Statement 2: Economic Outlook

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

STATEMENT 2: ECONOMIC OUTLOOK

The global economy is experiencing the sharpest synchronised downturn since the Great Depression, and is expected to contract in 2009 for the first time in six decades. The magnitude and speed of transmission of the global recession means that a recession in Australia has become inevitable. Strong and rapid policy action from the Australian Government and the Reserve Bank of Australia is helping to cushion the severe impact of the global recession on the Australian economy and employment. This action is one reason Australia is expected to experience a milder contraction than virtually all other advanced economies. Supported by policy, a recovery in the Australian economy is expected to gather pace over 2010.

OVERVIEW

The effects of the global financial crisis have surged through all advanced economies, destroying wealth, sapping confidence, and leading to a collapse in global trade. The scale of this downturn means that emerging economies have not been spared, with growth in these economies slowing significantly.

A collapse in global demand and production has seen commodity prices fall significantly. Australia's terms of trade are expected to decline from recent record highs, taking around $35 billion out of the economy in 2009-10. Business investment is expected to contract in the face of lower global and domestic demand. Households are confronting a sharp fall in wealth, with global stock markets falling sharply and the market almost halving in value in Australia.

Australia is expected to withstand these global pressures better than most other countries. The Australian financial system remains sound, and timely and substantial fiscal policy stimulus and lower interest rates are helping to moderate the effect of the global downturn on the domestic economy. Nevertheless, the global recession has become so severe that policy cannot completely offset the effects on the Australian economy.

The slowdown in the domestic economy will have unavoidable consequences for the labour market. Employment is expected to contract over 2009-10 before gradually strengthening over 2010-11. The unemployment rate will continue to rise over the forecast period, peaking at 8½ per cent in 2010-11. Inflation has already begun to moderate, and is likely to be subdued over the forecast period.

At a time of significant global upheaval, considerable risks surround these forecasts. The global economy remains fragile and could deteriorate further, with flow-on consequences for the Australian economy. However, international policy action, and prospects for an earlier recovery in China, could support a sharper turnaround than currently expected.

Summary of forecasts

The world economy is expected to contract by 1½ per cent in 2009, the first contraction in six decades. No economy has been immune from the global financial crisis. Advanced economies are in the midst of a deep recession, having borne the initial brunt of the crisis, with real GDP expected to contract by 3¾ per cent in 2009. A recovery is not expected to gather pace until mid-2010. Growth in emerging economies has also slowed sharply, and they are expected to record below-trend growth in the period ahead.

Australia's real GDP is forecast to contract in 2009-10, an inevitable consequence of the magnitude of the global recession. A fall of ½ of a per cent is forecast for 2009-10. The main contributors to the slowdown are sharp falls in business investment and exports, as well as a smaller contraction in household consumption. Strong growth in public investment is providing a substantial buffer to weakness elsewhere in the economy, moderating the size of the slowdown. Supported by policy, a recovery in the economy is expected to gather pace over 2010, although with growth remaining below trend in 2010-11 at 2¼ per cent.

Household consumption is expected to contract by ¼ of a per cent in 2009-10. This is a mild fall compared with many other advanced economies, despite the substantial negative shocks stemming from the global recession. The large falls in household wealth stemming from the collapse in global stock markets, combined with concern about rising unemployment, are expected to continue to weigh heavily on household confidence and consumption. Helping to moderate these negative effects is substantial assistance to the household sector from government stimulus packages, cuts to interest rates, and falls in oil prices. While this assistance has helped support economic activity, it cannot fully offset the negative effects of the global recession.

Dwelling investment is forecast to be subdued in the short term, with activity remaining flat through 2009-10, in line with recent weak building approvals data. The sector is expected to stage a solid recovery in 2010-11 with growth of 11½ per cent. Recent sharp cuts to interest rates, ongoing strong population growth and the First Home Owners Boost are expected to support the recovery.

Business investment is expected to contract sharply in 2009-10, falling by 18½ per cent. Strong investment activity in the mining sector has resulted in business investment recently reaching a four-decade high as a share of GDP. The collapse in global commodity prices, and weaker global and domestic demand, is expected to result in business investment returning rapidly to its pre-commodity boom share of GDP over the forecast period. Momentum from a number of large engineering projects is expected to provide some support to the sector.

Public final demand is forecast to fill some of the gap created by the contraction in private demand, growing by 7¾ per cent in 2009-10 and remaining at a high level in 2010-11. Growth will be led by a rise of almost 25 per cent in total public investment, the strongest on record, as investment from a range of stimulus packages flows through to increases in activity.

Exports are forecast to fall in 2009-10, consistent with the contraction in world trade. An overall fall of 4 per cent is expected, reflecting large falls in exports of elaborately transformed manufactures, non-rural commodities and services, partially offset by a continued recovery in rural exports. Overall, exports are forecast to recover in 2010-11 as global demand recovers.

Imports are forecast to contract by 6½ per cent in 2009-10, in line with the slowing in domestic demand and the depreciation of the Australian dollar since its peak in mid-2008. The fall in imports is expected to be broad-based, but led by a contraction in capital goods imports, given the sharp declines expected in business investment and its relatively import-intensive nature.

The **terms of trade** are forecast to fall by 13¼ per cent in 2009-10, taking them back to around 2006-07 levels. Commodity prices are expected to fall significantly in 2009-10. This fall comes after successive increases in key bulk commodity prices drove the terms of trade to a six-decade high. The global recession has seen a turnaround in demand for commodities, with industrial production falling sharply around the world and global trade collapsing.

The **current account deficit** is expected to widen to 5¼ per cent of GDP in 2009-10. The trade balance is forecast to move back into deficit as commodity prices unwind, while the net income deficit is forecast to remain relatively stable as a share of GDP.

Employment is expected to fall by 1½ per cent through the year to the June quarter 2010 as the global recession impacts on the domestic economy. Employment is expected to recover through 2010-11, rising by ½ of a per cent through to the June quarter 2011. This would see the unemployment rate rise to 8¼ per cent by the June quarter 2010, peaking at 8½ per cent in 2010-11. The participation rate is forecast to decline by 1¼ percentage points from its recent record high, reaching 64¼ per cent by the June quarter 2011.

Wages growth is expected to slow from recent solid rates to 3¼ per cent through the year to the June quarter of both 2010 and 2011, reflecting the easing in labour market conditions.

Inflation is forecast to continue to moderate over the forecast period, as the global recession eases previous demand pressures. Both headline and underlying inflation are expected to slow to 1¾ per cent through the year to the June quarter 2010, and 1½ per cent through the year to the June quarter 2011.

Nominal GDP is forecast to fall by 1½ per cent in 2009-10, reflecting the contraction in real GDP of ½ of a per cent and the expected substantial decline in the terms of trade that will result in the non-farm GDP deflator declining by 1 per cent in that year.

Table 1: Domestic economy forecasts[(a)]

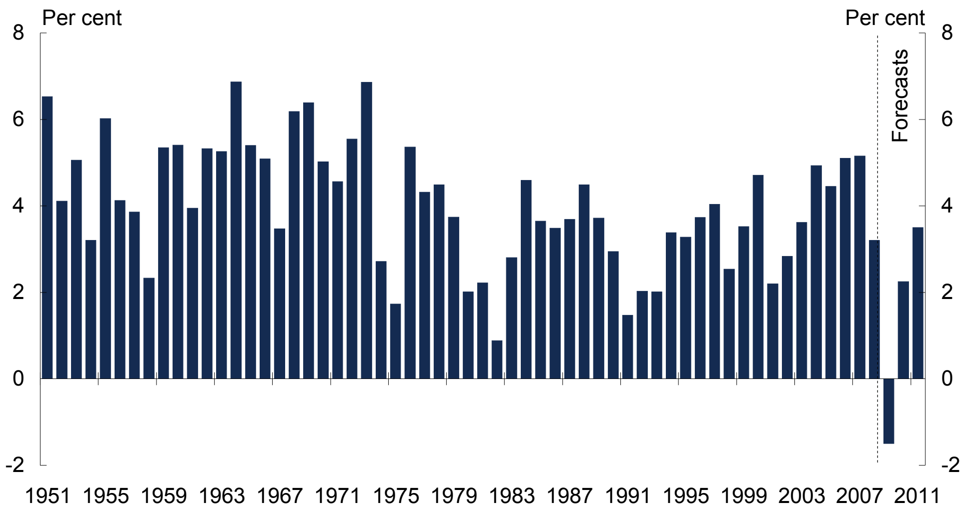
	Outcomes(b)	Estimates	Forecasts	
	2007-08	2008-09	2009-10	2010-11
Panel A - Demand and output(c)				
Household consumption	3.7	1	- 1/4	1 3/4
Private investment				
Dwellings	1.6	-2 1/2	0	11 1/2
Total business investment(d)	14.2	2 1/2	-18 1/2	3 1/2
Non-dwelling construction(d)	11.4	1/2	-26	3
Machinery and equipment(d)	16.0	3	-16 1/2	4
Private final demand(d)	5.5	1/2	-4	2 3/4
Public final demand(d)	4.6	5	7 3/4	- 1/2
Total final demand	5.3	1 1/2	-1 1/4	2
Change in inventories(e)	0.2	-1 1/2	1/4	3/4
Gross national expenditure	5.5	1/4	-1 1/4	2 1/2
Exports of goods and services	4.3	- 1/2	-4	4 1/2
Imports of goods and services	12.9	-1 1/2	-6 1/2	6 1/2
Net exports(e)	-1.9	1/4	3/4	- 1/2
Gross domestic product	3.6	0	- 1/2	2 1/4
Non-farm product	3.6	- 1/4	- 1/2	2 1/4
Farm product	4.5	13	1	0
Nominal gross domestic product	8.2	5 3/4	-1 1/2	3 3/4
Panel B - Other selected economic measures				
External accounts				
Terms of trade	5.2	8 3/4	-13 1/4	0
Current account balance (per cent of GDP)	-6.2	-3	-5 1/4	-5 3/4
Labour market				
Employment (labour force survey basis)(f)	2.4	- 1/4	-1 1/2	1/2
Unemployment rate (per cent)(g)	4.2	6	8 1/4	8 1/2
Participation rate (per cent)(g)	65.5	65 1/4	64 3/4	64 1/4
Prices and wages				
Consumer Price Index(f)	4.5	1 3/4	1 3/4	1 1/2
Gross non-farm product deflator	4.3	5 3/4	-1	1 1/2
Wage Price Index(f)	4.1	4 1/4	3 1/4	3 1/4

(a) Percentage change on previous year unless otherwise indicated.
(b) Calculated using original data.
(c) Chain volume measures except for nominal gross domestic product which is in current prices.
(d) Excluding second-hand asset sales from the public sector to the private sector.
(e) Percentage point contribution to growth in GDP.
(f) Through the year growth rate to the June quarter.
(g) Estimate for the June quarter.
Note: The forecasts are based on several technical assumptions. The exchange rate is assumed to remain around its recent average level — a trade-weighted index of around 59 and a United States dollar exchange rate of around 72 US cents. Interest rates are assumed to move broadly in line with market expectations. World oil prices (Malaysian Tapis) are assumed to remain around US$56 per barrel. The farm sector forecasts are based on an assumption of average seasonal conditions in the future, but account for current low water storage levels.
Source: Australian Bureau of Statistics (ABS) cat. no. 5206.0, 5302.0, 6202.0, 6345.0, 6401.0, unpublished ABS data and Treasury.

THE OUTLOOK FOR THE INTERNATIONAL ECONOMY

The world economic outlook has deteriorated significantly since the February 2009 *Updated Economic and Fiscal Outlook* (UEFO), with the first annual contraction in six decades expected for world GDP in 2009 (Chart 1).

Chart 1: World GDP growth



Source: International Monetary Fund (IMF) and Treasury.

No economy has emerged unscathed from the global financial crisis. Following the rapid intensification of global financial market stress in September 2008, strong financial and real economy linkages led to an unprecedented synchronised fall in world trade and production in the December quarter of last year (Box 1). With an estimated annualised contraction of 6¼ per cent, that quarter witnessed the sharpest fall in global output on record, and GDP outcomes were worse than already pessimistic expectations in every major economy.

Nearly every advanced economy is either in recession or recorded a decline in GDP late last year. Recent indicators, including first estimates from the United States and the United Kingdom, point to another set of sharp contractions or very weak rates of growth around the world in the March quarter 2009.

Against this backdrop, and in light of low levels of confidence, growth forecasts for 2009 have been marked down for most economies. The world economy is now expected to contract by 1½ per cent in 2009, a substantial 2 percentage point downward revision from the forecast in UEFO (Table 2).

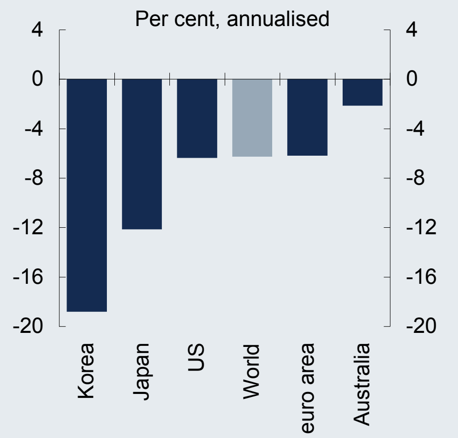
Box 1: The sharpest synchronised global downturn

Global economic activity plunged dramatically in the final months of 2008 following the collapse of Lehman Brothers in September.

While the prospect of a rapid intensification of financial market stress had earlier been identified as a clear downside risk to the global outlook, the speed and extent of the deterioration in global financial and economic conditions exceeded any event in living memory.

With rapid declines in credit flows, equity values and consumer confidence, strong financial and real economy linkages saw the tremors which rocked financial markets transform into an unprecedented synchronised global contraction of production, trade, and capital flows. The result was an annualised global GDP contraction of around 6¼ per cent in the December quarter 2008 (Chart A).

Chart A: December quarter 2008 GDP growth

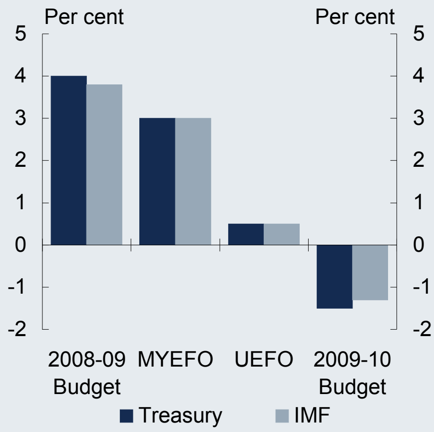


Source: National statistical publications and IMF.

While every country was inevitably affected, the impacts were especially stark amongst advanced economies. In the US and euro area, GDP declined in the December quarter at an annualised rate of over 6 per cent. Advanced economies in our region were hit even harder. Japan and Korea contracted at annualised rates of 12.1 and 18.8 per cent, with massive falls also recorded in Singapore and Taiwan.

Against this backdrop, and with signs of another set of sharp GDP contractions around the world in the March quarter, forecasts for global growth have been revised down significantly and frequently. The April *World Economic Outlook* presented the IMF's fifth set of forecast revisions in the past seven months, with a cumulative 4.3 percentage points shaved off the forecast for global growth in 2009 (Chart B).

Chart B: Evolution of 2009 global growth forecast



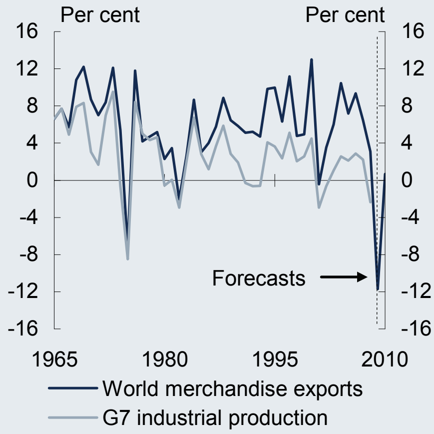
Note: IMF forecasts from April 2008, October 2008, January 2009, and April 2009.
Source: IMF and Treasury.

Box 1: The sharpest synchronised global downturn (continued)

IMF forecasts for production and trade are similarly dire. Global industrial production is expected to shrink by over 6 per cent in 2009, exceeding the contraction in industrial production during any post-war global downturn. Global merchandise trade is expected to fall by 11 per cent (Chart C).

While the rate of global economic decline witnessed since last September is unlikely to continue, the flow-on effects of the rapid fall in activity will linger. Around the world, households and businesses face an extended period of constrained credit, rising unemployment and heightened uncertainty, as policy makers seek to restore and reform financial markets and shield their economies from what would otherwise be the full brunt of even larger falls in aggregate demand.

Chart C: Trade and industrial production growth



Note: World trade forecasts and data since 1981 are from IMF, earlier data from the World Trade Organisation (WTO).
Source: IMF, WTO and OECD.

The global recession of 2009 looms as not only the most synchronised, but also the most severe in living memory.

Deep contractions are expected in virtually every advanced economy in 2009, with advanced economies collectively expected to contract by 3¾ per cent (Chart 2). While still expanding, China is forecast to grow at a below-trend pace. In other emerging economies, growth will be impeded by a combination of weaker external demand, capital outflows, and the associated negative spill-over effects on domestic demand.

Eight of Australia's top 10 trading partner economies are expected to contract in 2009, with major trading partners collectively expected to contract by 2 per cent — far weaker than their performance during the Asian Financial Crisis.

With post-war record falls expected in industrial production, trade and capital flows around the world, the global recession is expected to be the most severe since the Great Depression. The pace of the recovery is dependent on the success of global measures to stabilise the global financial system, restore credit flows, and boost growth and support jobs (Box 2).

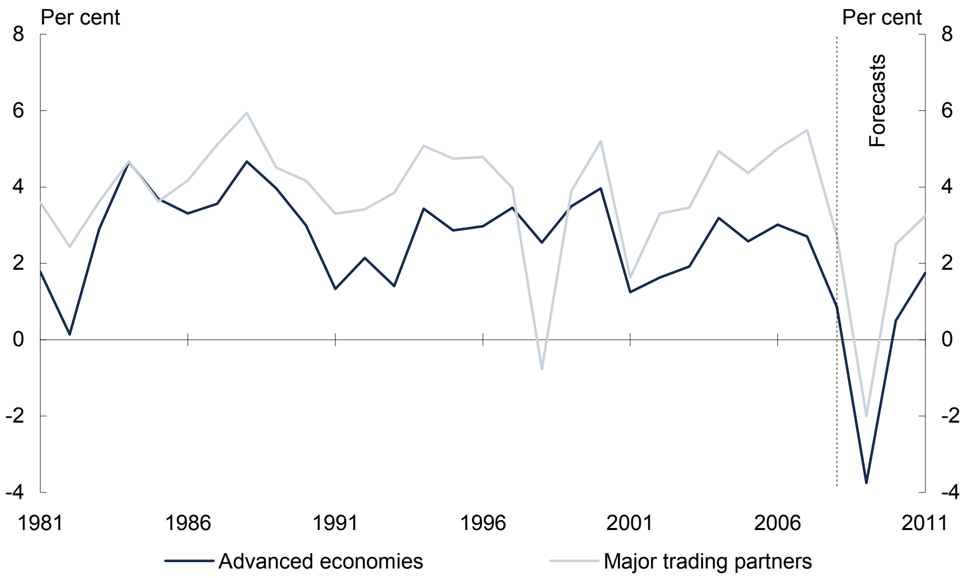
While there have been signs of improvement in financial market conditions in recent months, the global financial system remains under significant strain. After nearly halving, global equity prices have risen since early March. While still elevated relative to pre-crisis levels, indicators of stress in global credit markets have eased since late last year, providing some encouragement that the financial crisis may be moderating in its severity. Nevertheless, bank balance sheets remain under pressure, and much depends on the success of policy responses aimed at removing toxic assets from the balance sheets of US and European banks.

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

	Actual	Forecasts		
	2008	2009	2010	2011
United States	1.1	-3	1/4	1 3/4
Euro area	0.7	-4	0	1 1/4
Japan	-0.7	-6	1/2	3/4
China(b)	9.0	6 1/4	8	8 1/2
NIEs(c)	1.6	-4 3/4	2 3/4	3 1/4
ASEAN-5(d)	4.6	-1 1/4	2 1/2	3 3/4
India(b)	7.4	4	4 3/4	5 3/4
Major trading partners	2.7	-2	2 1/2	3 1/4
Advanced economies(e)	0.9	-3 3/4	1/2	1 3/4
World	3.2	-1 1/2	2 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, NIEs and ASEAN-5 are calculated using export trade weights.
(b) Production-based measures of GDP.
(c) The Newly Industrialised Economies (NIEs) are Hong Kong, South Korea, Singapore and Taiwan.
(d) The Association of Southeast Asian Nations group of five (ASEAN-5) comprises Indonesia, Malaysia, the Philippines, Thailand and Vietnam.
(e) Composed of the 33 industrialised economies classified as advanced by the IMF.
Source: National statistical publications, IMF and Treasury.

Chart 2: GDP growth in advanced and major trading partner economies



Source: IMF and Treasury.

Box 2: Global policy responses

Confronted with the worst economic conditions in living memory, global policy makers have responded by providing significant insurance against an even deeper and more prolonged recession and a delayed recovery.

Following the collapse of Lehman Brothers, authorities provided liquidity to financial markets on an unprecedented scale. Governments worldwide extended retail deposit guarantees and announced guarantees of banks' wholesale funding. In some countries, weak or insolvent financial institutions were recapitalised with public funds.

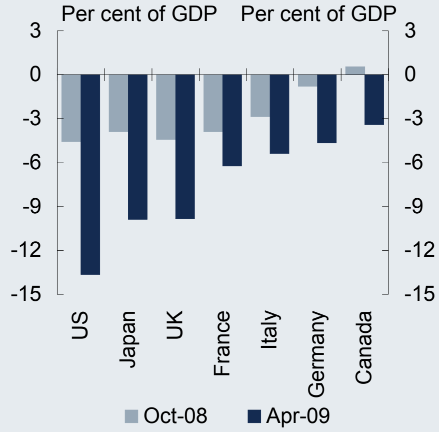
Policy responses have also focused on breaking the vicious cycle between financial market stresses and real economic activity.

Central banks have cut interest rates to record lows, and used a range of unconventional policy tools to support demand and ease credit market conditions, although the effectiveness of monetary policy has been hampered in some economies by problems in financial markets. The severity of the global recession has seen governments around the world implement substantial fiscal stimulus to boost growth and support jobs.

According to the IMF, the G-20 economies, as of late March 2009, had already announced fiscal stimulus worth 2 per cent of GDP in 2009 and 1½ per cent of GDP in 2010. This stimulus, as well as the operation of the automatic stabilisers, is expected to raise G-20 GDP by up to 3¼ percentage points in 2009.

Falling revenues, together with fiscal expansions, have resulted in worsening fiscal positions in major advanced economies (Chart A).

Chart A: Budget balance forecasts for 2009



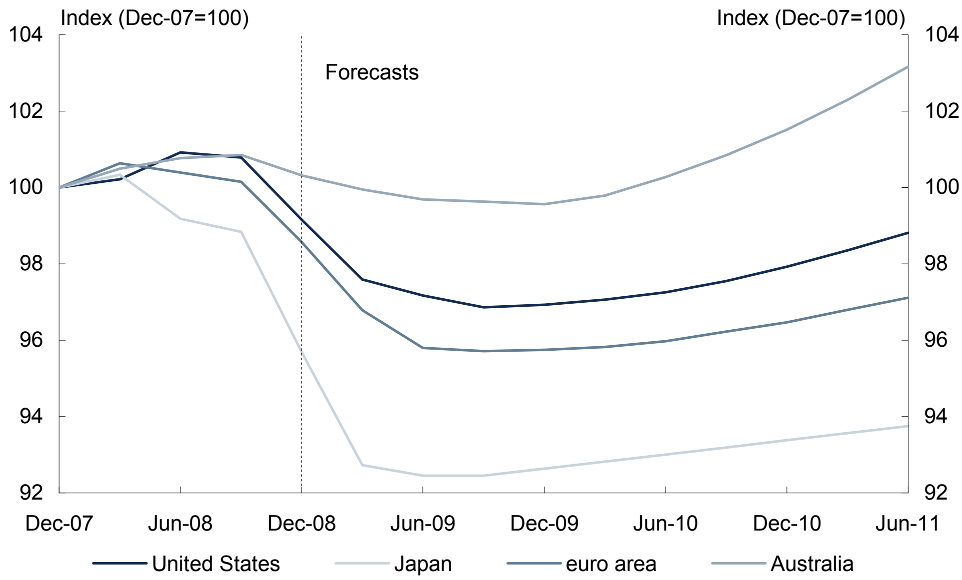
Source: IMF.

At the London Summit on 2 April 2009, G-20 Leaders committed to address decisively the problem of toxic assets, restore the stability of the financial system, and put in place credible exit strategies to ensure long-term fiscal sustainability and price stability.

Problems in accessing capital could further weaken economic activity in emerging economies. A key global response has been the G-20 Leaders' agreement to US$1.1 trillion of additional resources for the world economy through the international financial institutions and trade finance. These additional resources, together with enhanced and newly created facilities provided by the international financial institutions, are reducing the risk of damaging contagion.

Key to the recovery will be the restoration of confidence. Predicated on some degree of normality returning to the financial system by late 2009, the monetary and fiscal stimulus in the pipeline is expected to support a gradual recovery in the global economy in 2010. Notwithstanding this, output in the United States, the euro area and Japan — the three largest advanced economies — is still expected to be below pre-crisis levels by mid-2011 (Chart 3).

Chart 3: Level of GDP in major advanced economies



Note: US series includes the actual outturn for the March quarter 2009.
Source: National statistical publications and Treasury.

The economic outlook for the **United States** has deteriorated considerably since the beginning of the year, reflecting weaker economic conditions and ongoing stress in the financial system. The US economy is expected to contract by 3 per cent in 2009, before a modest recovery takes shape in 2010.

The labour market continues to worsen at a rapid pace, with around 6 million Americans joining the jobless queue since the beginning of the US recession. With rising unemployment, extremely tight credit conditions and plunging wealth, the outlook for consumption is bleak. The fiscal stimulus is expected to assist consumption in the second half of 2009. However, consumption growth is expected to be subdued in 2010 and 2011 relative to the pre-recession pace as household savings are rebuilt from historic lows.

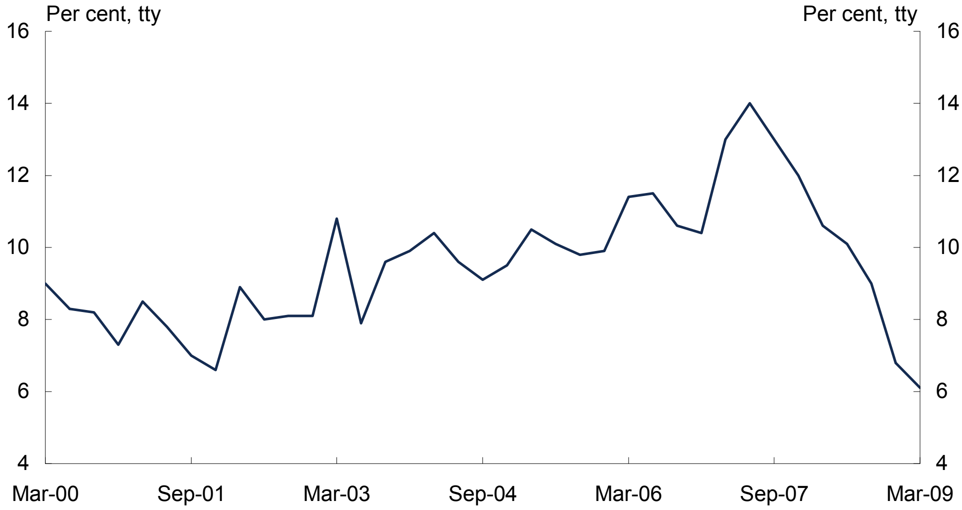
Given the depth of the GDP contraction and the tightness of credit, business investment, which had held up relatively well over most of 2008, has weakened sharply in recent quarters. The slump in the housing market continues, with the large oversupply of homes adding further downward pressure to house prices, which have already fallen by around 30 per cent from 2006 peaks, although there are signs that the rate of decline is slowing. A recovery in the housing sector is not expected until 2010.

While the US outlook is grim, the fiscal stimulus package provides some upside risk. Should financial market policies succeed in restoring trust and confidence, then the impact of the stimulus will be bolstered in 2010.

The **euro area** is expected to experience a severe recession in 2009. Investment is expected to detract most from growth, reflecting deteriorating credit conditions and falling global demand. Private consumption is expected to remain weak because of low confidence as well as falling employment and lower levels of wealth. Exports are expected to slump in line with sharply weaker global demand. A modest recovery is forecast for 2010.

China has been a key driver of global economic growth in recent years but its economy has now slowed dramatically (Chart 4), with 2009 GDP growth expected to be half its 2007 rate. The Chinese economy is expected to grow by 6¼ per cent in 2009, with a sharp slowing expected in its exports as a result of the severe slowdown in global demand.

Chart 4: GDP growth in China



Source: CEIC Data.

The RMB 4 trillion (around 15 per cent of 2007 GDP) fiscal package is already boosting public infrastructure investment and credit growth. The package includes both previously announced and new spending (around 6 per cent of GDP, according to the IMF). In line with this, industrial production has picked up. However, private investment will continue to be adversely affected by the widespread fall in export demand and a weak property market.

Though exports have slowed considerably, internal sources of growth should provide support to economic activity. With continued resilience in private consumption, and fiscal stimulus supporting growth from the second half of this year, China is likely to be the first major economy to recover from the global recession. Indeed, the recent GDP outcome for the March quarter suggests that the slowdown may already be bottoming out.

While a return to double-digit growth in 2010 and 2011 is unlikely given the expected tepid pace of the global recovery, growth of 8 per cent in 2010 and 8½ per cent in 2011 should see China contribute around 1 percentage point to annual world growth in both years, and help support the expected recovery in the Australian economy.

The economic outlook for **Japan** is bleak, with the economy set to experience a deep and protracted recession. In the December quarter 2008, Japan registered its largest quarterly GDP contraction since 1974. Industrial production is likely to continue to be undermined by falling corporate profits and business sentiment.

Exports, which in recent years have been an engine of growth, are expected to be a significant drag on the economy due to a strong yen and weak external demand. High unemployment and slower income growth have taken a toll on consumption, hampering the effectiveness of fiscal stimulus measures in restoring growth. Nevertheless, the recent announcement of a large economic stimulus package provides an upside risk to the forecasts.

The **Newly Industrialised Economies** (NIEs) are in the midst of a deep recession. Heavy dependence on exports and close financial integration with the rest of the world have made the NIEs extremely vulnerable. Exports have contracted at an extraordinary pace (Box 3), and industrial production has plummeted as firms run down inventories in response to the rapid fall in external and domestic demand. These economies are expected to contract by 4¾ per cent in 2009, a worse outcome than that recorded during the Asian Financial Crisis. The NIEs are expected to grow by 2¾ per cent next year.

Economic activity in the **ASEAN–5** region has weakened significantly in recent months, led by a collapse in exports. Elevated borrowing costs and disrupted access to funds also remain concerns. The Thai economy continues to be weighed down by political turmoil, with reduced tourism and foreign investment likely to hinder the recovery. While growth in Indonesia and Vietnam has slowed significantly, their growth in 2009 and 2010 is expected to be relatively stronger than the other economies.

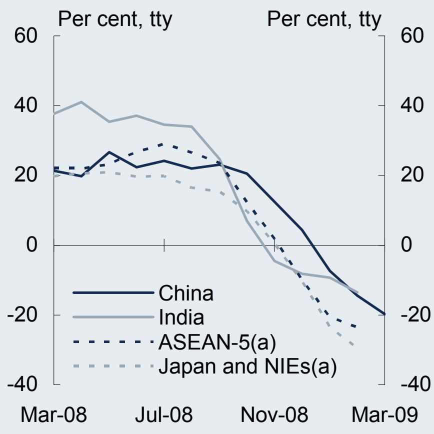
The **Indian** economy's recent strength is subsiding, with significantly weaker growth forecast over the next two years. Industrial production is declining at a rapid pace as the demand for manufacturing exports is drying up. The vibrant services sector, a major driver of economic growth in recent years, is unlikely to shield the economy from the corrosive impact of escalating job losses, shrinking foreign investment and deteriorating confidence.

Box 3: Asia's trade

Global trade is expected to shrink by 11 per cent in 2009, the first fall since 1982. If realised, this will be the sharpest fall in world trade in the post-war period, with Asia expected to account for most of the decline.

Exports from Asia have fallen sharply since September 2008 (Chart A). According to the IMF, merchandise exports in the region fell by 70 per cent in annualised terms between September 2008 and February 2009 — 1½ times worse than the 2001 global downturn and three times as bad as the Asian Financial Crisis.

Chart A: Export growth



(a) Calculated using export trade weights.
Note: Data are 3-month moving average.
Source: CEIC Data.

Three factors explain why the region's trade declines in recent months were worse than in past downturns. First, the speed and force of the recession drove world demand down to unprecedented lows. Second, the drop in global demand disrupted Asia's integrated web of trade linkages, production networks and supply chains. Third, as credit conditions deteriorated, access to trade finance became more difficult.

The current fall in trade appears more synchronised across Asia than in past recessions. This partly reflects growing trade interdependence in Asia. China's role as a hub for processing is critical, with the NIEs and ASEAN-5 economies reliant on sending their intermediate inputs to China for final assembly. Between September 2008 and February 2009, the IMF estimates that exports from the region to China fell at an annualised rate of 80 per cent.

As most manufactured exports from Asia ultimately end up in the US or Europe, exports are very susceptible to abrupt changes in discretionary spending in advanced economies. Recent falls in demand from advanced economies were quickly transmitted to final goods producers in China, and then to parts and components suppliers in the NIEs and ASEAN-5 economies.

Asia's heavy reliance on external demand will have a significant impact on Australian exports, over 60 per cent of which are to Asia. This, coupled with the sharp fall in commodity prices, will have adverse effects on Australia's national income.

When the global economy recovers, the growth trajectory of Asia's trade could be lower for many years. Global demand will be weaker and there is a risk that trade protectionism may rise. The extent to which domestic demand can be built up, thus boosting the share of final demand met in the region, will also influence Asia's trade prospects.

The most significant downside risk to the world economic outlook is around the possibility of an intensification of the adverse feedback loop between the financial system and the real economy in advanced economies. The mutually reinforcing nature of faltering economic activity and tightening financial market conditions is already apparent, with the ferocity of the global recession adding to, and being augmented by, the ongoing distress in the financial system. This feedback loop could become even more debilitating, and hamper production, trade and employment in hitherto unaffected regions and industries. If the current influenza outbreak were to worsen, this could negatively affect already fragile confidence in international financial markets.

Capital scarcity in emerging economies represents another key risk to the world outlook. Net capital flows to emerging markets have fallen to a fraction of their pre-crisis levels, and for these economies, problems in rolling over loans could further weaken economic activity and dent fragile confidence. A prolonged slump in global demand remains the key downside risk to the outlook for Australia's major trading partners in Asia.

On the other hand, should the substantial policy measures already in the pipeline restore stability in financial markets earlier than anticipated and boost consumer and business confidence, then the substantial global macroeconomic stimulus could present upside risks to the growth forecasts.

Even when growth returns, the recession will leave a legacy of significant policy challenges across the world. The extraordinary measures being taken to combat the current crisis will have to be unwound carefully.

As households and firms continue to repair their balance sheets, domestic demand in many advanced economies, including the US, will grow at a slower pace than in the recent past. This in turn could lead to excess capacity in export-oriented manufacturing in emerging economies, restraining investment and creating a strong premium on policy settings that support private consumption.

The global output gap will continue to widen into 2010, and deflationary forces will continue to mount. However, the substantial monetary and fiscal policy responses will act to limit the risk of substantial deflation becoming entrenched. Unemployment, already rising sharply, will remain high beyond 2010. With double-digit unemployment rates and markedly weaker fiscal positions in many economies, there is a risk that protectionist tendencies will surface.

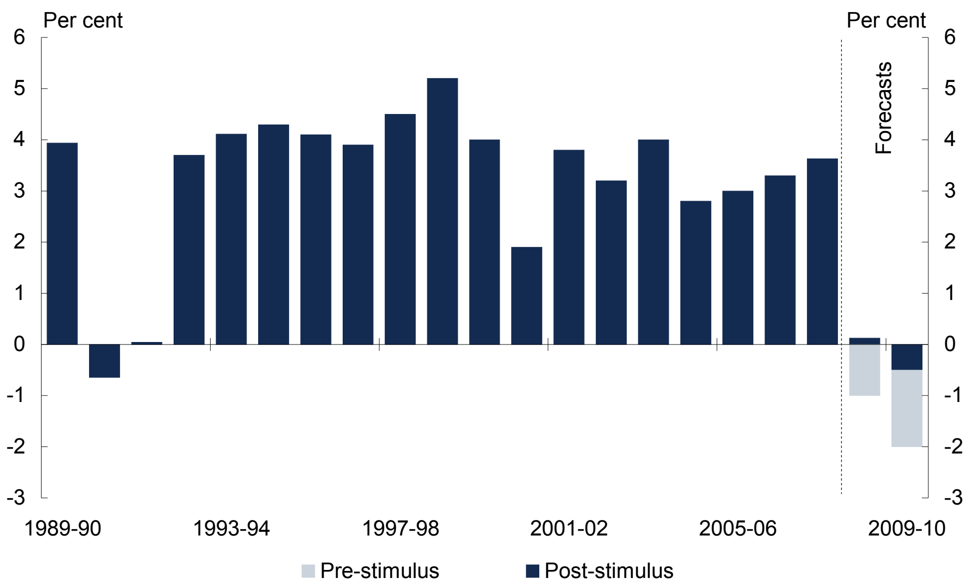
THE OUTLOOK FOR THE DOMESTIC ECONOMY

Demand and output

The magnitude of the global recession and the speed with which it has hit means that a recession in Australia has become inevitable. Strong and rapid policy action by the Australian Government and the Reserve Bank of Australia is helping to reduce the impact of the global recession on the domestic economy but cannot completely offset its effects. Real GDP is forecast to contract by ½ of a per cent in 2009-10. This is a much milder contraction than expected in other advanced economies, where output as a whole is expected to fall by 3¾ per cent in 2009. The downturn in the domestic economy is expected to be led by a contraction in business investment and exports.

With private demand contracting, the public sector is providing support through a combination of measures directed towards private consumption, and dwelling and business investment. Government stimulus packages are expected to lead to the largest rise in public investment on record in 2009-10, making a significant contribution to growth. In the absence of government action, the contraction in domestic activity would be much deeper (Chart 5). In total, the Government's stimulus is expected to raise the level of GDP by 2¾ per cent in 2009-10 and 1½ per cent in 2010-11. The stimulus is expected to support up to 210,000 jobs and reduce the peak in the unemployment rate by 1½ percentage points from what it would otherwise have been.

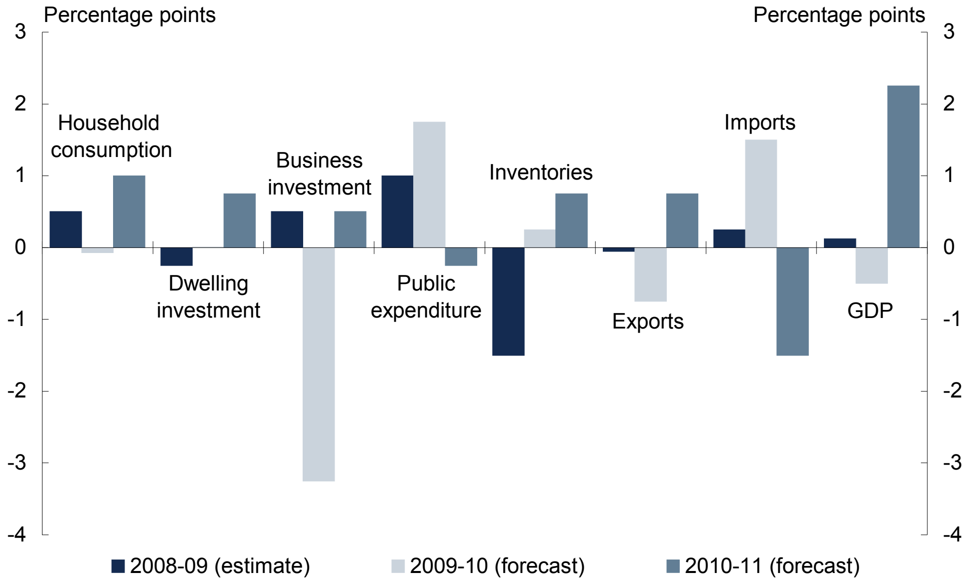
Chart 5: Real GDP growth pre- and post-stimulus



Note: Stimulus includes the Economic Security Strategy; November COAG reforms; Regional and Local Community Infrastructure Program; December Nation Building Package; Nation Building and Jobs Plan; National Broadband Network; and the net effect of 2009-10 Budget measures.
Source: ABS cat. no. 5206.0 and Treasury.

The 2009-10 Budget includes an additional forecast year which shows the likely recovery path of the economy as it emerges from recession (Box 4). The economy is expected to enter a gradual recovery in early 2010 as global conditions stabilise. The recovery in 2010-11 is expected to be led by solid growth in dwelling investment and strengthening export growth as global demand gradually recovers (Chart 6). At 2¼ per cent, growth in 2010-11 is nevertheless expected to remain below trend, with household consumption remaining subdued and business investment recovering only gradually, given excess capacity. While public final demand will remain at a high level, its growth will slow as a consequence of the temporary nature of the stimulus.

Chart 6: Contributions to GDP growth(a)



(a) Adjusted for second-hand asset sales from the public sector to the private sector.
Source: ABS cat. no. 5206.0 and Treasury.

Household consumption

After slowing sharply in 2008-09, household consumption is expected to contract by ¼ of a per cent in 2009-10. This is a mild fall given the substantial headwinds being faced by the household sector, and significantly less than that being experienced by most other advanced economies. While the household sector has been buffeted by a series of negative shocks stemming from the global recession, government stimulus packages are providing considerable support to household consumption. In the absence of this action, the contraction would be much more severe.

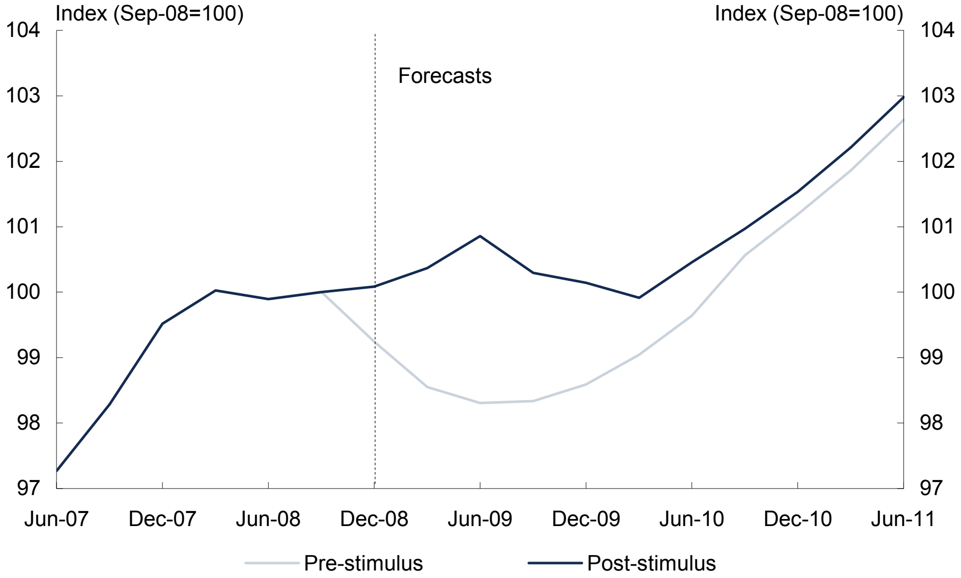
Households have benefited from a period of strong capital gains over recent years, driven in part by the mining boom, providing a substantial boost to household wealth and consumption. Sharp falls in global share markets, coupled with recent moderate falls in domestic house prices, have substantially eroded these gains. Household net financial wealth has fallen by a third over 2008 and, despite recent gains, share markets are still around 45 per cent lower than the peak in late 2007.

Ongoing uncertainty about the effect of the global recession, together with the prospect of rising unemployment, continues to affect consumer confidence. Households are paying down debt and rebuilding their savings. A stronger household financial position will help bolster confidence and lead to a more rapid recovery in household consumption.

A large amount of policy stimulus is helping to support household consumption. The Economic Security Strategy and the Nation Building and Jobs Plan will collectively add $19.7 billion to household incomes, and the pension increase announced in the 2009-10 Budget will also add significantly to household incomes and help support consumption. These stimulus payments are expected to support a higher level of consumption over the forecast period, with the bulk of this support coming in 2009, when the economy is at its weakest (Chart 7). This stimulus is estimated to add 1¼ per cent to the level of household consumption in 2008-09 and 2009-10. In the absence of this stimulus, household consumption would have contracted sharply, as it has in other countries. Mortgage interest rates have also been cut to their lowest level in more than 40 years, substantially raising household disposable income.

There is already evidence that the payments made under the Economic Security Strategy have provided a significant boost to household consumption. The level of retail trade in March 2009 was 4.5 per cent higher than prior to these payments, and retail sector employment rose in February 2009, for the first time in over a year (Box 5).

Chart 7: Stimulus effect on household consumption



Source: ABS cat. no. 5206.0 and Treasury.

Box 4: Updated methodology for forward estimates

The fiscal aggregates in the budget are underpinned by a set of forward estimates consisting of short-term economic forecasts and projections based on medium-term assumptions. These estimates provide the base from which to frame the budget and develop sound, forward-looking economic policy.

Since the mid-1990s, the budget has been based on forecasts for the current and budget year and an assumption that the economy grows at its long-run trend rate over the three-year projection period. This approach was suitable during a period of stable growth when the economy did not deviate far from trend, but is not appropriate in the current circumstances.

The magnitude of the global recession means that the Australian economy is expected to be operating below trend in 2008-09 and over the next two years, pushing the unemployment rate well above its longer-term sustainable rate (or NAIRU). Maintaining the previous approach would unrealistically lock into the projections a level of GDP significantly below potential, and does not provide a credible view of the likely growth path of the economy as it emerges from recession. As a result, this approach would provide a misleading picture of revenue and expenditure estimates.

In order to better inform Australians about the likely growth path of the economy, two substantive changes have been made to the forward estimates methodology in this Budget.

The forecast period has been extended by one year to 2010-11, when the economy is expected to grow below trend. Further, GDP is assumed to grow above (rather than at) trend in the projection years. Both of these changes are broadly based on the historical experience of the economy as it emerged from the 1980s and 1990s recessions.

Extending the forecasts to 2010-11 better reflects the expected growth path of the economy, notwithstanding the difficulties involved in forecasting that far in the future. Given the nature and severity of the global recession, the current downturn in the Australian economy is therefore expected to extend to three years of below-trend growth, compared with one year for the 1980s recession and two years for the 1990s recession (Chart A).

This period of below-trend growth will result in substantial spare capacity becoming available, and the economy is assumed to grow above trend in the projection period as this spare capacity is brought into use. Strong business investment in the period leading up to the recession has resulted in a substantial build-up in capacity, particularly in mining production and transport infrastructure. This will enable resource exports to respond quickly as global demand recovers, supporting GDP growth.

Real GDP is assumed to grow by 4½ per cent per annum in the projection period, above the medium-term trend rate of 3 per cent.

Box 4: Updated methodology for forward estimates (continued)

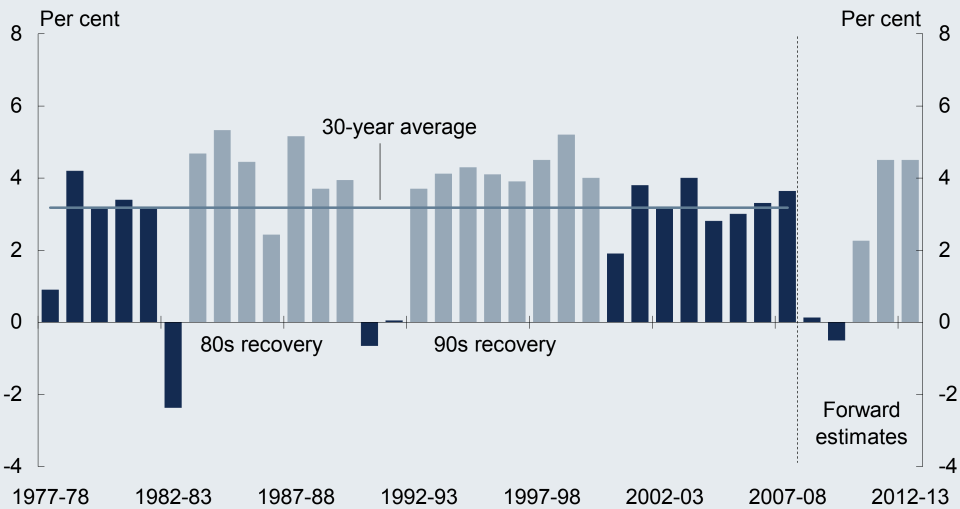
Growth over the first three years of the forecast recovery averages 3¾ per cent. This compares with an average of 4.8 per cent after the 1980s recession and 4 per cent after the 1990s recession (Chart A).

This period of above-trend growth has the effect of bringing down the unemployment rate by 1 percentage point in each year of the projections, reaching 6½ per cent by the end of the forward estimates. Again, after peaking in the 1980s and 1990s recessions, the unemployment rate declined by around 2 percentage points over the following two years.

This approach is also in line with that taken in budgets in the early 1990s, when above-trend rates of growth were assumed as the economy recovered from recession.

This approach is also similar to what is being done in other OECD countries, including the United States, the United Kingdom, New Zealand and Sweden.

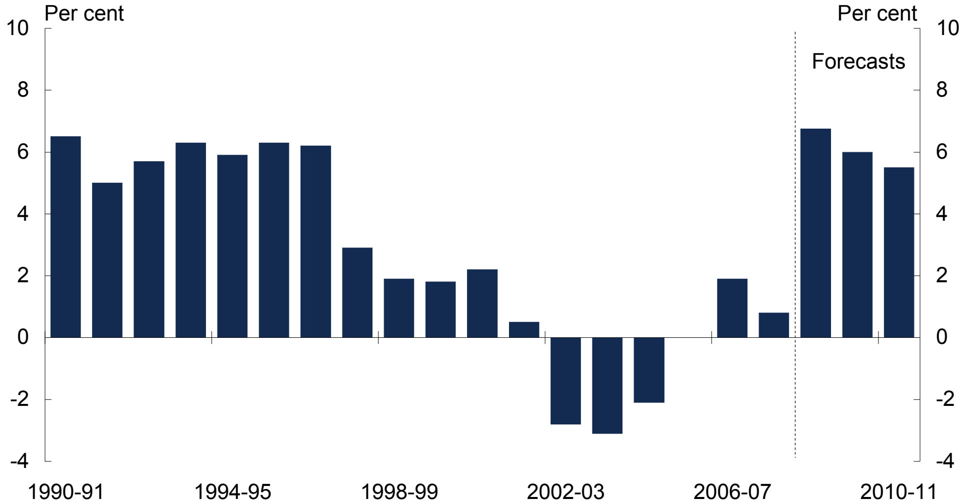
Chart A: Real GDP



Source: ABS cat. no. 5206.0 and Treasury.

Household consumption growth is forecast to strengthen to a still below-trend 1¾ per cent in 2010-11. With large falls in household wealth and slower income growth, coupled with still rising unemployment, household consumption is likely to be subdued for some time to come. As households rebuild their balance sheets, this will facilitate a recovery in household consumption. The household saving ratio is expected to average 6¾ per cent in 2008-09 and remain at a high level over the forecast period (Chart 8).

Chart 8: Household saving ratio



Source: ABS cat. no. 5206.0 and Treasury.

Dwelling investment

The near-term outlook for dwelling investment continues to be dominated by low levels of household confidence and persistent funding difficulties for medium-density dwellings. As a result, dwelling investment is expected to remain flat in 2009-10 before staging a solid recovery in 2010-11 with growth of 11½ per cent (Chart 9).

Building approvals were persistently weak over the second half of 2008, with large falls in approvals for both houses and medium-density dwellings. Total approvals remain more than 15 per cent lower than a year ago. Given the normal lags between approvals and building commencements, this means that overall activity in the sector is likely to be subdued until late 2009. New dwelling investment is expected to contract over 2009 but this will be partly offset by support coming from alterations and additions activity flowing from the Government's Energy Efficient Homes program.

Following this near-term weakness, activity in the sector is expected to be supported by firm population growth, the effects of the substantial easing in monetary policy and continued solid rental yields helping to encourage investors back into the market. The Government's First Home Owners Boost has contributed to a significant increase in demand by first home buyers, and thereby supported dwelling prices and auction clearance rates at the lower end of the housing market. Loans to first home buyers have risen sharply to the highest level as a proportion of the market since 1991. This demand is expected to continue to flow through to increased investment in new dwellings, and the extension of the First Home Owners Boost is expected to support activity over the year.

Box 5: The success of stimulus to date

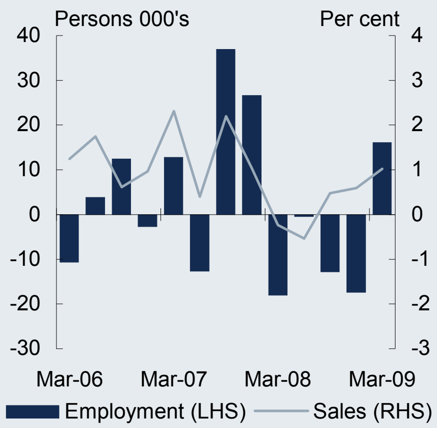
The Government's Economic Security Strategy (ESS) provided more than $8 billion in targeted stimulus payments to households in December 2008, and additional assistance to first home buyers. This stimulus was designed to support domestic demand and employment in the Australian economy. Further stimulus has been made under the Nation Building and Jobs Plan, and while there are early signs this is having an impact on activity, the full impact is yet to be felt.

Whilst it is not possible to measure precisely the actual impact of the ESS, a range of economic data suggest that the package has supported retail spending, employment and consumer confidence, and has stimulated activity in the housing sector.

Retail trade turnover was showing significant weakness prior to the ESS, having grown at an average monthly rate of 0.2 per cent in the previous year. Following the stimulus package, retail trade grew by 3.8 per cent in the month of December 2008, the largest rise in over eight years and the fourth highest in the 27-year history of the series. This positive outcome was followed by a rise in retail trade employment over the three months to February, the first rise since November 2007 (Chart A).

March 2009 data show that retail trade remains 4.5 per cent above its pre-stimulus level of November 2008, with Treasury's Business Liaison Program indicating that the stimulus had a substantial impact on retail trade during the post-Christmas sales period. This compares to falls in retail turnover in other parts of the world. In countries such as the United States, Japan, Canada and Germany, retail turnover is around 2 to 3 per cent lower.

Chart A: Retail sales and retail employment (qoq)



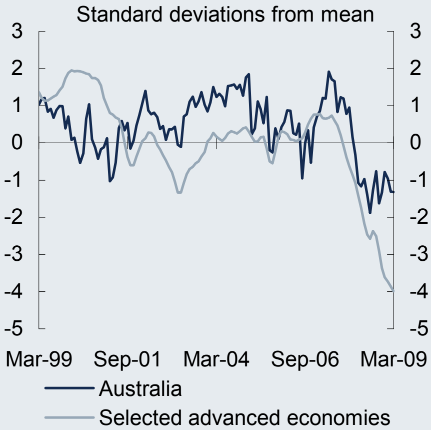
Note: Retail sales is a chain volume measure. Employment data are mid-month of quarter.
Source: ABS cat. no. 8501.0 and 6291.0.55.003.

As well as retail sales, consumer confidence has held up better than in many other countries, where confidence fell to record lows in the March quarter 2009 (Chart B). In Australia, consumer confidence has held up since the stimulus, and was 13 per cent higher in April 2009 than its October 2008 level, as measured by the Westpac — Melbourne Institute Index of Consumer Sentiment.

Box 5: The success of stimulus to date (continued)

Consumer confidence across the OECD is at around the lowest level in the 31-year history of the series. In the first few months of 2009, consumer confidence fell to 42-year lows in the US and 35-year lows in the UK, and to the lowest level since records began in 1985 in the euro area.

Chart B: Consumer confidence — Australia and international

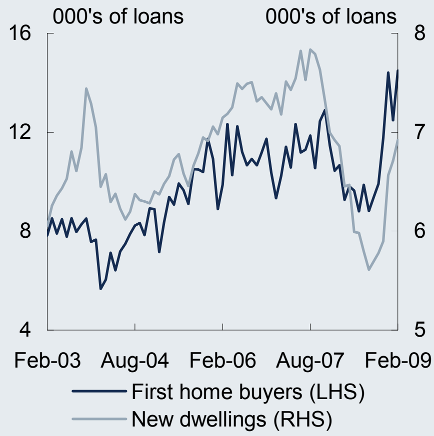


Note: Selected advanced economies is a GDP PPP weighted average of US, UK, Japan and euro area.
Source: Westpac — Melbourne Institute, OECD, IMF and Treasury.

The First Home Owners Boost has spurred activity in the housing sector since it was introduced in October 2008. Since then, housing finance for owner-occupiers has grown strongly, with the number of loans to owner-occupiers rising for the fifth consecutive month in February 2009, after falling in each of the eight months prior to the introduction of the policy.

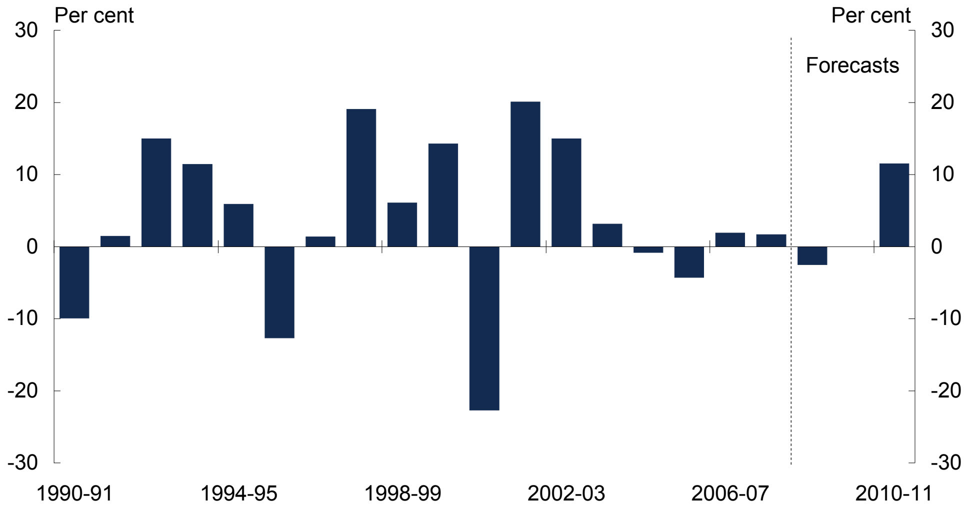
Activity has been buoyed by an increase in first home buyers. In February 2009, the number of loans to first home buyers was the highest since the series began in 1991, while finance for new dwellings — a key indicator of residential construction activity — has also grown strongly in recent months (Chart C).

Chart C: Housing finance



Note: First home buyers data are original. New dwellings data are seasonally adjusted.
Source: ABS cat. no. 5609.0.

Chart 9: Growth in dwelling investment



Source: ABS cat. no. 5206.0 and Treasury.

Business investment

The value of business investment had risen to a four-decade high as a share of GDP by the end of 2008, driven by rapid growth over the previous few years associated with the mining boom. Since then, the collapse in global and domestic demand, and lower commodity prices and profits stemming from the global recession, have reduced the impetus for business investment.

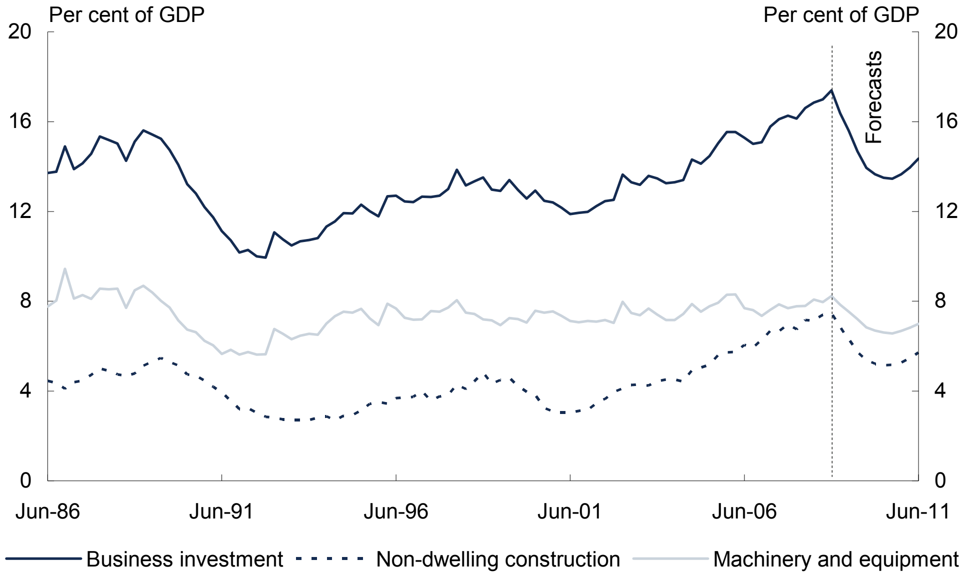
Business investment is expected to fall swiftly to pre-commodity boom levels as a share of GDP (Chart 10). Reflecting the deteriorating outlook, business sentiment has weakened further in recent months and business surveys consistently show sharply weaker investment intentions. Total new business investment is expected to fall by 18½ per cent in 2009-10, before stabilising in 2010-11 with growth of 3½ per cent. The Government is providing investment incentives through the Small Business and General Business Tax Break, and the Australian Business Investment Partnership will also help to support investment by providing liquidity support to the commercial property sector.

Investment in new machinery and equipment is forecast to contract by 16½ per cent in 2009-10 as firms cut back on discretionary spending in the face of lower global and domestic demand and a weaker profits outlook. A modest recovery is expected in 2010-11, with growth of 4 per cent, in line with the gradual strengthening in global and domestic demand. Recent data from the Australian Bureau of Statistics *Survey of Private New Capital Expenditure and Expected Expenditure* (CAPEX) indicate particular weakness in investment intentions for 2009-10 in the manufacturing, construction and property and business services sectors.

Total new non-dwelling construction is forecast to fall by 26 per cent in 2009-10, led by a fall of almost 40 per cent in non-residential building construction, in line with the substantial fall in building approvals for this sector.

Engineering construction is also expected to contract in 2009-10, albeit not as severely as non-residential construction. Weaker global and domestic demand, and a substantial decline in commodity prices, has eroded much of the momentum of engineering construction investment, and some projects have been postponed or cancelled in light of softer demand and funding constraints. Engineering construction is expected to lead the business investment recovery in 2010-11, with a number of high value resource projects scheduled to commence work in that year. There are considerable risks around the engineering investment outlook given the possibility of delays or cancellations in light of reduced demand and significantly lower commodity prices.

Chart 10: New business investment as a share of nominal GDP

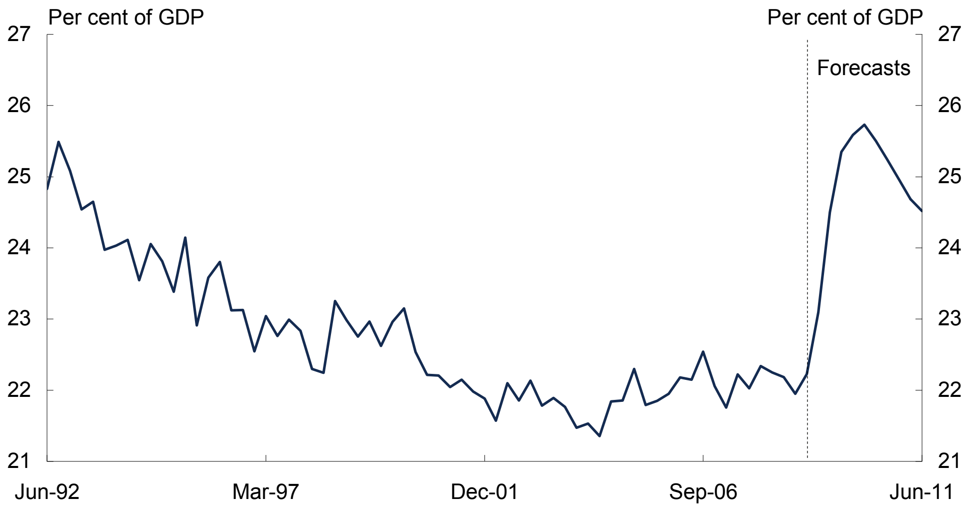


Note: Adjusted for second-hand asset sales from the public sector to the private sector.
Source: ABS cat. no. 5206.0 and Treasury.

Public final demand

As private demand slows in the face of the global recession, public demand is helping to fill the gap and moderate the severity of the downturn. Public final demand is expected to grow by 7¾ per cent in 2009-10, remaining at a high level through 2010-11 (Chart 11).

Chart 11: Public final demand as a share of nominal GDP



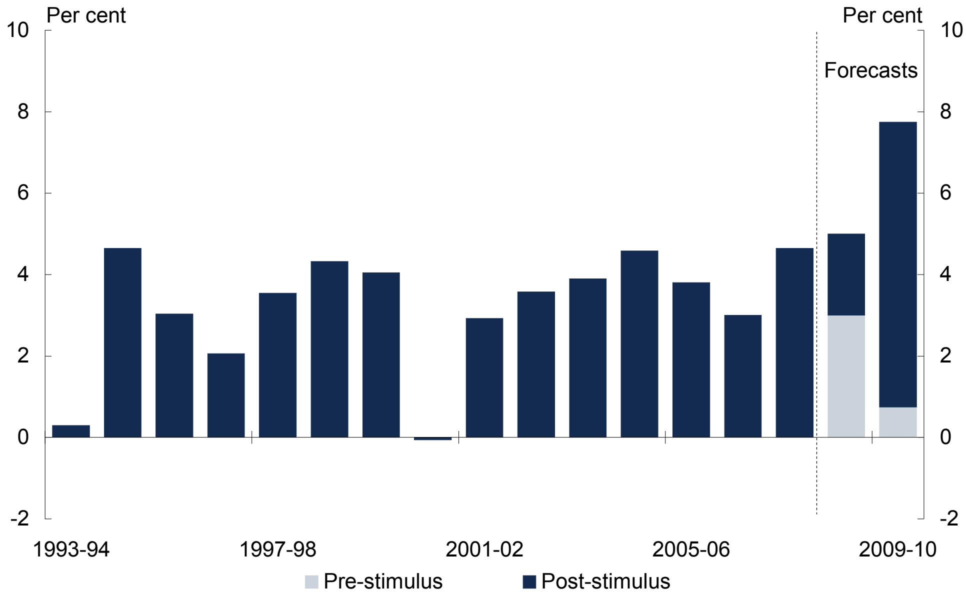
Source: ABS cat. no. 5206.0 and Treasury.

Strong growth in public final expenditure over the forecast period is driven by public investment flowing from the Government's economic stimulus packages (Chart 12). This includes the infrastructure funding announced in the 2009-10 Budget, the February 2009 Nation Building and Jobs Plan and other financial packages including the November 2008 Council of Australian Governments reforms and the December 2008 Nation Building package. This is on top of already high levels of state and local investment. These funding packages represent a significant boost to total public investment and are expected to see public investment rise by 25 per cent in 2009-10, the largest annual increase on record. The increase in government investment will help to cushion the effects of the global recession, support jobs and bolster Australia's long-term productive capacity.

The successful implementation of these spending programs in a timely manner is critical to the economic outlook. Public final demand is one of the few sectors expected to make a positive contribution to economic growth in 2009-10. The Commonwealth and State and local governments have put in place extensive arrangements to ensure that the programs are delivered on schedule. To manage risks and avoid slippage in implementation, a Commonwealth Coordinator-General has been appointed to oversee and coordinate the delivery of the Nation Building and Jobs Plan, and national coordinators have been appointed for each program area. This management structure is mirrored in each of the States and Territories.

Public final demand will remain at a high level in 2010-11, although its growth will slow as a consequence of the temporary nature of the stimulus.

Chart 12: Public final demand pre- and post-stimulus



Source: ABS cat. no. 5206.0 and Treasury.

Exports and imports

In line with the collapse in world trade resulting from the global recession, Australia's exports are expected to fall significantly in 2009-10. The sharp deterioration in the growth prospects of our major trading partners is expected to result in a loss of $50 billion in export income in that year. Exports of elaborately transformed manufactures, non-rural commodities and services are expected to decline rapidly, with some support coming from a continued recovery in rural exports. As global demand gradually strengthens, non-rural commodity exports are expected to lead the recovery in 2010-11. Overall exports are forecast to fall by 4 per cent in 2009-10, before rising by 4½ per cent in 2010-11.

While the collapse in world trade will lead to a decline in Australia's exports, the relatively low intensity of manufacturing in Australia's exports means that this decline will be less severe than in other advanced economies (Chart 13).

Rural exports are expected to increase solidly in 2008-09 and continue this recovery in 2009-10 with growth of 5½ per cent. Farm production in 2008-09 rose solidly owing to favourable seasonal conditions, which will flow through to increased rural exports. Farm production is expected to return to around pre-drought levels in 2009-10 and remain there over 2010-11 in line with an assumed return to average seasonal conditions.

Non-rural commodity exports are forecast to decline by 5 per cent in 2009-10. The global recession has resulted in a sudden and dramatic collapse in global demand for steel and raw materials. Industrial production has plummeted. Weaker demand has been reflected in lower commodity prices, with prices for key bulk commodities falling sharply from the historical highs in 2008-09. Global demand is expected to strengthen in 2010-11 underpinning a solid increase in exports of non-rural commodities of 7 per cent. Strong investment over the past few years in mining production and transport infrastructure has resulted in significantly increased capacity, which will enable resource exports to respond quickly as global demand recovers.

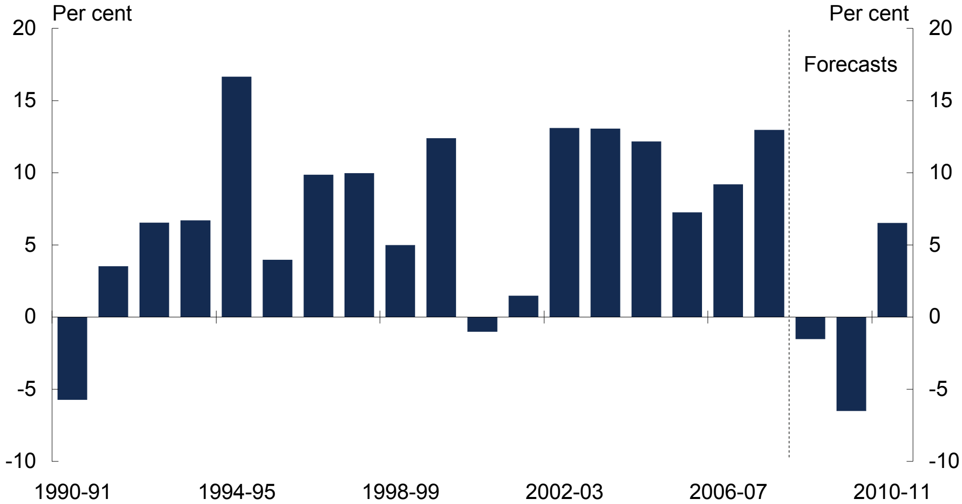
Chart 13: Growth in international and Australian export volumes

Source: ABS cat. no. 5302.0, IMF and Treasury.

Exports of elaborately transformed manufactures and services have borne the brunt of the downturn in demand from the global recession, which has outweighed any boost from the lower exchange rate. Exports of elaborately transformed manufactures are forecast to contract by 7½ per cent in 2009-10, driven particularly by the collapse in demand for motor vehicles that has seen sales plummet worldwide. Exports of services are forecast to fall by 4½ per cent as global demand for tourism, transportation and communications services also contracts.

Import volumes are forecast to contract by 6½ per cent in 2009-10, driven by the weaker outlook for domestic demand and the depreciation of the Australian dollar increasing prices of imported goods. The fall in imports is expected to be broad-based, but is led by a sharp fall in capital goods, reflecting the contraction in business investment which has a high imported component. Imports are forecast to rise solidly in 2010-11 as the recovery in the domestic economy flows through to a pick up in demand (Chart 14).

Chart 14: Growth in import volumes



Source: ABS cat. no. 5302.0 and Treasury.

Terms of trade

The large price rises over several years for Australia's key bulk commodities saw Australia's terms of trade reach a six-decade high in the September quarter 2008. Since then, the collapse in global demand stemming from the global recession, and the dramatic slowdown in growth in China, has seen prices fall sharply. This is expected to result in a decline in the terms of trade of 13¼ per cent in 2009-10, a slightly larger fall than forecast at UEFO. Even after this fall, the terms of trade would remain around 45 per cent higher than the average in the decade prior to the commodity boom, although downside risks remain. Just as the rising terms of trade drove increases in nominal GDP, national income and business investment in recent years, the unwinding of the mining boom is expected to result in falling nominal GDP in 2009-10 (Box 6). Further falls in the terms of trade would lead to more significant declines in nominal GDP, flowing through to national income.

Global commodity prices remain subdued, with spot prices for iron ore and coal well below 2008-09 contract prices (Chart 15). Consistent with the terms of trade forecast at the Mid-Year Economic and Fiscal Outlook and UEFO, benchmark thermal coal contract prices in $US have fallen by 44 per cent, while metallurgical coal contract prices have settled around 60 per cent lower. While benchmark iron ore contract prices are yet to be agreed, large falls in iron ore export prices are anticipated. Prices are likely to remain weaker than in recent years until global growth, and particularly demand from China, starts to recover.

Box 6: Unwinding of the mining boom

After rising rapidly over the past six years to a six-decade high, Australia's terms of trade are being hit hard by the global recession. Growth in China has slowed sharply, and commodity prices have fallen. Just as nominal GDP and national income rose with the strong gains in the terms of trade in recent years, nominal GDP and profits are expected to fall in 2009-10, partially reflecting the winding back of the terms of trade.

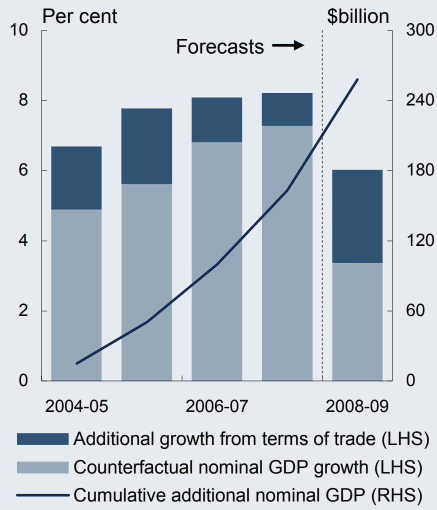
Industrial production across both developed and developing countries has slowed, particularly in our key markets of China, Japan and Korea, and this has seen demand for bulk commodities slow significantly, resulting in sharply lower prices.

Benchmark thermal coal contract prices in $US have fallen by 44 per cent, while metallurgical coal contract prices have settled around 60 per cent lower. While benchmark iron ore contract prices are yet to be agreed, large falls in iron ore export prices are anticipated.

Rapid growth in the terms of trade since 2003-04 has provided a significant boost to nominal incomes in recent years, but the forecast fall in 2009-10 means the terms of trade are now expected to detract from nominal incomes growth.

Quantifying this impact on nominal GDP depends on how the economy would have evolved in the absence of the terms of trade effects. The simplest approach is to recalculate nominal GDP holding the terms of trade constant at the 2003-04 level. This captures the direct effect of higher export prices on nominal GDP. Over the five years to 2008-09, the cumulative increase in nominal GDP is around $260 billion (Chart A).

Chart A: Nominal GDP

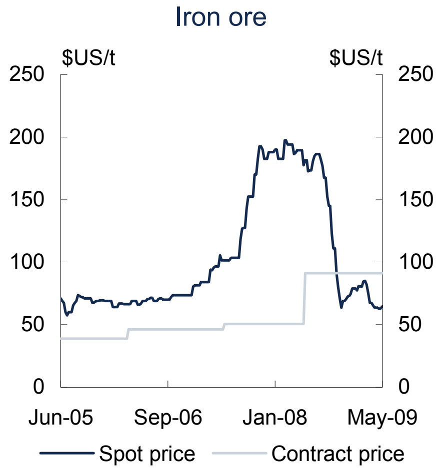


Source: ABS cat. no. 5206.0 and Treasury.

The forecast fall in the terms of trade in 2009-10 will unwind some of these gains. The 13¼ per cent fall in the terms of trade is expected to wipe off roughly 3 percentage points from nominal GDP growth in 2009-10, or around $35 billion.

Even after the sharp fall expected in 2009-10, the terms of trade would remain around 45 per cent higher than the average in the decade prior to the commodity boom.

Chart 15: Bulk commodity prices



Note: Iron ore spot price is cost and freight for India/China imports.
Source: Bloomberg, Global Coal and ABARE.

Current account balance

The current account deficit narrowed to a seven-year low of 2.2 per cent of GDP at the end of 2008, driven by a trade surplus. The current account deficit is forecast to widen over 2009-10 and 2010-11, as the trade account moves back into deficit with commodity prices falling. The net income deficit is expected to remain relatively stable. The current account deficit is expected to average 5¼ per cent of GDP in 2009-10 and 5¾ per cent of GDP in 2010-11.

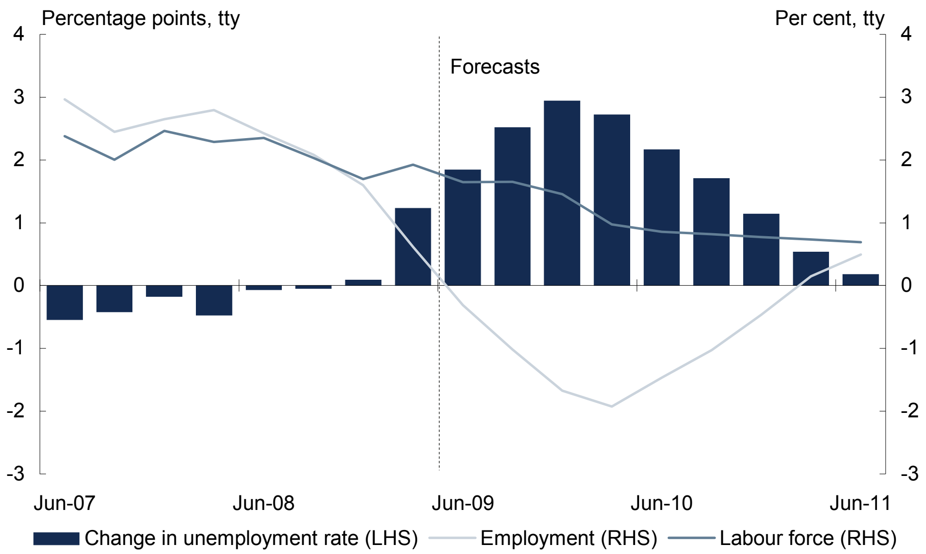
Labour market, wages and consumer prices

Labour market

The sharp slowdown in economic activity stemming from the global recession is expected to weigh heavily on demand for labour over the forecast period. Employment is forecast to contract through to mid-2010, falling by 1½ per cent through to the June quarter in that year, resulting in a rise in the unemployment rate to 8¼ per cent by that quarter, and a peak of 8½ per cent in the following year. The global recession has resulted in job losses in most countries, and many advanced economies are expected to record double-digit rates of unemployment.

Employment growth is expected to return gradually as the economic recovery begins, reaching ½ of a per cent through to the June quarter 2011. However, this gradual recovery in employment growth is not expected to be sufficient to absorb new entrants to the labour force and significantly reduce unemployment (Chart 16). As a result, while employment is expected to be increasing at this stage of the cycle, the unemployment rate is forecast to remain high (Box 7).

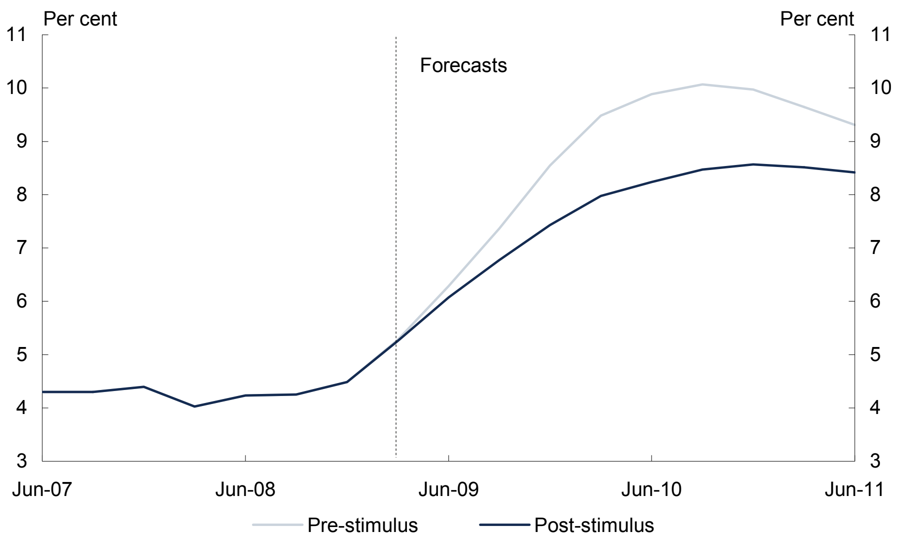
Chart 16: Employment growth, labour force growth and change in unemployment rate



Source: ABS cat. no. 6202.0 and Treasury.

The Government's stimulus packages will provide considerable support to economic activity, significantly raising the level of GDP from what would have been the case in the absence of this action. This in turn will support labour demand over the forecast period. The stimulus measures are estimated to reduce the forecast peak unemployment rate by 1½ percentage points. In the absence of policy action, the forecast unemployment rate would have reached 10 per cent (Chart 17).

Chart 17: Unemployment rate pre- and post-stimulus



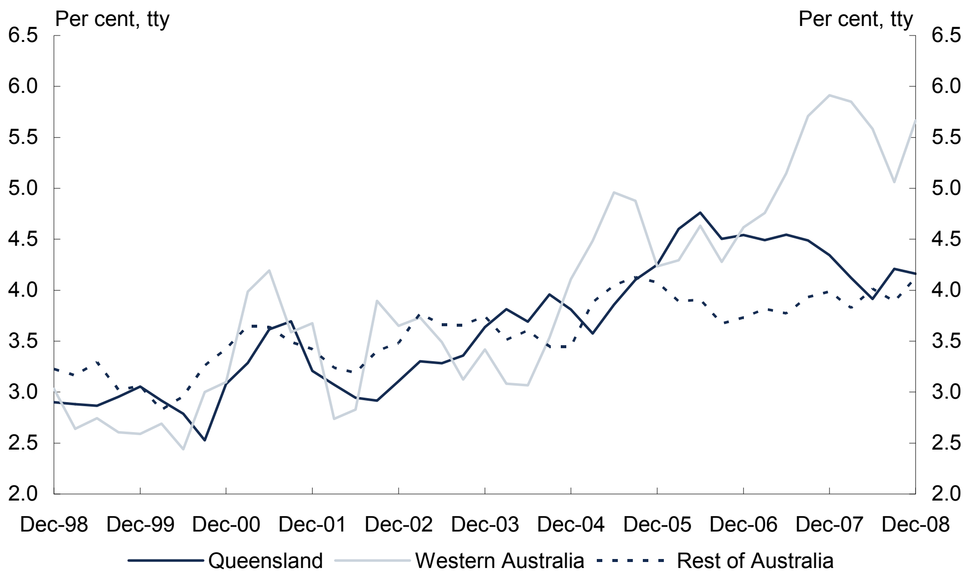
Source: ABS cat. no. 6202.0 and Treasury.

Wages

In line with the easing in labour market conditions, wages growth is expected to slow gradually. Growth in the Wage Price Index is forecast to moderate from 4¼ per cent through the year to the June quarter 2009 to 3¼ per cent through the year to the June quarters of both 2010 and 2011.

The moderation in wages growth is expected to be broad-based across the States and Territories. Wages growth has been strongest in those States most affected by the mining boom, with Queensland and Western Australia recording rates of growth well above the national average in recent years (Chart 18). Wage pressures in these States are expected to ease significantly across the forecast period, consistent with a significant easing in mining production and related investment activity as global and domestic demand slows.

Chart 18: Growth in the Wage Price Index



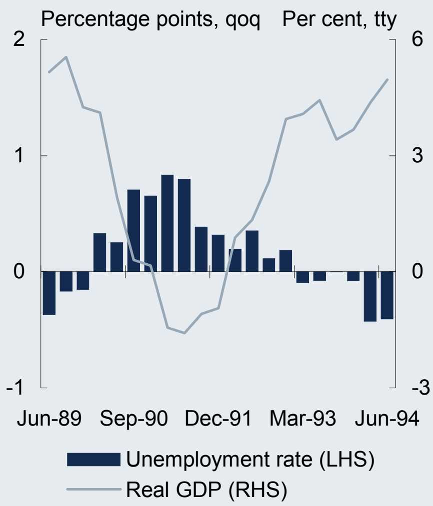
Source: ABS cat. no. 6345.0.

Box 7: The outlook for employment

Although the economy is forecast to begin to recover in 2010, the unemployment rate is not expected to peak until late 2010. This lagged response is consistent with historical experience. Econometric modelling suggests that movements in GDP affect employment growth between one and five quarters later, with the largest effects occurring after two quarters. The delay in part reflects employers' caution about taking on more staff until they see a sustained recovery in demand for their products.

A sustained period of above-trend GDP growth is typically required for the unemployment rate to fall, as was seen during the recovery from the 1990s recession. While the economy expanded through 1992, it was not until growth consistently exceeded trend growth that the unemployment rate began to decline (Chart A).

Chart A: GDP growth and changes in the unemployment rate in the 1990s recession

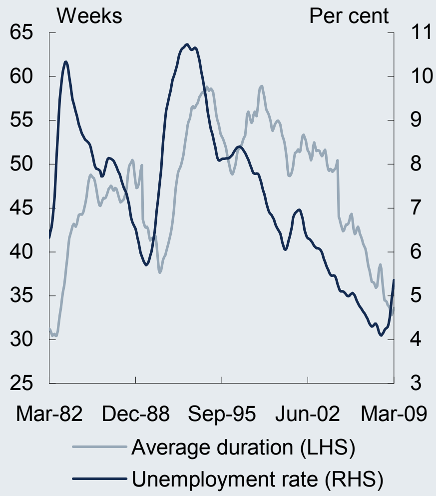


Source: ABS cat. no. 5206.0 and 6202.0.

While the unemployment rate fell relatively rapidly in the initial stages of past recoveries, attaining the pre-downturn low typically took much longer. This may partly reflect limits on how fast the economy can grow.

Although GDP can grow faster in the initial stage of a recovery when spare capacity is plentiful, growth subsequently tends to moderate as this spare capacity is employed. Moreover, the average duration of unemployment tends to increase during a downturn and continues to rise even after the unemployment rate begins to fall (Chart B).

Chart B: The unemployment rate and average duration of unemployment (trend)



Note: Average duration of unemployment since last full-time job.
Source: ABS cat. no. 6202.0, 6291.0.55.001 and Treasury.

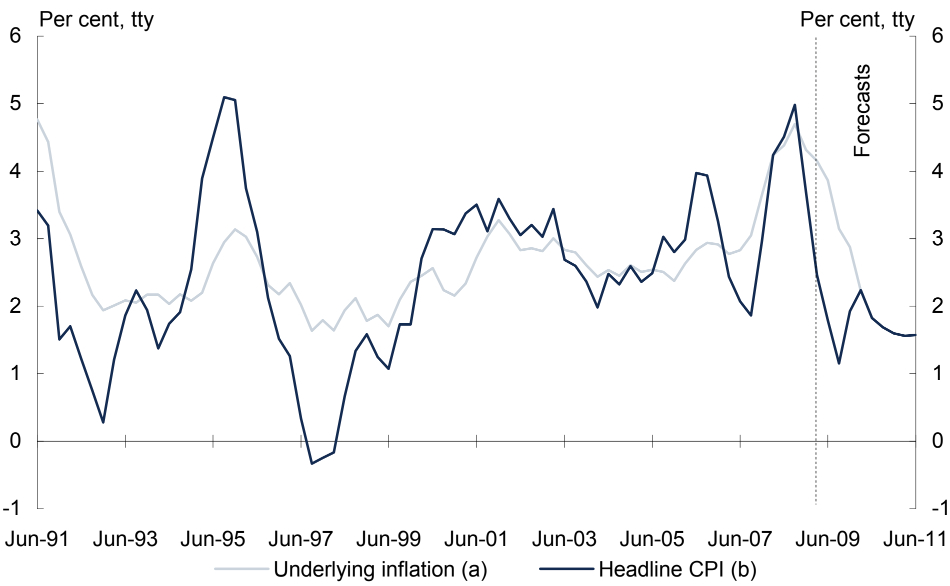
Consumer prices

Inflationary pressures have moderated significantly over the past year as the deepening global recession has lowered previous demand pressures. Growth in the Consumer Price Index (CPI) has fallen rapidly from a recent peak of 5.0 per cent to 2.5 per cent through the year to the March quarter 2009. Underlying inflation, which is less directly affected by falling oil prices and other one-off factors, has also eased from a peak of 4.7 per cent to 4.2 per cent through the year.

Price pressures are expected to ease further over the forecast period as the effects of the global recession continue to impact on the domestic economy. While underlying inflation is expected to remain elevated over the next few quarters, both headline and underlying inflation are expected to fall to 1¾ per cent through the year to the June quarter 2010 and 1½ per cent through the year to the June quarter 2011 (Chart 19).

These continued falls reflect the substantial spare capacity that is likely to exist in the global and domestic economies. Strong growth in nominal unit labour costs has contributed to upward pressure on prices over the past four years. These pressures are expected to moderate significantly over the forecast period as wages growth slows in line with easing labour market pressures.

Chart 19: Headline and underlying inflation



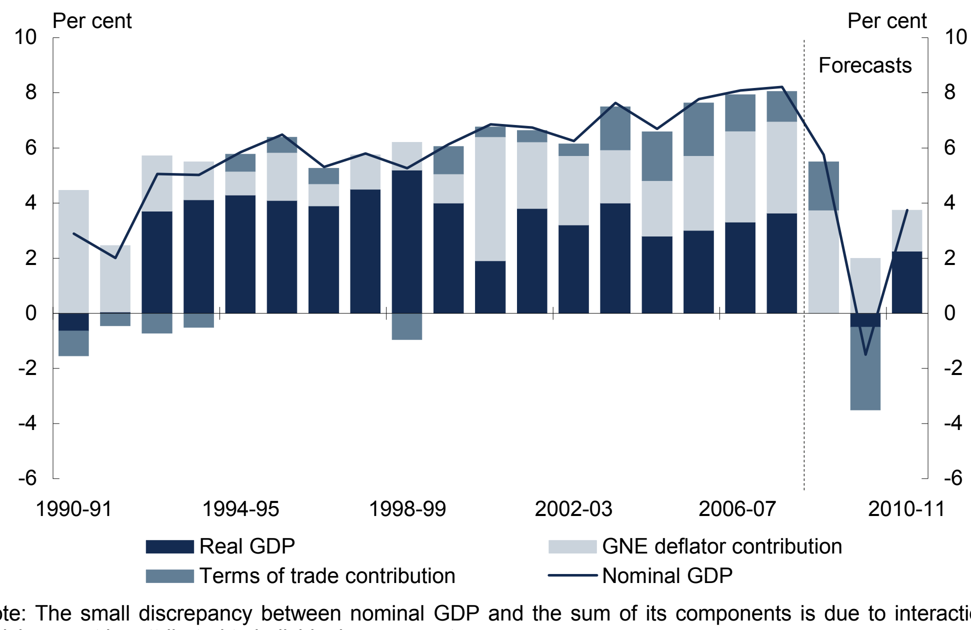
(a) The underlying inflation measure is the average of the RBA trimmed mean and weighted median.
(b) Adjusted for the effects of The New Tax System.
Source: ABS cat. no. 6401.0, Reserve Bank of Australia and Treasury.

Incomes

The commodity boom has supported large rises in the terms of trade and driven strong increases in real GDP as business investment and household consumption grew rapidly. This has led to rapid rates of growth in nominal GDP over recent years. The collapse in global demand, and the resulting sharp falls in commodity prices, has unwound much of this stimulus, and nominal GDP is expected to undergo a significant contraction in 2009-10, falling by 1½ per cent. Real GDP is expected to contract by ½ of a per cent, while prices, as measured by the non-farm GDP deflator, are forecast to fall by 1 per cent, reflecting the large fall in the terms of trade. Growth in nominal GDP in 2010-11 is forecast to strengthen to 3¾ per cent, remaining below trend in line with continued below-trend growth in both prices and the real economy (Chart 20).

The slowdown in nominal GDP growth is expected to be broadly distributed throughout the economy, with slower growth in compensation of employees, company gross operating surplus and gross mixed income. Compensation of employees reflects the total salary and wages paid to all employees. After rapid rates of growth in recent years driven by strong rises in both employment and wages, it is forecast to slow to 1½ per cent in 2009-10 as employment contracts and wages growth slows. Growth is expected to strengthen in 2010-11 as employment gradually recovers.

Chart 20: Decomposition of nominal GDP growth



Note: The small discrepancy between nominal GDP and the sum of its components is due to interactions which cannot be attributed to individual components.
Source: ABS cat. no. 5206.0 and Treasury.

Gross operating surplus is a broad measure of profits, and has been boosted in recent years by strong mining profits stemming from high non-rural commodity prices. Corporate profits are expected to fall by 11¼ per cent in 2009-10 as prices unwind and economic activity slows.

Gross mixed income, which includes profits of farm and unincorporated enterprises, is also expected to contract in 2009-10, albeit at a more moderate pace. This is driven by an expected fall in rural commodity prices, as well as reduced construction activity from the slowdown in dwelling and business investment.