prices for major bulk commodities such as iron ore and coal have fallen in line with Budget expectations. With lower prices, the **value of exports** is expected to contract by over $55 billion or 19½ per cent in 2009-10. The terms of trade are forecast to improve in 2010-11 as world demand for raw materials recovers. Despite this improvement, contract prices are expected to remain below the peaks of 2008-09 over the forecast horizon.

The **current account deficit** (CAD) is expected to widen to 5½ per cent of GDP in 2009-10. The turnaround in the trade balance to a deficit in 2009-10 is a result of the substantial fall in the terms of trade. In line with the recovery in Australian exports, the CAD is expected to narrow marginally to 5¼ per cent in 2010-11.

Mirroring the positive developments in the broader economy, the labour market has also displayed much more resilience than expected at Budget.

Employment growth is expected to be ¼ of a per cent through the year to the June quarter 2010, considerably stronger than the 1½ per cent contraction forecast in the Budget. In through-the-year terms, employment growth is now expected to reach a trough in late 2009. This would be a considerably smaller fall in employment than in the recessions of the 1980s and 1990s.

In the current downturn, many employers appear to have reduced staff working hours in preference to job shedding. Indeed, the recent fall in total hours has been significant, equivalent to a loss of more than 200,000 full-time jobs. The fall in average hours is expected to be reversed over the forecast period.

More favourable employment outcomes translate into a lower peak **unemployment rate**. The unemployment rate is expected to rise to 6¾ per cent by the June quarter 2010. This is a more subdued rise and a much lower peak than the 8½ per cent in the December quarter 2010 forecast at Budget.

After reaching all-time highs in 2008, the **participation rate** is beginning to moderate, although somewhat less sharply than envisaged at Budget. Better than expected employment conditions should lead to a less pronounced fall in the participation rate. In line with the better outlook for the labour market, fewer discouraged workers are likely to leave the labour force and demand for overseas workers may not fall as sharply. The participation rate is forecast to remain at around 65 per cent over the forecast period, somewhat higher than anticipated at Budget.

Relatively subdued demand for labour and rising unemployment are expected to continue to exert downward pressure on **wage growth**. Through-the-year growth in the wage price index (WPI) is expected to moderate further for the remainder of 2009 before levelling off in 2010. The WPI is expected to grow by 3¼ per cent and 3½ per cent through the year to the June quarters 2010 and 2011, reflecting a minor revision from the Budget forecasts of 3¼ per cent for both years.

Inflationary pressures are expected to remain subdued as the economy continues to operate below capacity and with wages growth expected to be moderate. However, **inflation** is forecast to be stronger than at Budget in line with the stronger economic outlook, only partially offset by the effect of a higher exchange rate on import prices. Headline and underlying inflation are both expected to be 2¼ per cent through the year to June in 2009-10 and 2010-11, slightly stronger than at Budget.

Nominal GDP is expected to grow by 1¼ per cent in 2009-10, higher than the contraction of 1½ per cent expected at Budget but still the weakest growth in nominal GDP since 1961-62. The upward revision largely reflects a stronger outlook for real GDP growth and stronger domestic prices, while the decline in the terms of trade is expected to be more modest than expected at Budget. Nominal GDP growth is expected to recover to 5½ per cent in 2010-11.

Nominal GDP broadly comprises compensation of employees, corporate gross operating surplus and gross mixed income. The revised outlook for growth in nominal GDP is reflected across all of these categories, although only compensation of employees is expected to record positive growth.

Compensation of employees is forecast to grow by 2¼ per cent in 2009-10, up from the 1½ per cent growth expected at Budget. This largely reflects a milder contraction in employment than expected at Budget. Growth in compensation of employees is expected to strengthen to 5 per cent in 2010-11 as both employment (hours worked) and wages growth accelerate.

Gross operating surplus, a broad measure of profits, is still expected to contract in 2009-10, albeit not to the same extent as forecast in the Budget. Corporate profits are expected to decline by around 3¼ per cent, compared with a fall of 11¼ per cent expected at Budget, reflecting a stronger than expected economy. In 2010-11, corporate profits are expected to grow by 6¼ per cent, reflecting a strengthening economy and rising non-rural commodity prices.

Gross mixed income is expected to fall by ½ of a per cent in 2009-10, less than the fall of 2¼ per cent expected at Budget. In 2010-11, gross mixed income is expected to grow by 4½ per cent. Farm profitability is expected to be a drag on gross mixed income over the period, reflecting falling rural commodity prices.

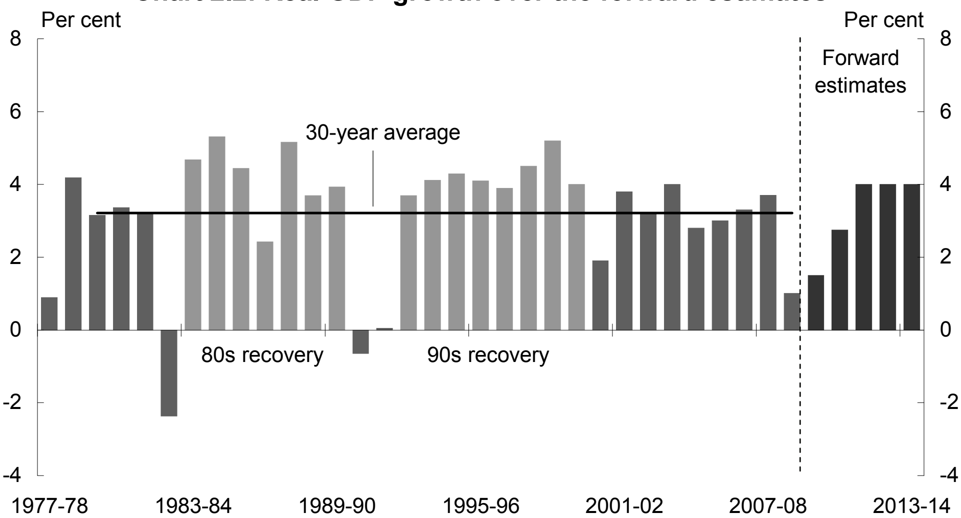
MEDIUM-TERM ECONOMIC PROJECTIONS

The fiscal aggregates in the MYEFO are underpinned by a set of forward estimates consisting of short-term economic forecasts and projections based on medium-term assumptions.

The medium-term projections included in the Budget were predicated on a more severe downturn than the MYEFO forecasts. The upward revisions to the short-term forecasts necessarily require a change in the assumptions underpinning the medium-term projections.

As illustrated in Chart 2.2, in the projection years, real GDP is now projected to grow at above-trend rates of 4 per cent, rather than 4½ per cent, as the shallower downturn means there is less spare capacity to absorb during the recovery. Despite the reduction in the above-trend rate of growth, the shallower downturn means that the level of GDP is higher than projected at Budget during this period. The economy is assumed to grow at 4 per cent until the output gap closes in 2014-15 (Table 2.3), about two years sooner than projected at Budget.

Chart 2.2: Real GDP growth over the forward estimates



Source: ABS cat. no. 5206.0 and Treasury.

As a result of the improved growth outlook, the labour market is not expected to deteriorate to the same extent as forecast at Budget. The unemployment rate is now expected to peak at 6¾ per cent in June 2010. The unemployment rate is projected to decline steadily over the period from 2011-12 to 2014-15, reaching the non-accelerating inflation rate of unemployment (NAIRU) of 5 per cent in 2014-15, two years earlier than anticipated at Budget. The participation rate is assumed to return to its long-run trend rate in 2014-15. From that point on, the participation rate is driven by demographic factors.

Despite the more positive forecasts for growth, the economy is still expected to be operating at below capacity for some time. In a downturn, there can be a permanent loss of output through the deterioration in the economy's capital stock (either through capital deteriorating more rapidly while it is unused or through a failure to invest in new capital) and a loss of skills among the unemployed.

The level of potential output is now estimated to be around 1¾ per cent lower than it would otherwise have been. This is an improvement of around ½ of a percentage point on the projected loss at Budget, reflecting the much shallower downturn, and implies a higher level of labour productivity. Stronger population growth and higher participation among older workers are also expected to lift potential output. These factors combined suggest that the level of real GDP when the economy returns to full capacity will be around 1 per cent higher than projected at Budget. Because the downturn is now likely to be shallower, economic activity, employment and incomes will be higher than previously estimated.

The level of nominal GDP is also expected to be higher than at Budget, reflecting stronger real GDP, higher domestic prices and the stronger outlook for the terms of trade. The terms of trade are projected to decline over time to the same level as projected at Budget. However, given the higher starting point, this adjustment is now assumed to take 15 years rather than 10 years as assumed at Budget.

Table 2.3: Medium-term parameters to 2019-20

	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
Real GDP growth	1.0	1 1/2	2 3/4	4	4	4	4
Nominal GDP growth	6.1	1 1/4	5 1/2	6 1/4	6 1/4	6 1/4	6 1/4
Unemployment rate	4.9	6 1/4	6 1/2	6	5 3/4	5 1/2	5
Headline inflation	3.1	1 3/4	2 1/4	2 1/4	2 1/4	2 1/2	2 1/2

Table 2.3: Medium-term parameters to 2019-20 (continued)

	2015-16	2016-17	2017-18	2018-19	2019-20
Real GDP growth	3	3	3	2 3/4	2 3/4
Nominal GDP growth	5 1/4	5 1/4	5 1/4	5	5
Unemployment rate	5	5	5	5	5
Headline inflation	2 1/2	2 1/2	2 1/2	2 1/2	2 1/2

Note: All parameters are expressed in year average terms.
Source: Treasury, ABS cat. no. 5206.0 and 6202.0.