STATEMENT 3: ECONOMIC OUTLOOK

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

STATEMENT 3: ECONOMIC OUTLOOK

The Australian economy is expected to grow strongly in 2007-08, after being affected by severe drought in 2006-07. The global economy continues to be strong. The high level of business investment is expanding the capacity of the economy, and is expected to translate into accelerating export growth. Strong income growth is anticipated to support solid household consumption growth and a modest pick-up in dwelling investment. Employment growth is expected to ease in 2007-08, following a period of strength, and inflation is forecast to moderate.

OVERVIEW

The **Australian economy** strengthened towards the end of 2006, despite the severe impact of the drought. This strength is expected to be sustained over the forecast period. Real GDP is expected to grow by 3¾ per cent in 2007-08, up from 2½ per cent in 2006-07. The forecast for 2007-08 reflects an assumed return to average seasonal conditions and a partial recovery from the drought, which is expected to add ½ of a percentage point to GDP growth. Strong growth in 2007-08 also reflects solid growth in consumption and business investment, a modest increase in dwelling investment and accelerating export growth.

The Australian economy is adjusting well to the increasing global demand for mineral and energy resources, with a substantial reallocation of labour and capital currently underway. While mining production and export volumes have not yet grown significantly, reflecting the long lead times from mining investment to production, solid growth is expected from 2007-08. Over the past five years, the mining sector has invested around $55 billion to expand production.

Prospects for the household sector have improved. While consumption grew modestly in 2005-06 and dwelling investment experienced a mild decline, growth is expected to strengthen in 2006-07 and 2007-08. This strengthening reflects the continued stimulus to household income and wealth from high commodity prices. Recent growth in household income reflects strong employment growth, which has accompanied a fall in the unemployment rate to 30-year lows and a rise in the participation rate to near-record highs. Employment growth is expected to moderate in 2007-08, and the unemployment rate is forecast to remain low.

Overall wage pressures are anticipated to remain contained, while inflation is expected to moderate. The forecast moderation in inflation reflects a stabilising of automotive fuel prices, the recent unwinding of large rises in fruit prices experienced during 2006 and an easing in underlying inflationary pressures.

The **world economy** is expected to continue to expand at a strong rate, with world GDP forecast to increase by 5 per cent in 2007 and 2008. The positive outlook reflects expectations for strong growth in China, India, Japan and the euro area. Growth in the United States is expected to ease in 2007, before strengthening in 2008.

In the domestic economy, **household consumption** is expected to grow by 3½ per cent in 2006-07 and 2007-08. Strong increases in household income and solid growth in wealth are expected to support consumption and allow households to further consolidate their balance sheets. Recent strong increases in household income reflect strong employment growth and solid wage growth.

Dwelling investment is expected to recover modestly after its recent mild fall, and grow by 2½ per cent in 2006-07 and 2007-08. Investment by owner-occupiers is expected to lead the recovery, with recent interest rate increases and low rental yields weighing more heavily on investors. An increase in rental yields is expected to encourage more investor activity during 2008.

The level of **business investment** is expected to remain high, although growth is likely to moderate from its recent strong rates. New business investment is forecast to increase by 7½ per cent in 2007-08, underpinned by continuing strength in the mining and construction sectors. The investment environment remains favourable, although there is some evidence of capacity constraints in the construction sector with cost pressures and delays in obtaining labour and materials.

Public final demand is expected to grow by 3¾ per cent in 2007-08, with strong growth in public investment and some moderation in public consumption growth.

Net exports are expected to subtract ½ of a percentage point from GDP growth in 2007-08. Significant growth in non-rural commodity exports is forecast in 2007-08, while growth in other exports is expected to be modest. Rural exports are forecast to make some recovery following the drought, while elaborately transformed manufactures and services exports are expected to be constrained by the relatively high exchange rate and continuing robust international competition. Import growth is expected to remain solid over the forecast period, consistent with the higher exchange rate and the outlook for domestic demand. Recent strong import growth is the counterpart of strong growth in investment and incomes in the economy.

The terms of trade reached their highest level in over 50 years in the December quarter 2006. They are expected to fall by 1½ per cent in 2007-08, reflecting anticipated falls in rural and non-rural commodity prices as global supply increases in these markets.

The **current account deficit** (CAD) is forecast to widen to 6 per cent of GDP in 2007-08, with growth in import volumes forecast to outpace growth in export volumes, and export prices expected to fall. The anticipated widening in the trade deficit is expected to be partially offset by a narrowing in the net income deficit reflecting slower growth in corporate profits. From a saving and investment perspective, the expected widening in the CAD reflects expected higher investment and relatively unchanged national saving as a share of GDP.

Employment growth is expected to ease to 1½ per cent in 2007-08, consistent with around-trend non-farm GDP growth and a modest rise in real labour costs. The participation rate is expected to rise to 65 per cent, while the unemployment rate is expected to increase modestly to 5 per cent in 2007-08. The forecast rise in the participation and unemployment rates partly reflects the new participation requirements for Disability Support Pension and Parenting Payment recipients, which are expected to result in more people entering the labour force.

Wage growth is expected to remain solid at 4¼ per cent in 2007-08. While there have been localised wage pressures in those sectors most affected by mining and construction activity, overall wage pressures remain contained.

Inflation is forecast to ease from 2¾ per cent in 2006-07 to 2½ per cent in 2007-08. Inflation is expected to temporarily fall below 2 per cent through the year to the June quarter 2007 as automotive fuel prices stabilise and fruit prices remain below the highs experienced in 2006. Underlying inflationary pressures are expected to moderate as nominal unit labour costs ease, reflecting improved productivity.

The risks confronting the Australian economy have become more evenly balanced in recent months. The risks are around the ongoing effects of the drought, the adjustment to the commodity price stimulus and the pace of household balance sheet consolidation.

The drought is expected to have a significant adverse impact on the economy in 2006-07, with 2006 being the driest year on record across parts of southern Australia. The forecast strength in the economy in 2007-08 partly relies on the normal budget assumption of average seasonal conditions. The timing and distribution of rainfall has an important impact on the prospects for rural production and exports, and the economy more broadly.

There is a downside risk to the outlook if rainfall for the farm sector remains inadequate. While the Bureau of Meteorology has announced the end of the 2006-07 El Niño conditions and stated that there appears to be little chance of a return to these conditions in 2007, the ending of El Niño does not necessarily imply drought-breaking rains. Further, the current low water storage levels will make it difficult for some parts of the farm sector to fully recover from drought. For example, there is a risk that farmers in the Murray-Darling Basin will have no water allocations in 2007-08, which would lead to a large fall in production in this region.

A long period of economic growth has absorbed much of the economy's spare capacity. In particular, the economy is as close to full employment as it has been for over 30 years. There is evidence of capacity constraints in the construction sector, with some cost pressures and delays in obtaining labour and materials to complete projects. There is a risk that these factors will constrain output growth and place greater-than-anticipated upward pressure on prices and wages. Alternatively, productivity may be stronger than anticipated once the adjustment of the economy to the reallocation of labour and capital is completed, leading to stronger growth without additional price pressures.

While the risks around consumption and dwelling investment have become more balanced, there remains uncertainty about the pace of household balance sheet consolidation. While household balance sheets are sound in aggregate, concerns remain about the vulnerability of a small proportion of highly-geared households to unexpected changes in interest rates and incomes.

The outlook for the world economy remains positive, although a number of risks remain. These risks include a sharper-than-expected slowing in the United States, increased inflationary pressures, a substantial increase in oil prices, a greater-than-expected pick-up in financial market volatility, and a disorderly unwinding of global imbalances. While the current housing-led slowing in United States growth is expected to be mild, should the weakness become more broadly based this could have adverse implications for economies elsewhere.

Table 1: Domestic economy forecasts[(a)]

	Outcomes(b) 2005-06 year average	Estimates 2006-07 year average	Forecasts 2007-08 year average	Forecasts Four quarters to June 2008
Panel A - Demand and output(c)				
Household consumption	2.6	3 1/2	3 1/2	3 1/2
Private investment				
Dwellings	-3.9	2 1/2	2 1/2	4
Total business investment(d)	16.2	4	7 1/2	5
Non-dwelling construction(d)	21.6	12	7	- 1/2
Machinery and equipment(d)	14.5	-1 1/2	6 1/2	9
Private final demand(d)	4.4	3 1/2	4 1/4	4
Public final demand(d)	4.3	4	3 3/4	4 1/2
Total final demand	4.4	3 1/2	4	4
Change in inventories(e)				
Private non-farm	-0.5	1/4	0	- 1/4
Farm and public authorities(f)	0.2	- 1/4	1/4	1/4
Gross national expenditure	4.1	3 1/2	4 1/4	4 1/4
Exports of goods and services	2.2	3	5	8 1/2
Imports of goods and services	7.2	8 1/2	6 1/2	8
Net exports(e)	-1.1	-1 1/4	- 1/2	- 1/4
Gross domestic product	2.9	2 1/2	3 3/4	4 1/4
Non-farm product	2.9	3	3 1/2	3 1/2
Farm product	4.6	-20	18	40
Panel B - Other selected economic measures				
External accounts				
Terms of trade	10.9	6	-1 1/2	-2 3/4
Current account balance				
$billion	-53.4	-58 1/4	-65 3/4	
Percentage of GDP	-5.5	-5 3/4	-6	
Labour market				
Employment (labour force survey basis)	2.2	2 1/2	1 1/2	1 1/2
Unemployment rate (per cent)(g)	5.1	4 3/4	5	5 1/4
Participation rate (per cent)(g)	64.5	64 3/4	65	65
Prices and wages				
Consumer Price Index	3.2	2 3/4	2 1/2	2 3/4
Gross non-farm product deflator	4.9	4 3/4	2 1/2	2 1/2
Wage Price Index	4.1	4 1/4	4 1/4	4

(a) Percentage change on preceding year unless otherwise indicated.
(b) Calculated using original data.
(c) Chain volume measures.
(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) For presentational purposes, inventories held by privatised marketing authorities are included with the inventories of the farm sector and public marketing authorities.
(g) The estimate in the final column is the forecast rate in the June quarter 2008.
Source: Australian Bureau of Statistics (ABS) cat. no. 5206.0, 5302.0, 6202.0, 6345.0, 6401.0, unpublished ABS data and Treasury.

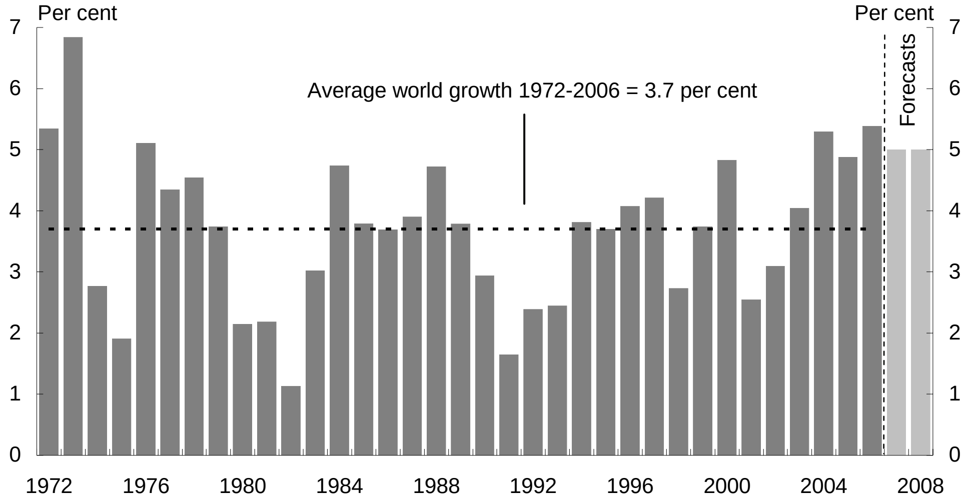
THE OUTLOOK FOR THE INTERNATIONAL ECONOMY

The world economy grew by 5.4 per cent in 2006, the fastest growth rate recorded in over 30 years, and slightly faster than the 5¼ per cent expected in the *Mid-Year Economic and Fiscal Outlook 2006-07*. While the United States economy slowed over the second half of 2006, Japan, India, China, and the euro area grew more strongly than expected.

The strong performance of the world economy occurred despite increases in official interest rates and high oil prices throughout much of the year. World growth continued to be underpinned by favourable financial market conditions and strong corporate balance sheets.

The world economy is expected to continue to expand strongly, and grow by 5 per cent in both 2007 and 2008 (Chart 1). Following growth of 4.8 per cent in 2006, Australia's major trading partners are expected to grow by 4½ per cent in 2007 and 2008 (Table 2).

Chart 1: World GDP growth[(a)]



(a) World GDP growth rates are calculated using GDP weights based on purchasing power parity.
Source: International Monetary Fund (IMF) and Treasury.

The **United States** is forecast to grow by 2¼ per cent in 2007, due to the lagged effects of tighter monetary policy and the downturn in the housing market. In 2008, a gradual recovery in the housing sector is expected to support a return to growth of around 3 per cent.

The housing downturn is likely to weigh on consumption growth over 2007. However, it remains unlikely that the housing market will cause a significant slowdown in other parts of the economy, with the momentum in employment and wage growth helping to offset the impact of the slowing housing market on consumption. Business investment is expected to remain firm over 2007, reflecting strong corporate profitability and high capacity utilisation rates.

While core inflation remains slightly elevated, it is expected to continue to moderate as a result of the slowdown in economic growth. Reflecting this, financial markets have priced in the possibility of a cut in official rates in the second half of 2007.

Table 2: International GDP growth forecasts[(a)]

	Actual	Estimate	Forecasts	
	2005	2006	2007	2008
United States	3.2	3.3	2 1/4	3
Euro area(b)	1.5	2.8	2 1/2	2 1/4
Japan	1.9	2.2	2	2
China(c)	10.4	10.7	10 1/2	10 1/4
India(c)	8.7	9.1	8 1/4	7 3/4
Other East Asia(d)	5.0	5.6	5	5
Major trading partners	4.4	4.8	4 1/2	4 1/2
Total OECD	2.6	3.2	2 1/2	2 3/4
World	4.9	5.4	5	5

(a) World, OECD 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), which constitutes Hong Kong, Korea, Singapore and Taiwan, and the Association of Southeast Asian Nations group of four (ASEAN-4), which constitutes Indonesia, Malaysia, the Philippines and Thailand.
Source: National statistical publications, IMF and Treasury.

Japan's economic expansion continued in 2006, with GDP growing by 2.2 per cent. Growth is expected to moderate slightly to 2 per cent in 2007, with a gradual pick-up in private consumption growth partially offsetting a moderation in the pace of business investment and export growth. Consumer spending is expected to be supported by tighter labour market conditions and improved wage growth.

While core inflation was positive in through-the-year terms in the second half of 2006, uncertainty remains over whether Japan has fully emerged from its prolonged period of deflation. In February 2007, the Bank of Japan raised the target policy rate by 25 basis points to 0.5 per cent, but is expected to adopt a cautious approach to further tightening, with monetary conditions likely to remain accommodative for some time.

In 2006, **China** recorded its fourth straight year of double-digit growth, with GDP expanding by 10.7 per cent. Growth is expected to remain strong at 10½ per cent in 2007. Investment should remain the primary driver of growth, which is also likely to be supported by strengthening private consumption and a solid, although lessening, contribution from net exports.

Despite the introduction of monetary and administrative measures to moderate investment growth, investment is expected to remain relatively high. Investment growth will be underpinned by strong fundamentals, including: high rates of national saving; urbanisation, which is generating strong demand for new infrastructure; the continued availability of a large pool of low cost labour for firms to draw upon; and strong profit growth.

Growth in the **rest of East Asia** accelerated in 2006, with GDP expanding by 5.6 per cent, supported by strong growth in exports and consumption. Growth is forecast to ease to 5 per cent in 2007, in part reflecting moderating external demand, and economic prospects across the region are expected to diverge. In particular, growth in the NIEs is expected to moderate, reflecting softer private consumption, while the ASEAN-4 economies are likely to continue growing strongly due to strengthening domestic demand.

The **Indian** economy continued to grow strongly, with GDP expanding by 9.1 per cent in 2006, supported by strong domestic demand (Box 1). Concerns around rising inflation and strong credit growth, however, have led Indian authorities to tighten monetary conditions through a combination of higher interest rates and increased cash reserve ratios for financial institutions. As a result, India's growth rate is expected to moderate slightly to 8¼ per cent in 2007.

The **euro area** grew by 2.8 per cent in 2006, its highest rate of expansion since 2000. The strong result was underpinned by increased investment spending and robust export growth. An improving labour market supported consumer spending.

Growth is expected to remain strong but moderate to 2½ per cent in 2007, largely due to the effects of monetary and fiscal tightening and a lower contribution from net exports. Inflation remains relatively benign, although the European Central Bank has noted that the risks remain on the upside in the medium term.

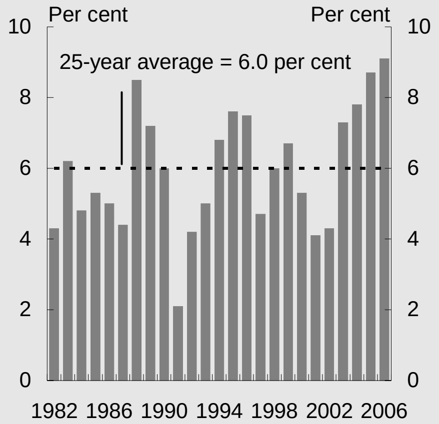
Despite the positive global economic outlook, a number of **risks** remain. The main risks are: a sharper-than-expected slowing in the United States; heightened inflationary pressures; a substantial increase in oil prices; a re-appraisal of financial market risk by investors; and a disorderly unwinding of global current account imbalances.

A worse-than-expected slowdown in the United States housing sector remains a key risk to the United States economy and the near-term world outlook. To date, the slowing housing market has had limited impact on the wider economy. Moreover, the recent difficulties in the sub-prime mortgage market do not appear to have flowed through to the prime mortgage segment or triggered broader credit problems. Nevertheless, if the housing downturn becomes more severe than currently envisaged, this could flow more broadly through the economy.

Box 1: India's economic emergence

India has emerged as one of the world's fastest growing economies. Over the past quarter-century, India's economy has grown at an average annual rate of 6 per cent and, more recently, reached rates of around 9 per cent (Chart A).

Chart A: India's growth performance



Source: IMF, April 2007.

India has grown from being the world's ninth largest economy in 1980 (in purchasing power parity, or PPP, terms) to being the fourth largest today. Over recent years, India has contributed more to world economic growth than the euro area and Japan combined. Based on current trends, India could double its share of world GDP to around 12 per cent by 2030.

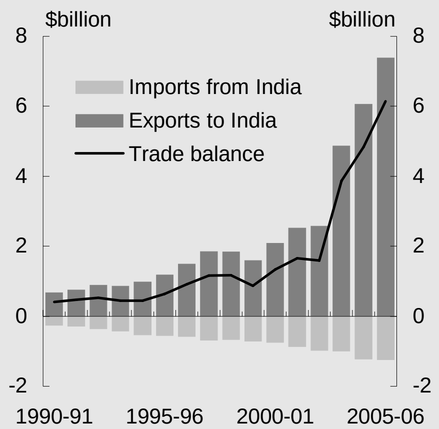
India nonetheless remains a relatively poor country, and around two-thirds of its labour force continues to be employed in the agricultural sector. In 2006, GDP per capita (in PPP terms) was an estimated US$3,737; about one-tenth of the United States' level and less than half that of China.

India's growth has been largely driven by domestic demand, with the services sector playing a leading role. In contrast to many other countries in Asia, India's external sector remains relatively small, with the sum of exports and imports accounting for only 33 per cent of GDP in 2006 (compared with 67 per cent for China).

India has the potential to grow rapidly well into the future as it adopts newer technologies and its labour force shifts to more productive sectors. Favourable demographics will also continue to underpin growth. However, in order to achieve its potential, India will need to undertake further structural reforms.

India has been Australia's fastest growing export market over the past five years, and is now our seventh largest export destination. In 2005-06, bilateral trade in goods reached $8.6 billion, of which $7.4 billion were exports to India (Chart B). Trade in services amounted to $1.7 billion and was dominated by Australian education exports to India.

Chart B: Bilateral merchandise trade



Source: ABS cat. no. 5368.0.

As the world's economic expansion has strengthened and broadened, spare capacity has diminished in a number of developed economies prompting monetary authorities to tighten policy. This policy response, and the associated expected moderation in world growth, should help contain inflationary pressures. However, labour markets have continued to tighten in a number of economies, including the United States. Although nominal unit labour costs remain relatively well contained, wage growth could feed into inflationary pressures at some point over the forecast period. If this eventuates, it may prompt higher-than-expected interest rates and result in lower-than-expected global growth.

Following substantial falls in the second half of 2006 and early 2007, West Texas Intermediate oil prices have stabilised in recent months. Nevertheless, spare production and refining capacity remain low, and in such an environment there is a significant risk that adverse geo-political developments could lead to a substantial rise in oil prices. Any such increase would add to global inflationary pressures and lead to weaker growth.

The recent rebound in financial market volatility suggests that some repricing of financial risk is currently underway. Some of the factors that have underpinned favourable financial market conditions in recent years — such as an abundance of global liquidity and improvements in corporate balance sheets — cannot be expected to continue indefinitely. A greater-than-expected pick-up in financial market volatility, and associated increase in risk aversion, could have negative consequences for the global economic outlook.

One of the more striking features of financial markets over the past year has been the strong increase in leveraged buyouts. While corporate default rates remain low and overall corporate balance sheets remain healthy, higher debt levels could cause a more painful adjustment if interest rates were to increase unexpectedly, or if global economic growth were to slow markedly.

The risk of a disorderly unwinding of global current account imbalances appears to have abated somewhat, with growth across the world economy becoming more balanced. While an orderly unwinding remains most likely, the potential for a sudden, disorderly adjustment will remain while large imbalances persist.

THE OUTLOOK FOR THE DOMESTIC ECONOMY

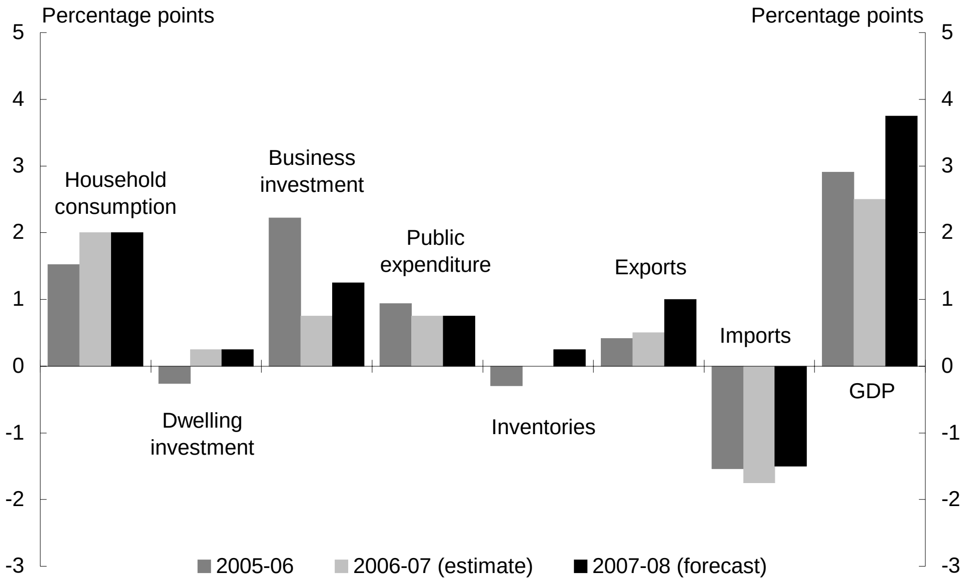
Key assumptions

The domestic economy forecasts are underpinned by several technical assumptions. The exchange rate is assumed to remain around its recent level — a trade weighted index of around 67 and a United States dollar exchange rate of around 82 US cents. Domestic interest rates are assumed to remain unchanged at current levels. World oil prices (West Texas Intermediate) are assumed to move in line with market expectations, and remain above US$65 per barrel throughout most of the forecast period. The farm sector forecasts are based on an assumption of average seasonal conditions in 2007-08, but take into account the current very low water storage levels.

Demand, output and income

Real GDP is forecast to grow by 3¾ per cent in 2007-08, with the partial recovery from drought expected to add ½ of a percentage point to growth (Chart 2). Farm GDP is forecast to rebound by 18 per cent in 2007-08, following a fall of 20 per cent in 2006-07, on the assumption of a return to average seasonal conditions.[1] The non-farm economy is expected to grow by 3 per cent in 2006-07 and 3½ per cent in 2007-08.

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.

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1 The *Mid-Year Economic and Fiscal Outlook 2006-07* contains a detailed discussion of the impact of the drought on the economy.

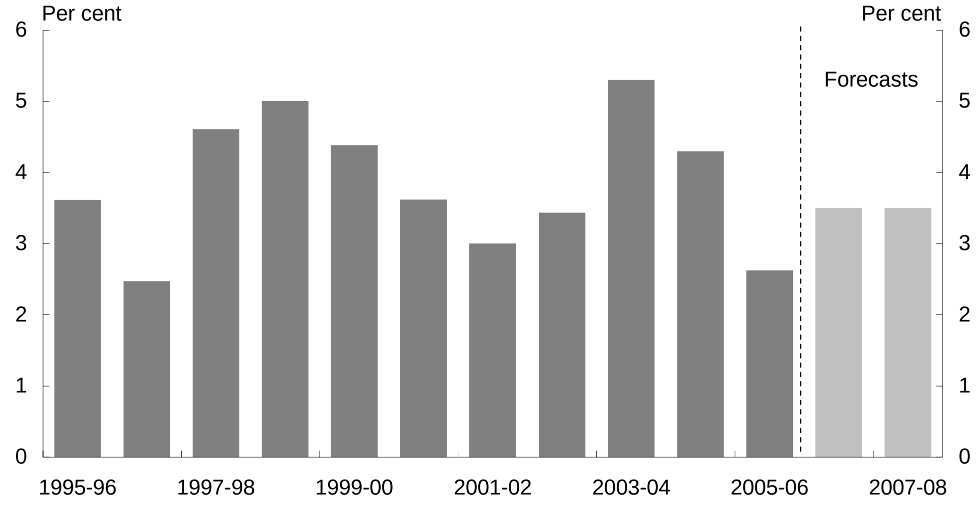
The Australian economy continues to benefit from strong world demand, with labour and capital continuing to shift towards the mining and construction sectors in response to the increase in commodity prices. Business investment growth is anticipated to moderate, but the level of investment is expected to remain high, supported by a record amount of planned engineering construction. Strong investment growth over recent years is expected to translate into accelerating export growth. The shift in resources within the economy is expected to continue to result in State and industry divergences (Box 2).

Growth in gross national income — which adjusts GDP for movements in the terms of trade and net primary income earned overseas — was 3.3 percentage points higher than GDP growth over the two years to the December quarter 2006. Ongoing growth in national income, household wealth and employment is expected to support solid household consumption growth and a modest pick-up in dwelling investment.

Household consumption

Household consumption is expected to grow by 3½ per cent in 2006-07 and 2007-08, following growth of 2.6 per cent in 2005-06 (Chart 3). Strong employment growth, solid wage growth and tax cuts allowed consumers to maintain modest consumption growth in 2005-06 despite higher petrol prices, increased debt servicing costs and an adjustment to little or no house price growth in some markets.

Chart 3: Growth in household consumption



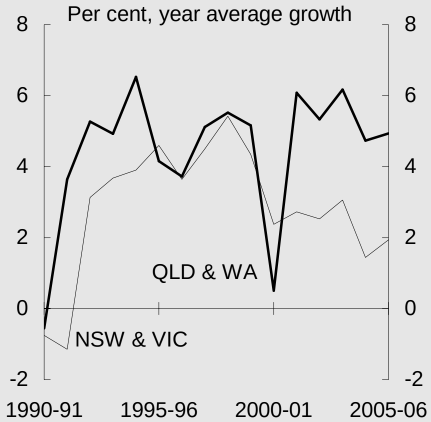
Source: ABS cat. no. 5206.0 and Treasury.

Box 2: Divergences among States and industries

The drought, housing market and the increase in commodity prices have all had State and industry dimensions. The significant increase in commodity prices has seen a shift in labour and capital towards mining-related industries. This has resulted in some States growing more quickly than others in recent years.

The resource-rich States of Queensland and Western Australia grew at a weighted-average rate of 4.9 per cent in 2005-06, compared with 1.9 per cent for New South Wales and Victoria (Chart A).

Chart A: Gross State Product

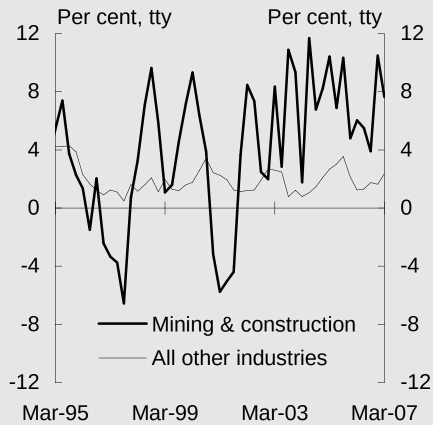


Source: ABS cat. no. 5220.0.

While business investment has been a major factor behind divergent State growth, household consumption growth has also diverged. For example, consumption growth in New South Wales was modest at 1.7 per cent in 2005-06, compared with 4.1 per cent in Western Australia.

The commodity price stimulus has been evident in the labour market (Chart B). Construction and mining employment grew by 7.6 per cent through the year to the March quarter 2007 (an increase of 77,900 jobs). Employment in mining and services to mining represents just 1.3 per cent of total employment. Outside construction and mining, employment also grew strongly by 2.4 per cent through the year to the March quarter 2007, resulting in an increase of 213,400 jobs.

Chart B: Industry employment



Note: Mid-month quarterly data.
Source: ABS cat. no. 6291.0.55.003.

Outside mining, businesses have benefited from strong demand underpinned by high employment. Households have benefited from higher incomes, driven by both employment and wages, and higher wealth through the housing and share markets.

In aggregate, the saving performance of households improved in 2005-06. This reflected a decision by households to continue to rebuild their balance sheets following a period in 2002-03 and 2003-04 when rapid consumption growth outpaced income growth. Abstracting from the impact of the sharp fall in farm incomes related to the drought, the saving performance of households continued to improve in the latter half of 2006.

Favourable conditions for household consumption are expected to continue over the forecast period. Household disposable income is expected to continue to grow solidly, supported by employment and wage growth. Consumer price inflation is expected to moderate from its recent highs, as automotive fuel prices stabilise, large rises in fruit prices unwind and underlying inflationary pressures ease.

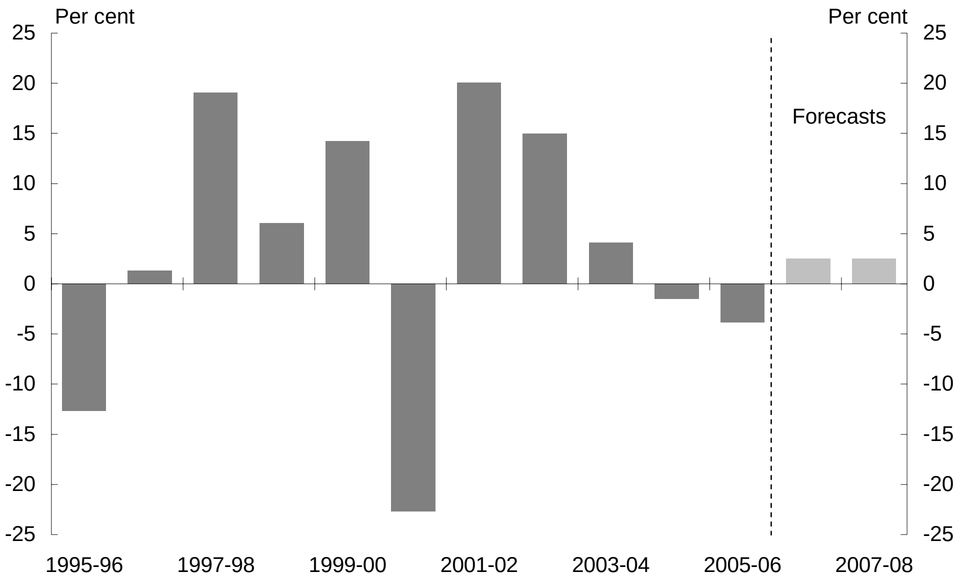
Consumption is also likely to be supported by recent increases in household wealth. Real household net wealth has increased strongly in recent years, rising by over 15 per cent over the past two years to June 2006. The growth in wealth has come from both dwelling and non-dwelling wealth, although non-dwelling wealth has increased at almost three times the rate of dwelling wealth over the past two years. In contrast, between June 2000 and June 2004 dwelling wealth grew at more than twice the rate of non-dwelling wealth. Consumption in Australia, and elsewhere, appears to be more responsive to changes in dwelling wealth than changes in non-dwelling wealth, suggesting that recent wealth increases will support consumption growth, but not by as much as when house prices were rising rapidly.

The risks around the consumption outlook have become more balanced in recent months. In aggregate, the housing market and consumption expenditure have adjusted smoothly to higher interest rates and higher petrol prices. In addition, household balance sheets are generally sound. However, concerns remain about the vulnerability of a small proportion of highly-geared households to unexpected changes in interest rates and incomes.

Dwelling investment

Dwelling investment fell slightly in both 2004-05 and 2005-06, after growing at an average annual rate of 12.9 per cent over the preceding three years. Dwelling investment is forecast to grow by a modest 2½ per cent in 2006-07 and 2007-08 (Chart 4). Growth is expected to be led by alterations and additions, with purchases of new dwellings picking up towards the end of the forecast period. Recent interest rate rises and low rental yields are expected to weigh on investors in the near term.

Chart 4: Growth in dwelling investment



Source: ABS cat. no. 5206.0 and Treasury.

Investment in alterations and additions is forecast to grow steadily, and to increase as a share of overall dwelling investment. This process is more advanced in New South Wales, reflecting a combination of factors. These include the limited availability of land in some locations and, in more recent years, the increased transaction costs involved with buying and selling a house. This trend has been evident in recent data, with alterations and additions having grown by 4.1 per cent Australia-wide over the six months to the December quarter 2006.

The near-term indicators of new housing construction activity remain subdued, in part reflecting recent increases in interest rates. Nevertheless, housing demand remains solid. Sustained growth in household incomes and employment, combined with increased immigration, is expected to support new dwelling investment growth in 2007-08.

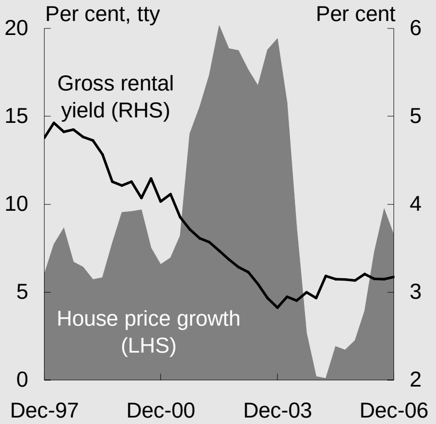
Investor activity in the housing market has been discouraged in recent years by increases in the cost of borrowing, low rental yields, low growth in house prices and strong returns on alternative investments, such as shares. However, current low vacancy rates and ongoing solid demand for housing suggest that rental yields are likely to rise, largely through increases in rents (Box 3). The timing and effect of any rental yield rise is uncertain, and if yields were to rise more quickly than anticipated there could be a stronger-than-forecast increase in dwelling investment growth.

Box 3: Rental property and investment

Investor activity in the housing market has been weak in recent years. Loans to investors fell sharply in late 2003 and have remained low. This reflects low gross rental yields and the reduced potential for capital gain.

Between 2001 and 2003 house prices rose much faster than rents, resulting in a sharp decline in gross rental yields (Chart A). In more recent years, low house price growth has led to weak capital gains. All else equal, a lower rental yield and less potential capital gain means that property has become less attractive relative to other assets.

Chart A: Gross rental yield and nominal house price growth

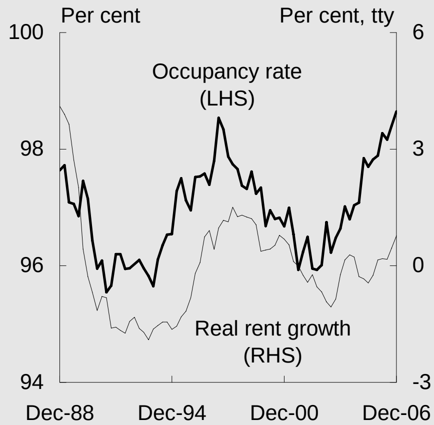


Source: ABS cat. no. 6416.0, Real Estate Institute of Australia and Treasury.

Reduced investor activity, combined with ongoing solid housing demand, has resulted in rental vacancy rates falling to unusually low levels across Australia's capital cities.

Historically, low vacancy rates (or high occupancy rates) have led to a pick up in real rent growth (Chart B).

Chart B: Occupancy rate and real rent growth



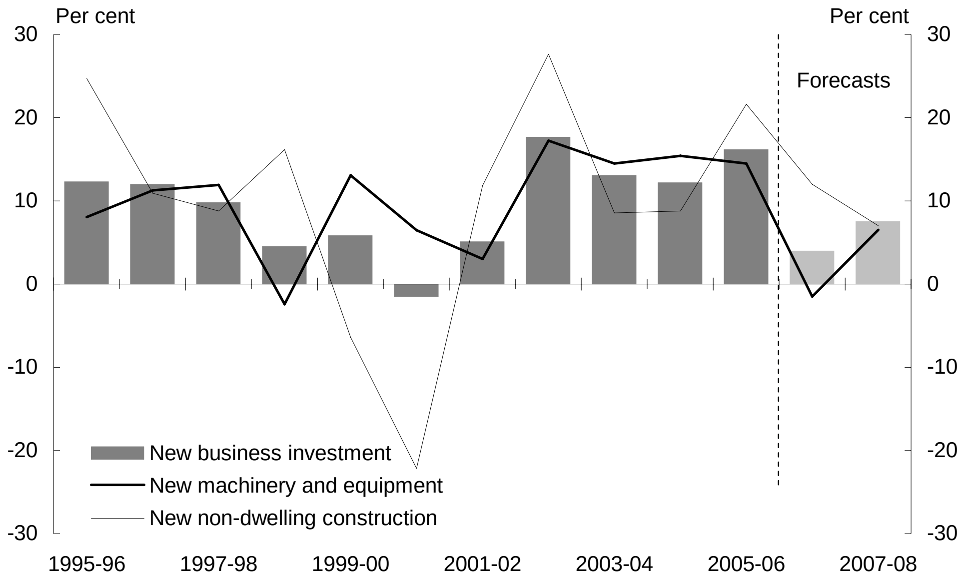
Source: Real Estate Institute of Australia and Treasury.

Given the solid demand for housing, rents are expected to continue to rise, leading to an increase in rental yields.

Business investment

After recording double-digit rates over each of the past four years, new business investment growth is expected to moderate over the forecast period, to be 4 per cent in 2006-07 and 7½ per cent in 2007-08 (Chart 5). Part of the forecast growth reflects Telstra's reclassification as a private non-financial corporation. The reclassification is expected to reduce public final demand and increase new business investment effective from the March quarter 2007.

Chart 5: Growth in new business investment



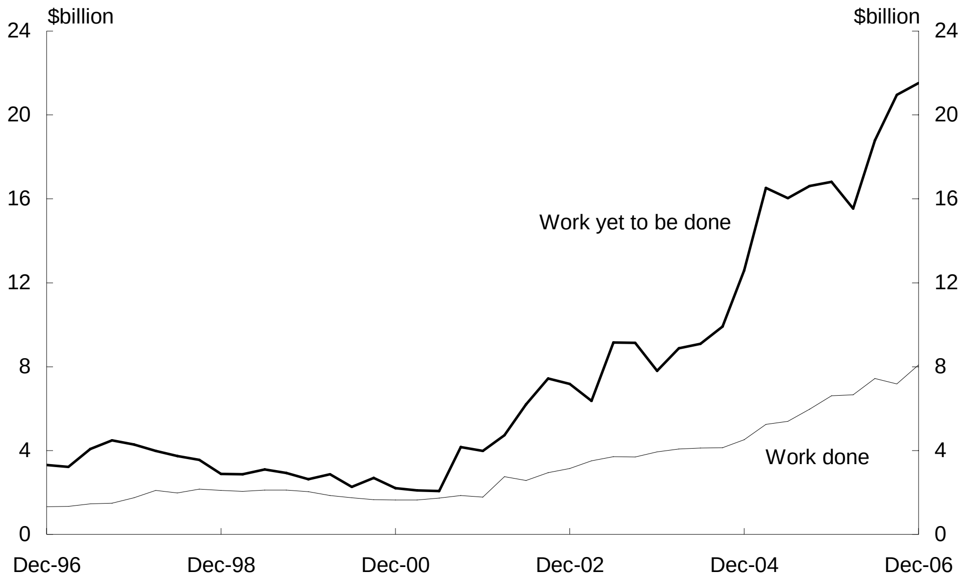
Source: ABS cat. no. 5206.0 and Treasury.

The business investment environment remains favourable, with high corporate profits, high rates of capacity utilisation, a relatively low cost of capital and continuing strong global demand for mining commodities. While the increase in commodity prices has boosted mining investment, it has also had a positive impact on investment in other sectors, such as manufacturing and property and business services. Over the past four years, the mining industry has accounted for around 20 percentage points of the 65 per cent growth in nominal investment. In addition, the share of non-dwelling construction undertaken by the mining industry has doubled from around 10 to 20 per cent since the beginning of this decade. However, continued solid growth in non-dwelling construction investment is at some risk from capacity constraints in key labour and capital markets.

The expansion in new machinery and equipment investment is expected to pause in 2006-07, with investment falling by 1½ per cent, before increasing by 6½ per cent in 2007-08. The Australian Bureau of Statistics' *Survey of Private New Capital Expenditure and Expected Expenditure* (ABS CAPEX survey) suggests widespread weakness in plant and equipment investment intentions in the period ahead. Agricultural machinery and equipment investment (not included in the ABS CAPEX survey) is also likely to fall in 2006-07, reflecting low farm production and profits. New machinery and equipment investment is expected to rebound in 2007-08, with business conditions anticipated to remain strong.

Total new non-dwelling construction investment is expected to grow by 12 per cent in 2006-07 and 7 per cent in 2007-08. New engineering construction investment growth is expected to increase sharply in 2006-07, before moderating slightly in 2007-08, supported by new projects and a record amount of work that has begun construction but is yet to be completed (Chart 6). New non-residential building investment growth is expected to moderate from recent strong rates. Commercial office, other business premises and retail construction are expected to experience the strongest growth.

Chart 6: Nominal new engineering construction



Source: ABS cat. no. 8762.0.

Inventories

Inventories are not expected to contribute to or subtract from GDP growth in 2006-07, as a rise in business stocks offsets a run-down in grain stocks. With farm production forecast to partially recover in 2007-08, grain stocks are expected to rise, with inventories contributing ¼ of a percentage point to growth in 2007-08.

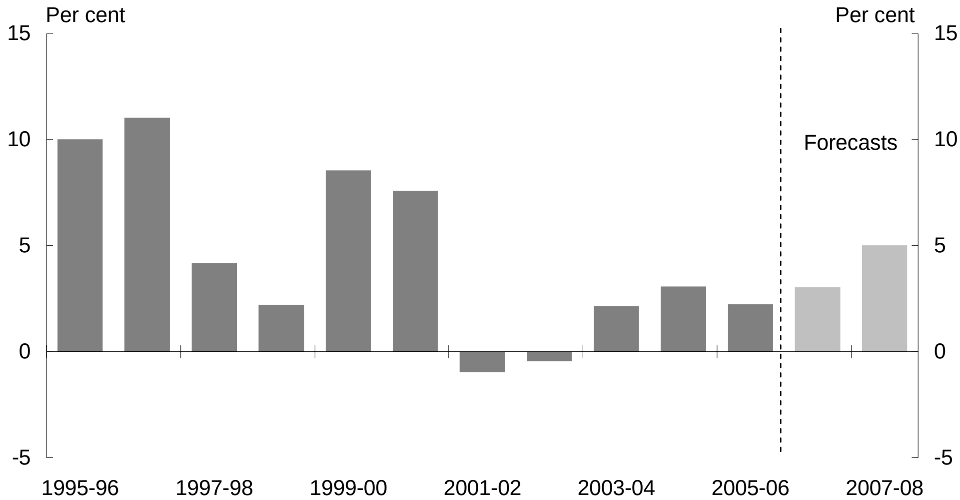
Public final demand

Public final demand is expected to grow strongly in 2006-07 and 2007-08. State and local government investment is expected to increase sharply over the forecast period, reflecting a large number of infrastructure projects. General government consumption is expected to grow strongly in 2006-07, with growth moderating in 2007-08. As is the case for business investment, there is some risk to public investment from capacity constraints.

Net exports

Net exports are expected to subtract ½ of a percentage point from GDP growth in 2007-08. Exports are forecast to grow by 3 per cent in 2006-07 and 5 per cent in 2007-08 (Chart 7). The modest export growth forecast in 2006-07 reflects the impact of the drought on rural exports and moderate growth in exports of elaborately transformed manufactures and services. Export growth is expected to increase in 2007-08, reflecting stronger non-rural commodity exports.

Chart 7: Growth in exports



Source: ABS cat. no. 5302.0 and Treasury.

Rural exports are expected to fall in 2006-07, reflecting the drought-driven 20 per cent fall in farm production. However, a run-down in grain stocks is expected to soften the impact of the fall in farm production on exports. As farm production will partially rebound in 2007-08 under the assumption of average seasonal conditions, some rural exports are also expected to rebound.

Growth in non-rural commodity exports is expected to accelerate in 2007-08, after solid growth in 2006-07. The acceleration in growth reflects the huge investment of around $55 billion undertaken by the mining industry over the past five years.

Nevertheless, uncertainty remains around the timing of the forecast acceleration in non-rural commodity export growth, with the lead times in mining investment having been surprisingly long. While export growth in some commodities — for example, liquefied natural gas and iron ore — has been strong over recent years, others have not performed as well. Coal exports have grown at an average annual rate of 4 per cent over the past four years, while exports of crude oil and condensate have fallen at an average annual rate of 14 per cent. However, there are signs that mining production (including oil production) may have started to turn around. Mining production grew by 9 per cent over the six months to the December quarter 2006 and mineral fuel exports increased by 23 per cent. In addition, while coal exports have been hampered by infrastructure constraints in some supply chains, there are significant expansion plans underway.

Elaborately transformed manufactures and services exports are expected to grow modestly over the forecast period, with the relatively high exchange rate and competitive pressures expected to constrain growth. Manufacturing exports have grown at an annual average rate of 2.7 per cent since 2000-01, well below the 20-year average of 10.5 per cent. There have been a number of factors contributing to the slow growth, including a turbulent world economy in the early part of the decade, the relatively high exchange rate, and increasing competition from industrialising economies such as China. These factors have also hindered services exports.

The increase in commodity prices is contributing to higher import growth, through a higher exchange rate and strong growth in domestic demand. Strong import growth is the counterpart of strong growth in investment and incomes in the economy. Since 2001-02, imports have grown at an average annual rate of 11.4 per cent, with capital imports growing at an average annual rate of around 20 per cent.

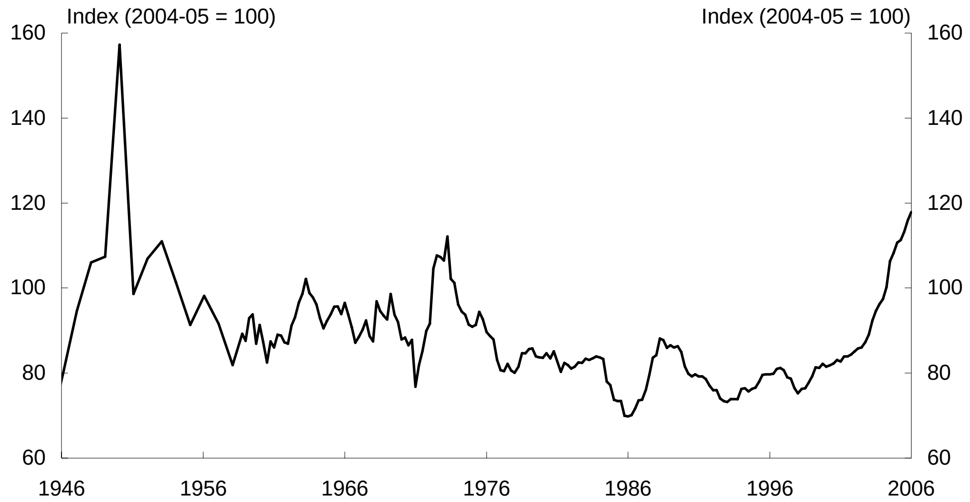
Imports are forecast to grow by 6½ per cent in 2007-08. Growth in capital imports is expected to moderate from its recent high rates in line with an expected moderation in business investment growth. Imports of consumption goods are expected to remain solid, in line with growth in household consumption.

Terms of trade

Following an increase of around 22 per cent over the past two years, the terms of trade are forecast to rise by 6 per cent in 2006-07, before falling by 1½ per cent in 2007-08 (Chart 8). The expected fall is largely driven by anticipated falls in non-rural commodity prices. Despite continued strong world growth, these prices are expected to fall as global mining supply comes on line. Rural prices are also expected to moderate, reflecting a partial recovery in Australian farm production in 2007-08.

The recent strength in the terms of trade has predominantly been driven by non-rural commodity export prices, which rose by around 67 per cent over the past two years. This aggregate increase was dominated by large rises in the prices of iron ore and coal, as well as mineral fuels, gold and metals. Non-rural commodity price rises also contributed to import prices rising modestly. However, import prices are expected to moderate over the forecast period. Despite increasing cost pressures and higher world inflation, the prices of manufactured imports are expected to continue to fall.

Chart 8: Terms of trade



Note: Annual data prior to September 1959 and quarterly data thereafter.
Source: ABS cat. no. 5302.0 and Reserve Bank of Australia.

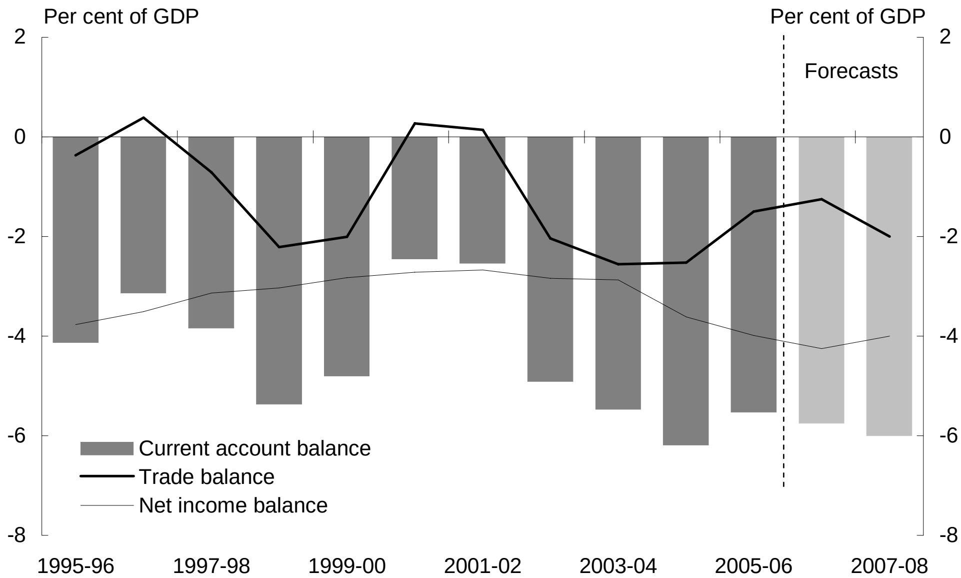
There is a risk that non-rural commodity prices will not fall as expected. While there have been recent falls in oil, alumina, some coal and some base metal prices, there are still signs of strength in other prices. Illustrating the mixed results, the prices of zinc and copper fell by 8.3 per cent and 19.0 per cent over the six months to March 2007, while the prices of nickel and lead increased by 48.4 per cent and 35.5 per cent. If world demand remains strong, and the global supply response does not match its pace, prices could be higher than expected. However, commodity prices are volatile, and there is the potential for a sharp correction if there were to be a reduction in demand or a faster-than-anticipated global supply response.

Current account balance

The current account deficit (CAD) is expected to widen to 6 per cent of GDP in 2007-08 (Chart 9). It is anticipated that the trade deficit will widen, with import volumes outpacing export volumes and an expected fall in export prices. This is expected to be partially offset by a narrowing in the net income deficit (NID).

The past two years have seen a significant rise in the NID as a share of GDP following a long period when this ratio was declining. The earlier decline in part reflected a narrowing in the spread between the yields on foreign liabilities and those on foreign assets (Box 4). This differential has widened in the past two years as strong mining profits, coupled with a relatively high degree of foreign ownership in the mining sector, have underpinned a rapid increase in equity income accruing to the rest of the world. Reflecting an anticipated easing in commodity prices and corporate profits, equity income accruals are expected to moderate in 2007-08. This is expected to be partially offset by a rising stock of net foreign liabilities resulting from past current account deficits, and higher world interest rates.

Chart 9: Current account balance



Source: ABS cat. no. 5302.0 and Treasury.

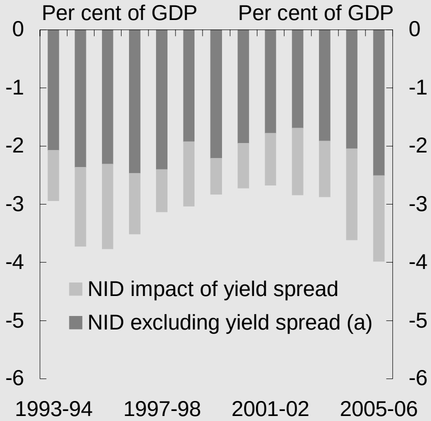
From a saving and investment perspective, the expected widening in the CAD reflects expected higher investment and relatively unchanged national saving as a share of GDP. The widening in the CAD since 2002-03 initially reflected a deterioration in the net lending position of households. In recent years, the net lending position of households has improved as they have begun to consolidate their balance sheets. However, this change has been partially offset by increased borrowing by the corporate sector in order to fund business investment.

Box 4: Net income and valuation gains on the net foreign liability position

Historically, the yield on foreign liabilities has been higher than the yield on foreign assets. The fall in the NID as a per cent of GDP in the late 1990s mainly reflected a narrowing in this differential (Chart A).

However, over the past two years, the NID as a per cent of GDP has risen significantly. Around half of this increase is due to a combination of growth in net foreign liabilities as a share of GDP and a general rise in yields on both assets and liabilities.

Chart A: Net income deficit and the yield spread



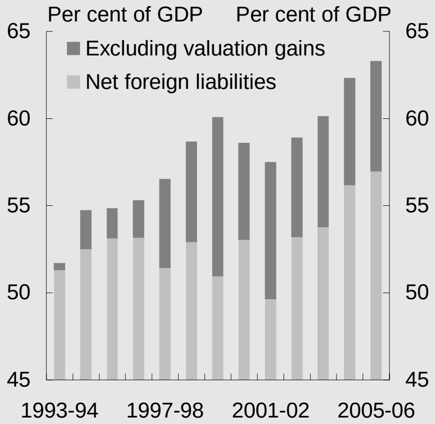
(a) Calculation assumes yields converge to the midpoint of the spread.
Source: ABS cat. no. 5302.0 and Treasury.

The other half is due to an increase in the spread between yields on foreign liabilities and foreign assets. The combination of strong mining profits and the relatively high degree of foreign ownership in the Australian mining sector has led to a rapid increase in the investment income received by foreigners. Profitability of Australian non-mining companies has also been relatively strong.

Interestingly, Australia's net foreign liabilities have not increased by as much as would have been suggested by the CAD alone. The CAD, through the NID, does not capture valuation gains arising from exchange rate and asset price changes. These valuation gains are volatile, but have generally favoured Australia.

Cumulative valuation gains have reduced net foreign liabilities by 6 per cent of GDP since 1993-94 (Chart B). This has offset over half of the increase in net foreign liabilities as a share of GDP that would otherwise have occurred.

Chart B: Impact of valuation gains on net foreign liabilities



Source: ABS cat. no. 5302.0 and Treasury.

These valuation gains have largely arisen from asset price gains, reflecting stronger growth in foreign asset prices compared with Australian asset prices. The Australian dollar's depreciation between 1996-97 and 2000-01 also provided exchange rate gains, but these were reversed with the subsequent appreciation.

Labour market, wages and prices

Labour market

Employment growth is expected to ease to 1½ per cent in 2007-08, consistent with around-trend non-farm GDP growth and a modest rise in real labour costs. The growth in employment is expected to be underpinned by higher-than-average population growth resulting from increased immigration.

The participation rate is expected to rise to 65 per cent in 2007-08, partly reflecting the Government's Welfare-to-Work reforms. This is expected to contribute to a modest increase in the unemployment rate to 5 per cent. The new participation requirements for Disability Support Pension and Parenting Payment recipients are likely to lead to more people entering the labour force, increasing the unemployment rate in the short term as new entrants to the labour market take time to find jobs.

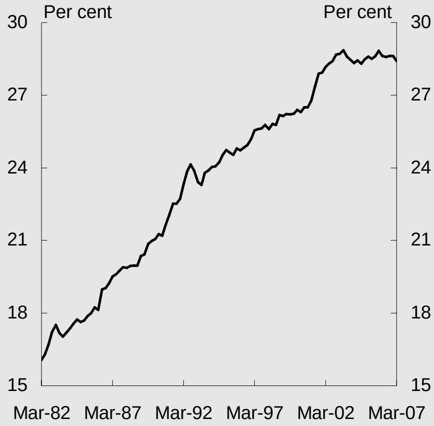
The recent strong rise in the demand for labour has been largely met by increased labour supply. The strong growth in employment has been reflected in a rise in the number of people entering the labour force, as well as a fall in the number of people who are unemployed. Around 27 per cent of the growth in employment between June 2004 and March 2007 reflected rising participation, with around 16 per cent associated with a fall in the number of people unemployed. In Queensland and Western Australia — the two States with the strongest mining industries — increased labour force participation is a reflection of the strong increase in demand for labour.

A near-record-high participation rate and an unemployment rate at 30-year lows suggest a tight labour market. Another illustration of the tight labour market is the increase in full-time jobs, which have accounted for the majority of jobs created in recent years (Box 5). Moreover, measures of labour utilisation, which adjust for the number of hours worked by part-time and full-time workers, are at near-record levels (since the monthly labour force survey began in February 1978). In fact, for those aged 25 to 54, this measure is at its highest level on record.

Box 5: Part-time and full-time employment

Part-time jobs have accounted for around 30 per cent of jobs created in the past five years, compared with over 55 per cent of jobs created over the previous two decades. After rising consistently since the early 1980s, the part-time share of total employment has been steady for the past five years (Chart A).

Chart A: Part-time share of total employment



Source: ABS cat. no. 6202.0.

The shift away from growth in part-time employment towards full-time employment has occurred in most States. This shift has also occurred, to a varying extent, across age and gender cohorts. Further, it has occurred despite an increase in the share of older workers (55 and over) in total employment, where part-time jobs are more prevalent.

The shift towards full-time job growth is partly related to strong employment growth in the mining and construction industries. In February 2007, these industries accounted for around 11 per cent of total employment, up from around 8 per cent in 2001. Around one in eight jobs in these industries is part-time, compared with about one in four across all industries.

However, there has also been a shift towards full-time employment growth within industries that are more part-time intensive. For example, after rising since the 1980s, the part-time share of retail trade employment has been steady at around 47 per cent since 2001. This industry accounts for about a quarter of part-time workers.

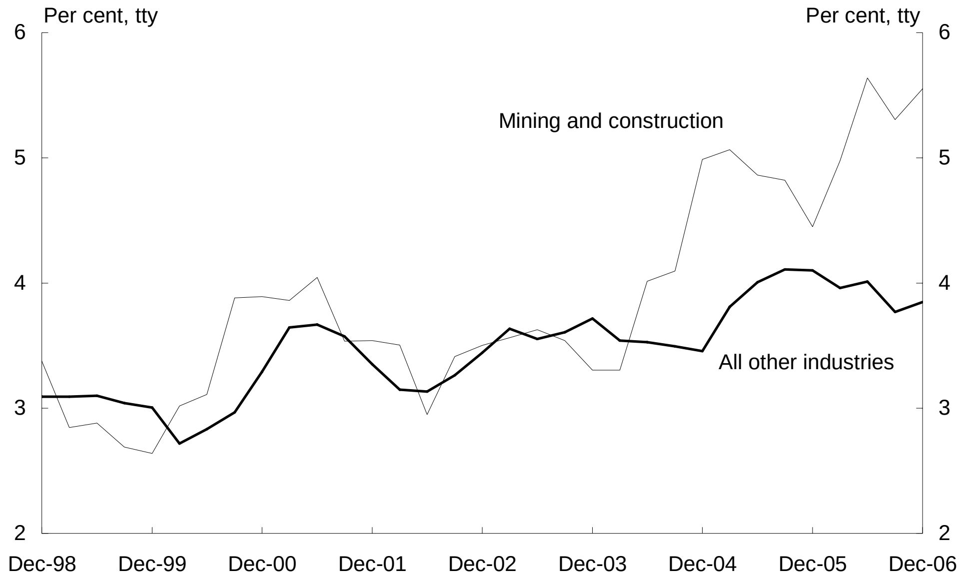
Future changes in the part-time share of employment will depend on economic conditions, structural changes and demographic factors. Historically, economic upturns are accompanied by slower growth in part-time jobs compared with full-time jobs. As the share of older persons in the labour force increases, the part-time share of total employment could rise further, reflecting the transition to retirement. However, as noted earlier, a rising share of older persons in total employment has not seen an increase in the part-time share of employment in recent years.

Wages

Wage growth is expected to moderate slightly in 2007-08, in line with an easing in employment growth. The Wage Price Index is forecast to grow by 4¼ per cent through the year to the June quarter 2007, before easing to 4 per cent through the year to the June quarter 2008. The pattern of through-the-year growth will be affected by the timing of the Australian Fair Pay Commission's 2006 Federal Minimum Wage decision, which is likely to result in stronger wage growth in the March quarter 2007.

Despite strong employment growth and continuing falls in the unemployment rate in recent years, overall wage pressures have not increased considerably (Box 6). There have, however, been localised wage pressures in those sectors most directly affected by the mining and construction industries (Chart 10). Wage growth in the mining and construction sectors was 5.6 per cent through the year to the December quarter 2006, compared with growth of 3.8 per cent for all other industries. The strength in wages in these sectors is expected to continue, and there is a risk that this may lead to more widespread wage pressures with the tight labour market.

Chart 10: Growth in the Wage Price Index



Source: ABS cat. no. 6345.0 and Treasury.

Box 6: Inflation and unemployment

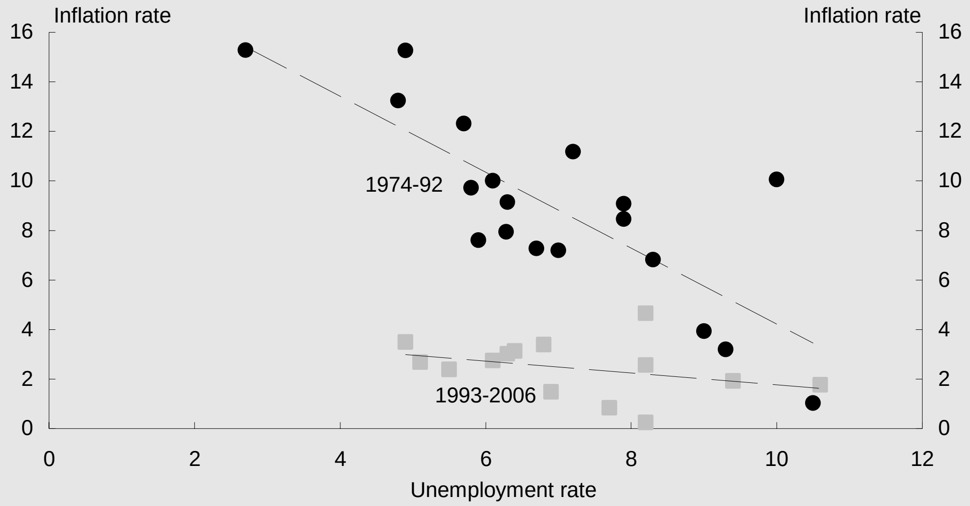
Over the past decade, inflation in Australia has been well-anchored, with annual inflation averaging 2½ per cent. At the same time, the unemployment rate has been falling steadily and the economy is now as close to full employment as it has been for over 30 years.

The relationship between inflation and the unemployment rate over the past 30 years can be interpreted as a series of shifting short-run Phillips curves, with downward shifts reflecting lower inflation expectations (Chart A).

The combination of low unemployment and low inflation has been sustained for some time, which suggests that the short-run trade-off between unemployment and inflation has diminished. This has been a consequence of credible macroeconomic policy frameworks, which have anchored inflation at low rates.

Moreover, the labour market is more flexible than it was in the past. As a result, relative wages among industries now provide a stronger signal for labour to move in response to demand without creating economy-wide wage pressures.

Chart A: Phillips curves in Australia[(a)]

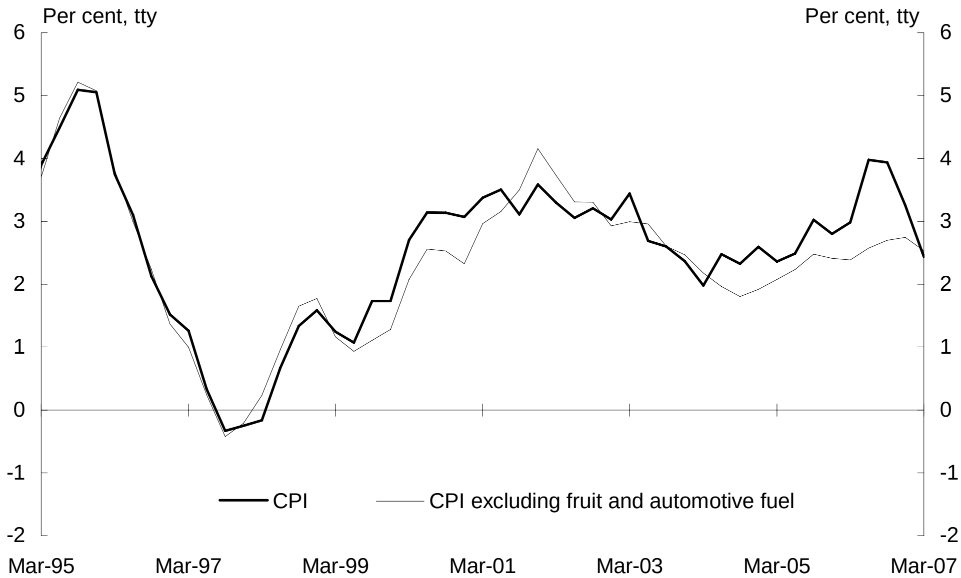


(a) Annual data; and inflation is adjusted for the effects of *The New Tax System*.
Source: ABS cat. no. 6401.0, 6202.0 and Treasury.

Prices

Consumer price inflation has been affected recently by significant movements in the prices of automotive fuel and fruit (Chart 11). These items subtracted 1¼ percentage points from Consumer Price Index (CPI) growth over the six months to the March quarter 2007, after contributing 1¼ percentage points in the preceding six months. As automotive fuel prices stabilise and fruit prices remain below the highs experienced in 2006, inflation is expected to temporarily fall below 2 per cent through the year to the June quarter 2007.

Chart 11: Inflation(a)



(a) Adjusted for the effects of *The New Tax System*.
Source: ABS cat. no. 6401.0 and Treasury.

In addition to these one-off factors, there have been some underlying inflationary pressures reflecting the indirect effects of higher oil prices and solid growth in nominal unit labour costs. After slowing at the beginning of the decade, growth in nominal unit labour costs picked up in 2004-05 and 2005-06 reflecting a slowdown in productivity and a modest pick-up in wages. Nominal unit labour costs are expected to ease in line with a strengthening in productivity. As a result, underlying inflationary pressures are expected to moderate.

The inflation rate is forecast to be 2¾ per cent through the year to the June quarter 2008. Behind the moderate outlook for inflation are divergent trends for the prices of different goods. The downward trend in the price of some tradeable items, such as clothing and footwear and computing equipment is expected to continue. However, as discussed in Box 3, house rental prices are expected to continue to increase. This, combined with a forecast modest increase in house purchase prices — which together account for around 13 per cent of the CPI basket — is expected to place upward pressure on inflation. Low water allocations in the Murray-Darling Basin will also add to the upward pressure on inflation through higher fruit, vegetable and dairy prices, although alternative Australian and international supply sources are expected to reduce this impact. While upward price pressures are not anticipated to lead to significant increases in consumer price inflation, they remain a risk.