The following is a reprint of Statement 3, Economic Outlook, from Budget Paper No. 1: Budget Strategy and Outlook 2002-03.

STATEMENT 3: ECONOMIC OUTLOOK

Australia is well positioned to be one of the world's top performing economies in 2002-03. Economic growth is expected to remain robust, driven by strong growth in business investment. Employment growth is forecast to strengthen, with the unemployment rate to decline to around 6 per cent by mid-2003. Inflation is expected to remain within the target band, with the current account deficit to remain moderate by historical standards. World growth is set to recover through 2002 and 2003, following the sharp slowdown in 2001.

Part I: Overview

In 2001–02, **economic growth** in Australia is forecast to be around 3¾ per cent in year-average terms, an upward revision to the 3 per cent growth forecast contained in the *Mid-Year Economic and Fiscal Outlook 2001-02*. In 2002-03, growth is forecast to again be 3¾ per cent in year-average terms and a strong 4 per cent through the year to the June quarter 2003. Business investment is expected to contribute strongly to growth in 2002-03 and, combined with robust growth in household consumption, should more than offset the impact of moderating dwelling investment. Domestic demand is expected to grow strongly and more rapidly than overall economic growth, with the difference reflecting a declining net export performance. Rapid growth in imports, reflecting strong plant and equipment investment, should outweigh a rebound in export growth in line with the recovery in world growth. The current account deficit (CAD) as a percentage of GDP is expected to widen but to remain moderate and be well below earlier peaks. Inflation is forecast to remain within the target band, while solid employment growth is expected to see the unemployment rate continue to decline over the coming year.

The Australian economy strengthened as 2001 progressed, in sharp contrast to the weakening seen in most of the rest of the world. Productivity growth in Australia was strong as GDP grew by 4.1 per cent through the year to the December quarter 2001 and employment growth was subdued. Both business and consumer confidence rebounded in the latter part of the year following the initial impact on confidence of the terrorist attacks of 11 September 2001, and business investment and household consumption grew solidly over the second half of 2001. Dwelling construction grew strongly through 2001, driven by historically low interest rates and the Government's enhanced First Home Owners Scheme (FHOS).

The outlook for **world growth** has improved since the start of 2002 with the international downturn bottoming and a moderate recovery now underway, underpinned by a recovery in the United States (US) and a modest pick up in Europe. While significant uncertainties remain, the sharp downside risks surrounding the outlook for the US following the events of 11 September 2001 appear to have diminished. The recovery in the US will, in turn, assist the recovery of the non-Japan East Asian countries. The Japanese economy, however, remains weak and fragile and is likely to continue to underperform even as the rest of the world recovers. Overall, following growth of 2.5 per cent in 2001, world growth is expected to be around 2¾ per cent in 2002, rising to around 4 per cent in 2003. Australia's **major trading partner growth** is expected to be around 2¼ per cent in 2002 (mainly reflecting the weakness in Japan), rising to around 3¾ per cent in 2003.

Export growth is expected to rebound by a solid 6 per cent in 2002-03, underpinned by the recovery in world growth and increased commodity production. **Import** growth is expected to be above average at 11 per cent, driven by strong growth in the import-intensive sectors of the economy, particularly plant and equipment investment.

Net exports are expected to subtract around 1 percentage point from overall GDP growth in 2002-03, reflecting the strength of import growth. In turn, the **current account deficit** is expected to increase moderately to around 4 per cent of GDP. However, at these levels, the CAD would remain well below earlier peaks of around 6 per cent of GDP.

The **business investment** outlook has improved substantially, with strong business confidence starting to flow through to actual business investment. Initial data point to very strong investment intentions for 2002-03, particularly in the mining and transportation sectors. The outlook for investment in both plant and equipment and non-dwelling building and structures is for strong growth.

Forward indicators suggest that new dwelling construction has peaked and activity is expected to decline in 2002-03. However, alterations and additions should continue to grow, partly offsetting the forecast decline in new dwelling construction. Overall **dwelling investment** is forecast to decline by around 3 per cent in 2002-03.

The outlook for **household consumption** expenditure appears to be quite strong. Consumer confidence is at relatively high levels, assisted by strong wealth accumulation (particularly in housing), with low interest rates and better labour market conditions supporting disposable income.

The **inflation** outlook remains in check, with the CPI forecast to increase by around 2¾ per cent in 2002-03, and around 2½ per cent through the year to the June quarter 2003, the mid-point of the medium-term target band. Despite some temporary upward price pressures expected in the first half of 2002, subdued unit labour costs, reflecting moderate wage increases and strong productivity growth, point to inflation moderating over the forecast period.

Employment growth is expected to be a robust 1¾ per cent in 2002-03, largely reflecting the robust economic growth outlook, continued moderate wages growth and relatively strong business and consumer confidence. In turn, the **unemployment rate** is expected to decline to average around 6 per cent in the June quarter 2003.

The **uncertainties** surrounding both the international and domestic economic outlook have generally declined since late 2001 and seem to be relatively evenly balanced. Nevertheless, the recent increase in the oil price (which is being driven mainly by concerns about conflict in the Middle East), if sustained above the assumed price of $US23 per barrel underlying the forecasts, could adversely affect confidence both domestically and internationally. Higher oil prices could reduce discretionary expenditures to below that forecast and higher petrol prices could also feed into ongoing inflation.

In addition to higher petrol prices, there are a number of other short-term price pressures evident in the period ahead, including higher insurance premiums. While these short-term price pressures are not expected to become a source of ongoing inflation, they represent some risk in relation to the outlook.

There is also some uncertainty surrounding the downturn in the dwelling sector, with the phasing out of the enhanced FHOS. The forecasts incorporate ongoing growth in alterations and additions, with a decline in new dwelling construction. If alterations and additions were also to significantly decline, then dwelling investment would fall by significantly more than currently forecast, detracting from the rate of employment growth and household consumption.

Table 1: Domestic economy forecasts[(a)]

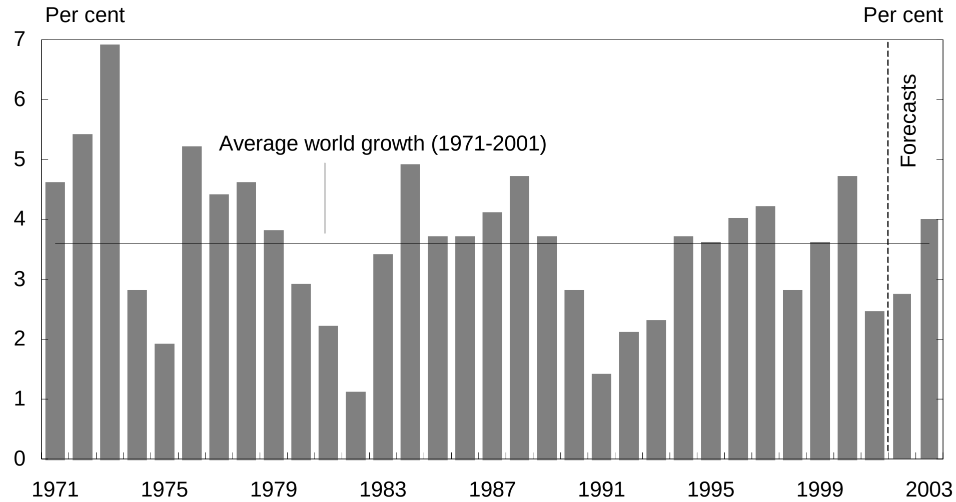
	Outcomes (b)	Estimates	Forecasts	
	2000-01 year average	2001-02 year average	2002-03 year average	Four quarters to June 2003
Panel A - Demand and output(c)				
Household consumption	2.4	3 3/4	4	4
Private investment				
Dwellings	-20.6	16	-3	-3
Total business investment(d)	-3.1	4	12	12
Other buildings and structures(d)	-20.1	6	14	10
Machinery and equipment(d)	0.6	3	12	14
Intangible fixed assets	18.2	4	9	9
Private final demand(d)	-0.3	4 3/4	4 3/4	4 3/4
Public final demand(d)	0.5	3 1/2	3 1/4	3 1/4
Total final demand	-0.2	4 1/2	4 1/2	4 1/4
Change in inventories(e)				
Private non-farm	0.1	- 1/4	1/4	0
Farm and public authorities	-0.1	0	0	1/4
Gross national expenditure	-0.2	4 1/4	4 3/4	4 1/2
Exports of goods and services	7.0	-2	6	6
Imports of goods and services	-1.4	2	11	8
Net exports(e)	1.7	- 3/4	-1	- 1/2
Gross domestic product	1.9	3 3/4	3 3/4	4
Non-farm product	2.2	3 3/4	3 3/4	4
Farm product(f)	-3.4	1 1/4	3 3/4	2 1/4
Panel B - Other selected economic measures				
External accounts				
Terms of trade	3.1	2 1/4	2 3/4	1 1/4
Current account balance				
$billion	-18.9	-22 1/2	-29	
Percentage of GDP	-2.8	-3 1/4	-4	
Labour market				
Employment (labour force survey basis)	2.1	1	1 3/4	1 3/4
Unemployment rate (per cent)(g)	6.4	6 3/4	6 1/4	6
Participation rate (per cent)(g)	63.7	63 3/4	63 3/4	63 3/4
Prices and wages				
Consumer Price Index	6.0	2 3/4	2 3/4	2 1/2
Gross non-farm product deflator	4.3	1 3/4	2	1 1/2
Average earnings(h)	3.9	3 1/4	4 1/4	4 1/4

(a) Percentage change on previous year unless otherwise indicated.
(b) Calculated using original data.
(c) Chain volume measure.
(d) Excluding transfers of second-hand asset sales from the public sector to the private sector.
(e) Percentage point contribution to growth in GDP.
(f) Calculated at basic prices.
(g) The estimate in the final column represents the forecast level in the June quarter 2003.
(h) Average non-farm compensation of employees (national accounts basis).
Source: Australian Bureau of Statistics (ABS) Cat. No. 5206.0, 5302.0, 6202.0, 6401.0, unpublished ABS data and Treasury.

Part II: The outlook for the international economy

The world economy grew by 2.5 per cent in 2001 after recording strong growth of 4.7 per cent in 2000. The United States (US) economy deteriorated early in 2001 and conditions in other economies weakened as the year progressed. The weakness was particularly apparent in Australia's major trading partners (MTPs), where growth is estimated to have slowed to around 1.4 per cent in 2001, well below long-run average growth rates. The events of 11 September 2001 were expected to exacerbate the weakness of the world economy, raising the spectre of a sharper and deeper downturn. However, the downturn has been milder than many expected. More recently, a recovery appears to have commenced and the world economy is expected to slowly gather further momentum over the course of 2002. Against the backdrop of a more settled outlook, world growth is expected to be around 2¾ per cent in 2002, increasing to around 4 per cent in 2003 (Chart 1).

Chart 1: World GDP Growth[(a)]



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

The global recovery is expected to be broadly based, although Japan is likely to remain weak for some time, moderating the pace of global recovery. The US performed better in the early part of 2002 and is expected to grow moderately in 2002 with a sustained pick up becoming established in the second half of the year. The recovery follows an unwinding of some cyclical imbalances, such as excess inventories and capital investment, and is expected to be underpinned by supportive monetary and fiscal policies. Stronger growth in the US should support the economies of Europe and non-Japan East Asia. Meanwhile, Japan's continuing financial and other structural problems create a significant risk that the economy will continue to underperform even as the rest of the world recovers.

Recovery in East Asia may also be less rapid than in the past due to ongoing corporate and financial sector problems and the expected slow recovery in information and communication technology (ICT) demand in 2002. Faltering ICT demand has been an important factor behind the sharp slowdown in East Asia over the past year and prospects for recovery over the next year depend heavily on the extent of the pick up in ICT demand. With US investment expected to remain weak until the latter part of 2002, and industry groups pointing to a subdued recovery in global ICT demand until later in the year, the pace of recovery in this region may be a little slower than in the past. As a result, and with Japan remaining weak, Australia's MTP growth is expected to remain subdued in 2002 at around 2¼ per cent, rising to 3¾ per cent in 2003 (Table 2). World trade is set to grow more strongly in 2002, although the pace of recovery is expected to be gradual.

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

	1998 Actual	1999 Actual	2000 Actual	2001 Actual	2002 Forecasts	2003 Projections
World	2.8	3.6	4.7	2.5	2 3/4	4
Total OECD(c)	2.9	3.4	4.0	1.2	1 3/4	3
United States	4.3	4.1	4.1	1.2	2 1/2	3 1/2
Japan	-1.0	0.7	2.2	-0.4	-1 1/4	1 1/4
European Union	2.9	2.6	3.4	1.7	1 1/2	3
Major Trading Partners	-0.2	4.0	5.1	1.4	2 1/4	3 3/4
Non-Japan East Asia(d)	-2.2	6.5	8.0	1.9	4 1/4	5 1/4

(a) Percentage change on previous year.
(b) Growth rates for World and the European Union are calculated using GDP weights based on purchasing power parity, while growth rates for Major Trading Partners and Non-Japan East Asia are calculated using export trade weights.
(c) Total OECD comprises the United States, Japan, Germany, France, Italy, the United Kingdom, Canada, Australia, Austria, Belgium, the Czech Republic, Denmark, Finland, Greece, Hungary, Iceland, Ireland, Korea, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, Slovak Republic, Spain, Sweden, Switzerland and Turkey.
(d) Non-Japan East Asia comprises Korea, Singapore, Taiwan, Hong Kong, China, Indonesia, Malaysia, Thailand and the Philippines.
Source: National statistical publications, IMF and Treasury.

Global inflation is expected to remain low despite the forecast pick up in activity. Significant excess capacity has emerged over the past year and a uniform and gradual return towards full capacity utilisation is unlikely to put pressure on global inflation, which is close to a 30 year low. Strong competitive pressures and ongoing productivity improvements should support low inflation even as world growth strengthens.

World oil prices are assumed to be around $US23 per barrel for the remainder of the forecast period.[1] This is towards the bottom of the Organisation of the Petroleum Exporting Countries (OPEC) target band, with global demand for oil expected to

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1 World oil prices are measured by the world trade weighted oil price. This price is the average of the contract price of different types of oil, weighted by their share of the world oil trade.

recover modestly over the forecast period, in line with the moderate nature of the global economic recovery. World oil prices are currently above this assumed level, with increased tensions in the Middle East significantly increasing prices over recent months. If oil prices are sustained above the assumed level, this would constitute a risk to the global economic activity and inflation outlook.

The **US** economy grew by 1.2 per cent in 2001, following four consecutive years when growth exceeded 4 per cent per year. Clear signs emerged in early 2001 that a cyclical adjustment was underway, with sharp reductions in business investment and large and sustained reductions in business inventories weighing against growth. The economy entered a mild recession in March 2001 with a broadly-based slowdown in economic activity.

The weakness became more pronounced in some sectors of the US economy following the 11 September 2001 terrorist attacks, when a heightened state of uncertainty and risk aversion led to falls in business and consumer confidence. Investment spending slowed further and the rate of inventory liquidation gathered pace. Consumer spending held up well, however, moderating the weakness, and by early 2002 signs had emerged that the economy had troughed and that a recovery had commenced.

Following the relatively shallow recession, the outlook for the US is for a moderate and uneven recovery in 2002, with further strengthening into 2003. Consumption should remain solid although the pace of growth may be muted in 2002 by weakness in the labour market and elevated debt levels. The absence of pent-up demand may mean consumption growth will be less robust during the recovery phase than would normally occur. Investment may also be a drag on recovery, with uncertainty over the prospects for a sustained recovery in profits, excess capacity and high levels of corporate debt likely to continue to inhibit spending during the first half of 2002. On the other hand, a modest pick up in demand is likely to see the rate of inventory liquidation taper off over the first half of 2002. Increased government expenditures and gathering export demand should also support recovery. More generally, the continuing strength of productivity growth, which occurred even during the slowdown, should underpin stronger profits and incomes growth once recovery takes hold.

Japan's economy contracted by 0.4 per cent in 2001, entering its third recession in a decade in the June quarter, after two years of weak economic growth. Japan was affected by weak domestic spending, the ICT sector slump and slowing external demand more generally over the course of 2001. These developments caused a further deterioration in the economy that was already languishing under the weight of persistent deflation and ongoing structural problems in the corporate and financial sectors. Despite an expected global recovery, including a modest pick up in ICT demand, the economy is expected to remain weak in 2002. Increasing unemployment, ongoing deflation and low levels of consumer confidence are expected to limit the prospects for a recovery in consumption spending, while corporate balance sheet problems and weak profitability are likely to limit any recovery in investment spending. While a muted cyclical rebound is in prospect, Japan's growth potential will remain seriously constrained. Demographic changes are also likely to be a long-term constraint on growth in the absence of policy change.

Non-Japan East Asia economies slowed sharply in 2001, with several economies entering recession. Non-Japan East Asian output is highly dependent on the global manufacturing cycle and growth slowed dramatically as US activity and global demand for ICT products slowed. The region grew by around 1.9 per cent in 2001, well down on the growth rate of around 8 per cent in 2000. Growth prospects for Non-Japan East Asia in 2002 have picked up in recent months with evidence of stronger activity towards the end of 2001 and partial data underscoring the impetus of improved conditions in the US. The outlook for 2002, while still below trend, is for growth of around 4¼ per cent. Stronger growth in the US and Europe and a recovery, albeit subdued, in world ICT demand should see stronger growth in Non-Japan East Asia as 2002 progresses. Recovery should also be underpinned by supportive monetary and fiscal policies. In contrast to other countries in the region, which tend to be heavily dependent on external trade, the Chinese economy continued to grow at a solid pace through the current global slowdown and is expected to grow strongly over the coming year.

Economic growth across the **European Union** slowed during the course of 2001, with Germany entering recession from mid year and growth in the other major economies stalling. National fiscal policies remain constrained by the agreements reached in support of monetary union. However, monetary policy has been more responsive and should help underpin a modest recovery once external demand starts to recover. The United Kingdom held up better than most European economies throughout 2001, although growth slowed in line with other European economies towards the end of the year. With the US likely to strengthen through 2002, growth in the region is expected to pick up from mid year.

Part III: The outlook for the domestic economy

KEY ASSUMPTIONS

In line with usual practice, the exchange rate is assumed to remain unchanged from the average levels reached in recent months, at around US53c and around 52 against the trade weighted index (TWI). The assumed continued very competitive level of the exchange rate over the forecast period is expected to support solid export growth over 2002-03.

Similarly, interest rates are assumed to remain consistent with the existing monetary policy framework, and at levels which are supportive of domestic demand, especially business investment, residential investment and household consumption spending.

An assumption of average seasonal conditions is expected to drive a slight pick up in growth of farm production in 2002-03.

DEMAND AND OUTPUT

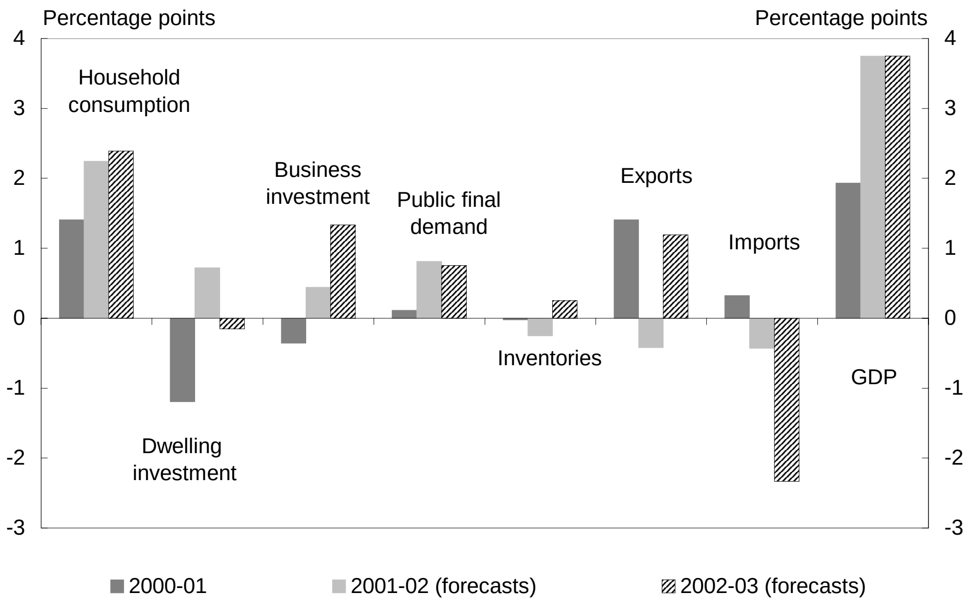
In 2002-03, economic growth in Australia is forecast to be around 3¾ per cent in year-average terms and a strong 4 per cent through the year to the June quarter 2003. The unemployment rate is forecast to decline slightly from recent levels to be around 6 per cent in the June quarter 2003. Inflation is expected to be around 2¾ per cent in year-average terms in 2002-03 and around 2½ per cent through the year to the June quarter 2003, within the medium-term target band of 2-3 per cent. The current account deficit is forecast to widen slightly to around 4 per cent of GDP, continuing below its average level of the 1990s.

The Australian economy's resilience during the global slowdown has attracted considerable attention. In contrast to most of the rest of the world, economic growth in Australia strengthened over 2001. While weaker world growth did lead to a moderation in export growth, domestic activity has been supported by robust household consumption growth and a sharp rebound in investment in residential construction following the temporary slowdown in this sector during the second half of 2000. Economic growth is expected to be around 3¾ per cent in 2001-02, an upward revision to the 3 per cent growth forecast presented in the *Mid-Year Economic and Fiscal Outlook 2001–02*, which was prepared in the immediate aftermath of the events of 11 September 2001. The IMF and OECD both forecast Australian economic growth to be among the highest of developed economies in 2002 and 2003.

Domestic demand is expected to strengthen over 2002-03, with gross national expenditure forecast to grow by a very strong 4¾ per cent in year-average terms, following expected strong growth of 4¼ per cent in 2001-02. There is likely to be some change in the main drivers of domestic demand over 2002-03, with a strong pick up in business investment and continued robust household consumption expected to more than offset subdued activity in residential construction (Chart 2).

Following relatively subdued activity over recent years, business investment is expected to rebound strongly in 2002-03, supported by low interest rates, solid profitability and high business confidence, while improving employment levels should support continued robust household consumption growth. Dwelling investment is expected to post a small decline in 2002-03, as the normal cyclical factors reassert after the bring forward of building related to the enhanced First Home Owners Scheme is completed. Not all of the increase in domestic demand will be met by domestic production (GDP), with net exports expected to be weaker. Despite a solid rebound in export growth, strong domestic demand, particularly in the more import-intensive sectors of the economy such as plant and equipment investment, will lead to even stronger growth in imports.

Chart 2: Contributions to GDP growth[(a)]

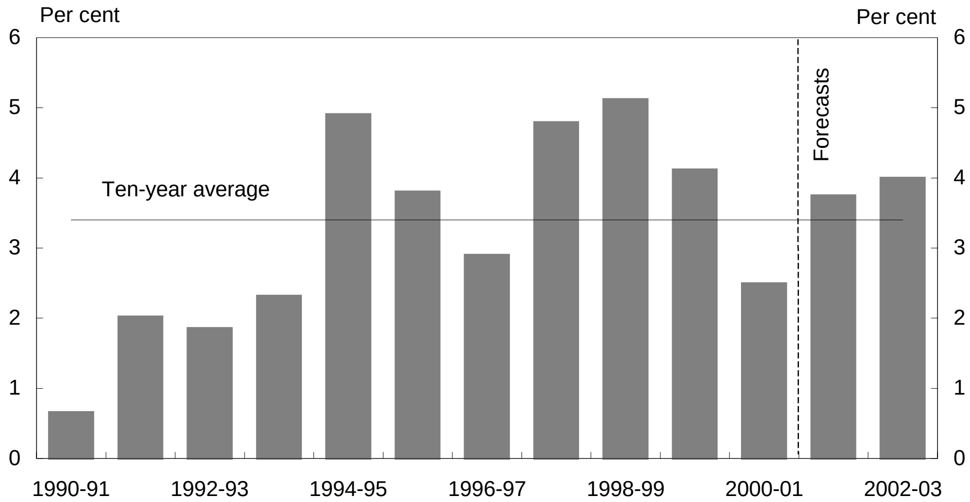


(a) Adjusted for second-hand asset sales as noted in Table 1.
Source: ABS Cat. No. 5206.0 and Treasury.

Household consumption

Household consumption is forecast to increase by around 3¾ per cent in 2001-02 and 4 per cent in 2002-03 (Chart 3). This is expected to return growth to a little above trend rates after very subdued growth in the first half of 2000-01.

Chart 3: Annual growth in real household consumption



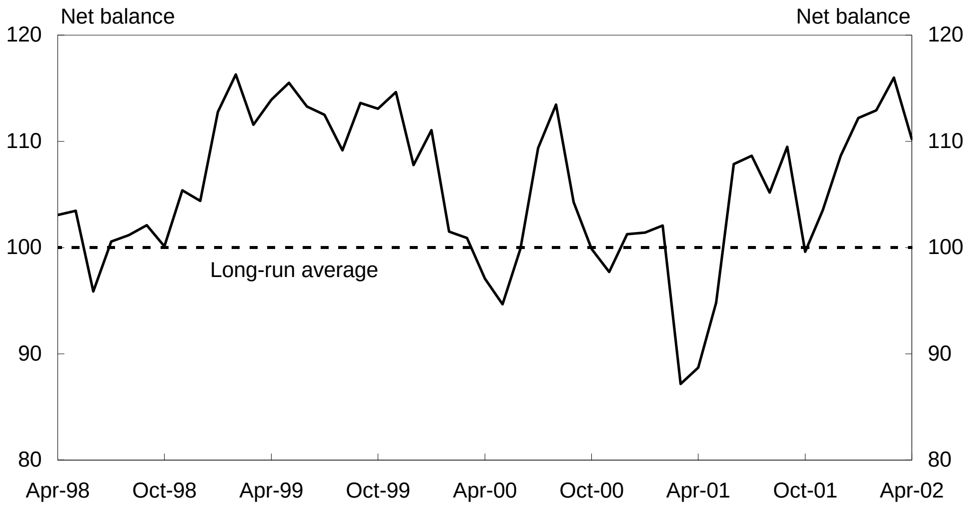
Source: ABS Cat. No. 5206.0 and Treasury.

Consumer spending grew strongly in 2001 despite only modest growth in real household disposable income through this period. Consumption was assisted, in part, by the boost to household spending power generated by low interest rates, strong dwelling investment which boosted consumption of durable goods, declining petrol prices and strong growth in household wealth. Household interest expenses fell in 2001 as official interest rates were cut six times, by a cumulative 2 percentage points. Consumers also saved on petrol outlays as the automotive fuel component of the CPI fell by 12 per cent over the year to December 2001. Strong gains in household wealth — established house prices rose strongly by 16 per cent over the year to the December quarter 2001 and the local share market recovered to near record highs — also assisted in maintaining solid consumption spending.

Growth in real household disposable income is expected to increase to around trend rates in the forecast period, in line with improved labour market conditions. In contrast, higher world oil prices have seen petrol prices increase steadily in the first four months of 2002. There is a risk that petrol prices may have a moderating impact on household consumption if external developments lead to sustained higher oil prices. In addition, following the rapid increases in established house prices over recent years, it is assumed that gains in household wealth from this source will be closer to trend in the period ahead. On balance, overall growth in household spending power, assisted by low interest rates and improved labour market conditions, is expected to be supportive of consumption growth over the forecast period.

Consumer confidence, as measured by the Westpac-Melbourne Institute index, is currently at a relatively high level, providing further support for the consumption outlook (Chart 4).

Chart 4: Westpac-Melbourne Institute consumer sentiment index

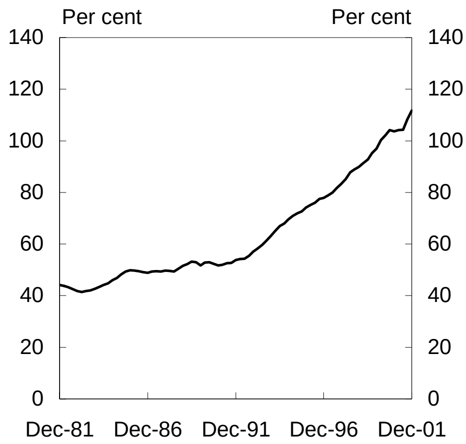


Source: Westpac-Melbourne Institute.

The household sector's financial position remains sound despite an expansion in household debt levels during the last decade.[2] The increase in household borrowing over recent years largely reflects an increase in affordability brought about by low interest rates and the continuing impact of financial deregulation on the availability of credit. The build-up in debt has led to a significant increase in the ratio of household debt to disposable income (Chart 5), bringing this ratio to levels more comparable to those in other developed countries (Chart 6). However, household assets have also grown strongly in recent years, with the household debt-to-asset ratio showing only a gradual increase (Chart 7). Further, households' current ability to service debt is high. Household interest payments are now around 6¼ per cent of disposable income, down from a peak of around 12 per cent in 1989-90 (Chart 8). Although the position of overall household balance sheets is sound, the expansion in household debt has left the sector more exposed to increases in interest rates and declines in asset prices. In addition, while household debt ratios are not a cause for concern in the near term, sustained further increases in debt-to-income ratios would increase sensitivity to interest rate and asset price movements.

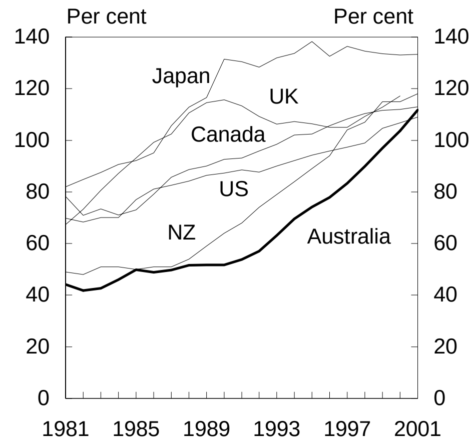
2 See Economic Roundup Summer 2002, *Australian Net Private Wealth*, Department of Treasury, Canberra; and Tan, Alvin and Voss, Graham, 2000, 'Consumption and Wealth', Reserve Bank of Australia Research Discussion Paper 2000-09.

Chart 5: Household debt (per cent of disposable income)



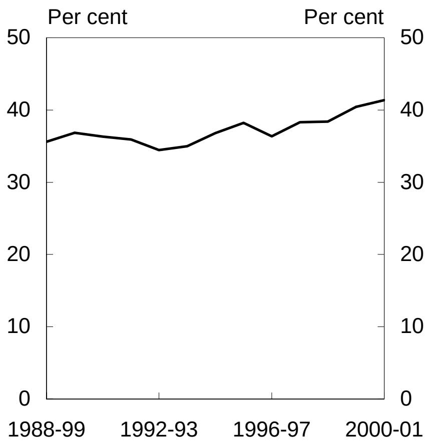
Source: Reserve Bank of Australia (RBA).

Chart 6: Household debt, international comparisons (per cent of disposable income)



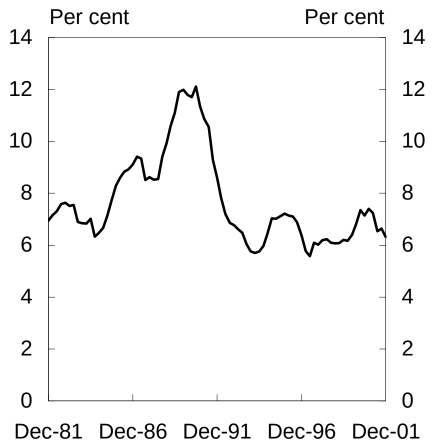
Source: RBA, OECD, Reserve Bank of NewZealand and Treasury.

Chart 7: Household debt-to-asset ratio



Source: ABS Cat. No. 5204.0

Chart 8: Interest payments (per cent of disposable income)



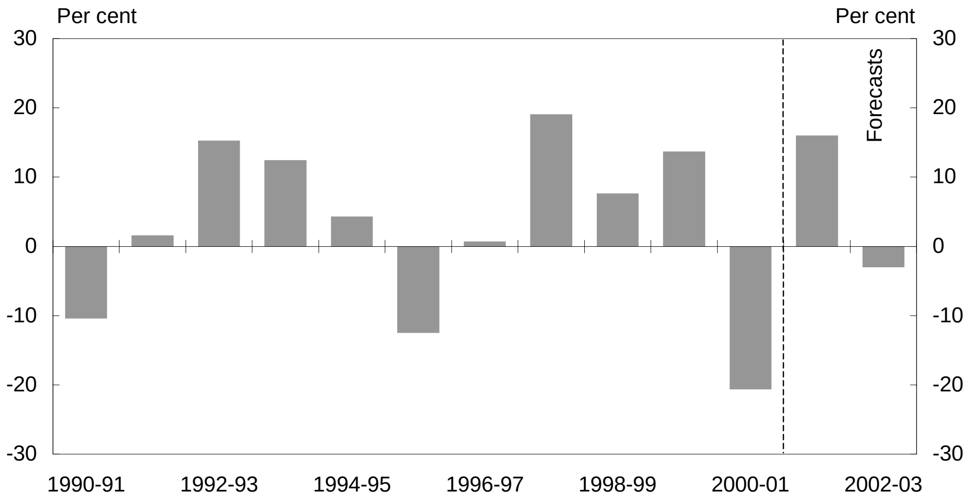
Source: ABS Cat. No. 5206.0

Dwelling investment

Following estimated very strong growth of around 16 per cent in 2001-02, dwelling investment is forecast to decline by 3 per cent in year-average terms in 2002-03 (Chart 9).

Dwelling investment rebounded sharply from the temporary slowdown in the second half of 2000 to be a key driver of GDP growth in 2001-02. The sharp turnaround in the residential construction sector was driven by historically low mortgage interest rates and the Government's more generous First Home Owners Scheme (FHOS) for new (rather than established) dwellings. The more generous FHOS provided a targeted, short-term boost to building activity. It is now being phased out at a time of strength in the sector and the economy more generally.

Chart 9: Annual growth in dwelling investment



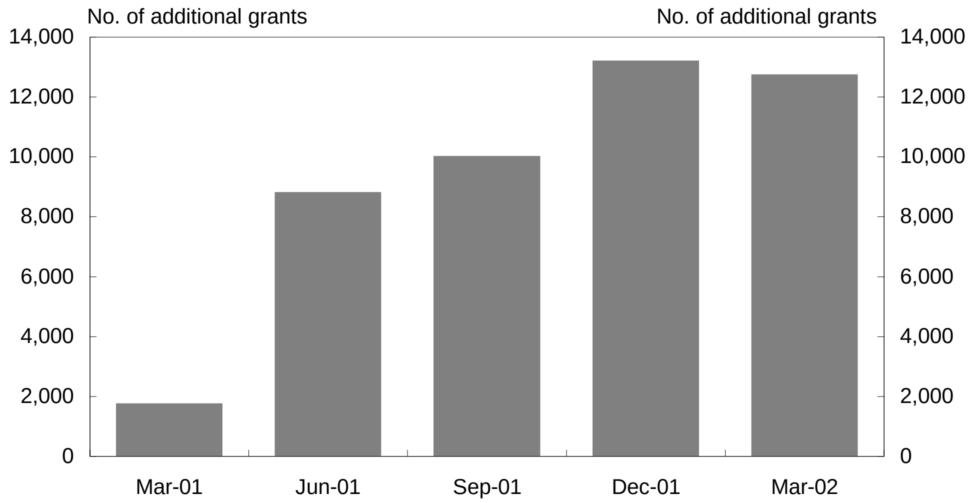
Source: ABS Cat. No. 5206.0 and Treasury.

In 2002-03, dwelling investment is expected to decline moderately by around 3 per cent, driven by a significant fall in new dwelling investment, partly offset by ongoing growth in expenditure on alterations and additions. The forecast decline in new dwelling investment comes as FHOS-related bring forward of building is completed. FHOS data to March 2002 indicate that the take up of the additional (total grant of $14,000) and phased-down (total grant of $10,000) grants has been extremely strong (Chart 10). This suggests that a significant amount of residential building activity has been brought forward and will subsequently unwind over the course of 2002-03.

The 2002-03 forecasts also incorporate some reduction in the significant stock of excess supply that has developed in some segments of the dwelling market. Evidence of excess supply has emerged in the market with vacancy rates, particularly for medium/high density dwellings in Sydney and Melbourne, rising significantly through the year to December 2001 to around historically high levels.

Ongoing growth in expenditure on alterations and additions is expected to moderate the overall decline in dwelling activity in 2002-03, supported by low interest rates, solid employment growth and recent gains in household wealth. While past activity in alterations and additions moved broadly in line with new dwelling construction, there are grounds to believe that alterations and additions will continue to grow over the forecast period, notwithstanding a downturn in new dwelling construction. This is because the downturn in new dwelling construction principally relates to the phasing out of the additional FHOS. Overall conditions remain supportive of the outlook for alterations and additions.

Chart 10: FHOS grants for new dwellings



Source: Treasury.

The forecast overall modest decline in dwelling investment in 2002-03 is likely to have flow-on effects for other areas of the economy. Specifically, employment is expected to fall in this labour intensive sector, while sales of durable goods typically associated with the purchase of a new dwelling are also likely to moderate.

Business investment

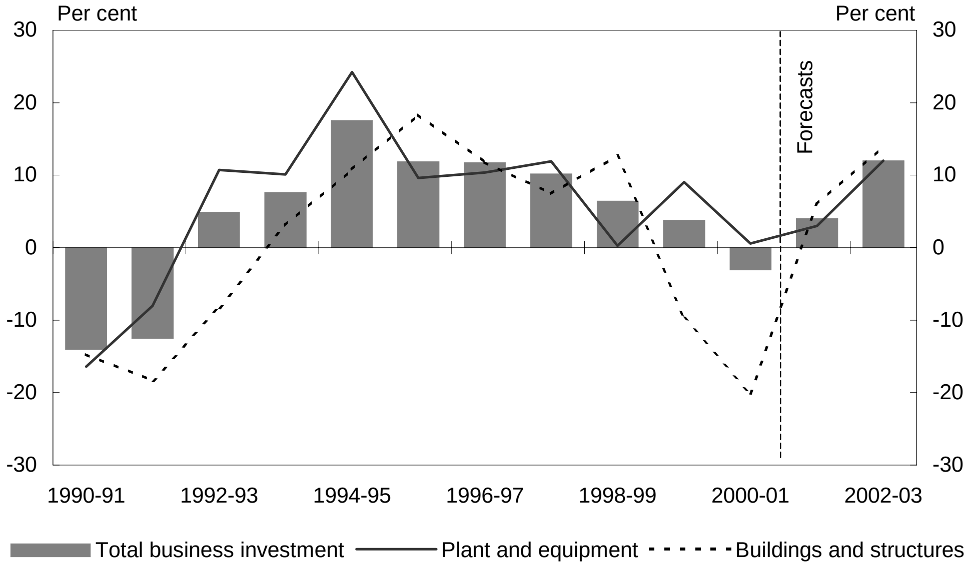
New business investment[3] is forecast to grow by a very strong 12 per cent in 2002-03, following expected growth of around 4 per cent in 2001-02, and a fall of 3.1 per cent in 2000-01 (Chart 11). The very positive outlook for business investment reflects strong fundamentals: low interest rates; the competitive level of the exchange rate, which continues to support Australia's export and import-competing sectors; the reduction in the company tax rate; and corporate profitability, which is above longer-run averages as a percentage of GDP and is particularly strong in the rural and mining sectors.

The subdued business investment levels of the last two years have resulted in above average capacity utilisation, particularly in the mining industry. Business sentiment

3 Private sector net purchases of second-hand public assets can have a significant impact on estimates of business investment and public final demand, despite the fact that these asset purchases have no impact on aggregate economic activity. Accordingly, the forecasts of new business investment abstract from these transactions.

has also strengthened significantly in recent months, rebounding from the impact of the 11 September 2001 terrorist attacks, and buoyed by an expected recovery in the world economy. Virtually all business surveys have shown a relatively strong improvement in business confidence and investment intentions.

Chart 11: Annual growth in new business investment[(a)]



(a) Excluding net purchases of second-hand public sector assets by the private sector.
Source: ABS Cat. No. 5206.0 and Treasury.

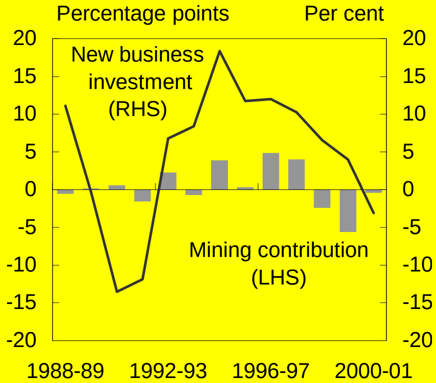
New investment in machinery and equipment is expected to grow by a very strong 12 per cent in 2002-03, following expected subdued growth of around 3 per cent in 2001-02, and essentially no growth in 2000-01. The outlook is partly driven by an expected substantial strengthening in mining investment (Box 1). After a couple of very weak years during and immediately following the Asian financial crisis, conditions in the mining sector are conducive for strong investment, with record levels of profitability boosted by the competitive level of the exchange rate and higher world prices for some key export commodities. Equipment expenditure intentions are also very strong in the transport and storage sector, which partly reflects scheduled new investment by the aviation industry.

The latest Australian Bureau of Statistics (ABS) capital expenditure survey showed that firms' first estimate of plant and equipment investment intentions for 2002-03 were very strong, although early estimates only provide a broad indication of likely outcomes. While investment intentions have picked up strongly across several sectors, intentions in other areas, especially some parts of manufacturing, remain subdued.

Box 1: Investment in the mining industry

The mining industry accounts for around 5 per cent of Australian GDP, but contributes around 35 per cent of total export earnings and around 12 per cent of new business investment expenditure. Mining is one of Australia's most capital-intensive industries, with about $1.4 million of capital stock per employee — around five times the average across industries.

Chart A: Mining contribution to new business investment



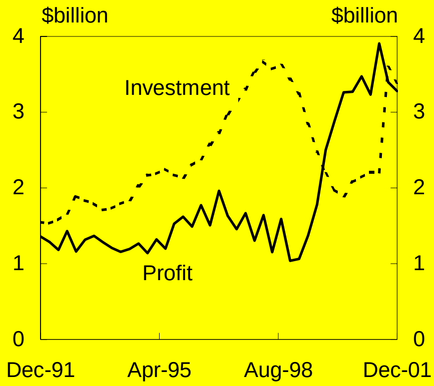
Source: ABS Cat. No. 1364.0.15.003.

Prior to the Asian financial crisis, Australian business investment was lifted by a surge in mining investment, which grew by around 81 per cent in the four years to 1997-98. The onset of the Asian financial crisis saw mining investment fall substantially in the ensuing three years, making a significant subtraction from growth in new business investment volumes (Chart A).

Mining investment is set to pick up markedly in the period ahead, particularly in the gas, coal and metals sectors. Work on a number of large projects is already underway, or about to commence.

The competitive Australian dollar, together with higher world prices for some key export commodities (Box 3), has helped boost profitability in the mining industry well beyond previous levels (Chart B). A competitive and profitable mining industry, assisted by an expected world recovery, is driving investment and employment within the sector.

Chart B: Mining industry profit and nominal investment

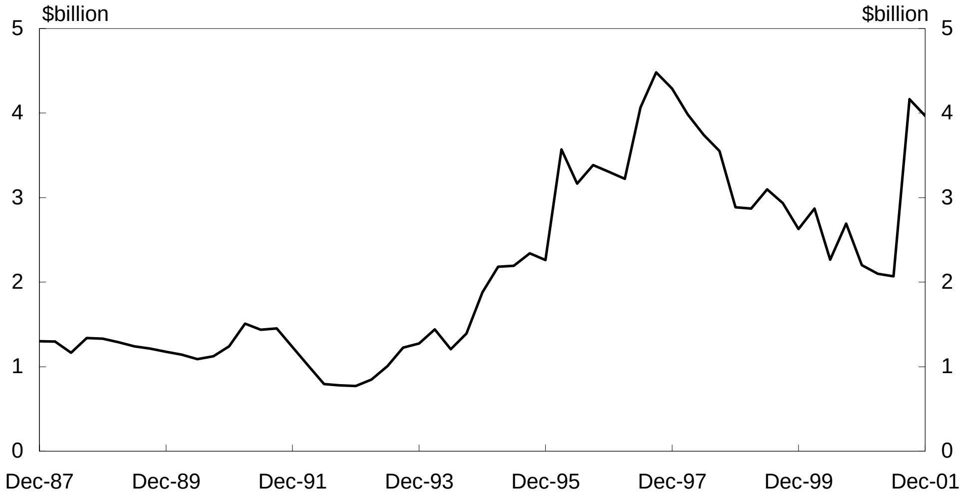


Source: ABS Cat. No. 5676.0 and Treasury.

This outlook is supported by the latest ABS capital expenditure survey, where firms indicate growth in mining investment of 25 per cent or more is in prospect in 2002-03.

New investment in non-residential buildings and structures is expected to grow by a very strong 14 per cent in 2002-03, following forecast moderate growth of around 6 per cent in 2001-02, and a substantial fall of around 20 per cent in 2000-01. Engineering construction is expected to drive overall growth in non-residential construction in 2002-03. The commencement of engineering construction work on the North West Shelf Expansion and the Alice Springs to Darwin railway increased the level of engineering construction work yet to be done by around $2 billion in the September quarter 2001 (Chart 12). Further project commencements are expected in 2002-03 in the mining industry, including a number of coal and metals projects, and several road projects are also expected to commence in the transport and storage sector.

Chart 12: Work yet to be done — engineering construction



Source: ABS Cat. No. 8762.0.

Investment in new non-residential buildings (that is, offices, shops, hotels and other business premises) is also expected to pick up in 2002-03, albeit with less vigour than engineering construction investment. Growth in non-residential building is likely to be driven by increased building activity in retail, and finance and insurance, given the positive business conditions and strong profitability recently experienced in these sectors.

Investment in intangible fixed assets (that is, computer software, mineral exploration rights and artistic originals) is also expected to pick up in 2002-03, dominated by solid growth in software investment, although at a slower rate than seen in recent years. Software investment is expected to pick up following an easing in growth in 2001-02, after the completion of work relating to the introduction of *The New Tax System* in 2000, and Y2K-related work in 1999.

While investment intentions data in the mining industry and the transport and storage sector are very strong, investment intentions in some other sectors remain subdued, particularly in parts of the manufacturing industry. If investment intentions strengthen in these sectors over the coming year and current intentions in the mining industry and the transport and storage sector are fully realised, or exceeded, business investment could be stronger than forecast. On the other hand, the lumpy nature of major mining and other engineering construction projects means that potential delays or deferrals pose some downside risks to the forecasts.

Inventories

Private non-farm inventories are expected to subtract around ¼ of a percentage point from growth in 2001-02. In the second half of 2001 it appears that firms attempted to run-down inventory levels, possibly as a result of the global uncertainty following the events of 11 September 2001. This trend is expected to reverse in the first half of 2002, in response to a more certain global outlook.

Private non-farm inventories are expected to contribute around ¼ of a percentage point to GDP growth in 2002-03, as firms continue to rebuild inventories, in line with strong forecast growth in sales.

Public final demand

In 2002-03, public final demand[4] is anticipated to grow by around 3¼ per cent in year-average terms, around the longer-term trend and a little below the expected 3½ per cent growth in 2001-02, but well above the 0.5 per cent increase recorded in 2000-01. The expected increase in public final demand reflects additional spending at the Commonwealth, State and Local Government levels. At the Commonwealth level, the expected additional expenditure is linked to the war on terrorism, airport security and border protection. At the State and Local Government levels, the expected increase in expenditure is related to new initiatives on transport, education, health and community services, with a number of infrastructure projects expected to continue into 2002-03.

NET EXPORTS AND THE CURRENT ACCOUNT DEFICIT

The current account deficit (CAD) is forecast to widen modestly to around 3¼ per cent of GDP in 2001-02 and to around 4 per cent of GDP in 2002-03. At these levels, the CAD would remain below its average share of GDP during the 1990s, despite strong domestic growth and the recent global slowdown.

4 The forecasts of public final demand abstract from private sector net purchases of second-hand public sector assets — see footnote 3.

Net exports

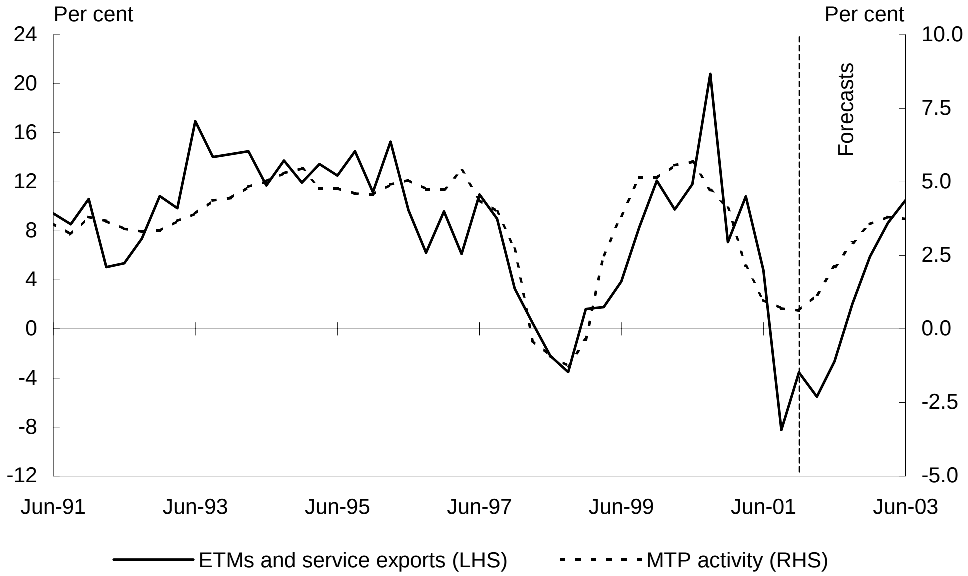
Net exports are expected to subtract around ¾ of a percentage point from GDP growth in 2001-02, largely reflecting the impact of lower world growth on demand for exports. In 2002-03, net exports are expected to subtract 1 percentage point from GDP growth. While export growth is expected to resume solidly over the course of 2002-03, this is expected to be more than offset by strong import growth.

Export volumes are estimated to decline by 2 per cent in 2001-02, and then grow in 2002-03 by a solid 6 per cent. Even with this rebound, growth will remain slightly below the longer-term trend, reflecting the moderate nature of the recovery in world growth. Export growth in 2002-03 is expected to be underpinned by a rebound in exports of elaborately transformed manufactures (ETMs) and services as demand for these exports increases in response to the moderate pick up in major trading partner (MTP) growth. Exports of non-rural commodities are also expected to record solid growth as domestic capacity increases in 2002-03, while growth in exports of rural commodities should be supported by increases in farm production.

The recovery in world economic growth in 2002-03 — in particular in Australia's MTPs — should have a significant impact on Australia's exports of ETMs and services. These two export categories are very sensitive to economic conditions in the destination country and so have come under considerable downward pressure in 2001-02. Exports of tourism-related services came under additional downward pressure as international air travel declined in response to heightened international tensions arising from the events of 11 September 2001. The recovery in MTP growth, together with the supportive level of the exchange rate, should see ETM and service exports rebound over the course of 2002-03 (Chart 13).

In contrast to ETM and service exports, commodity export volumes tend to be affected more by domestic supply conditions than by international demand in the short term. Following expected modest growth in 2001-02, non-rural commodity exports are forecast to increase solidly over 2002-03 as a number of new mining projects commence production. The strong profitability in Australia's resources sector over recent times, which has been supported by the very high level of Australian dollar non-rural commodity prices, has boosted investment in the capacity of domestic mines. While the timing of the start up of new mining projects can be subject to some uncertainty, a step up in local production, particularly in coal and iron-ore, is expected to support an increase in export volumes from around mid 2002.

Chart 13: Through-the-year growth in ETM and service exports and MTP activity



Source: ABS Cat. No. 5302.0 and 1364.0.15.003 and Treasury.

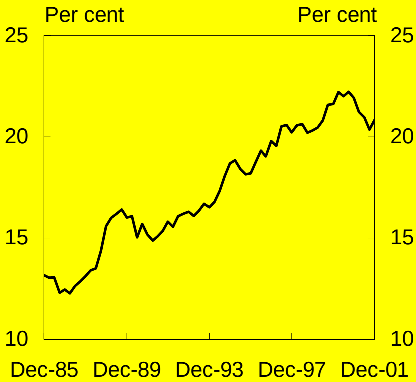
Farm production is expected to grow by around 1¼ per cent in 2001-02, with a near record grain crop partly offset by more subdued production of fibres, particularly wool. In 2002-03, farm production is expected to grow by around 3¾ per cent, reflecting the assumed return to average seasonal conditions. Exports of rural commodities are expected to grow more strongly than farm production in 2002-03 as stocks — particularly wheat and meat — are drawn down to meet demand.

Import volumes have been very subdued over the last two years, with a decline of 1.4 per cent in 2000-01, the lowest growth rate in 10 years. In 2001-02, imports are forecast to turn around, rising by 2 per cent, underpinned by solid growth in most components of merchandise imports, including in several large 'lumpy' import components such as military equipment and civil aircraft. In 2002-03, import volumes are expected to grow by a strong 11 per cent, mainly driven by a large expected pick up in the very import-intensive sectors of the economy, particularly in plant and equipment investment and ETM exports, while less import-intensive sectors of the economy, such as dwelling investment, are forecast to moderate (see Box 2).

Box 2: The drivers of import demand

Import volumes fell for the first time since the early 1990s in 2000-01, and are expected to be subdued in 2001-02, before picking up strongly in 2002-03. The profile of activity can only partly explain the profile of imports. For example, the import penetration ratio — the ratio of imports to domestic final demand — fell sharply below trend levels in early 2001 (Chart A).

Chart A: Import penetration ratio



Source: ABS Cat. No. 5206.0.

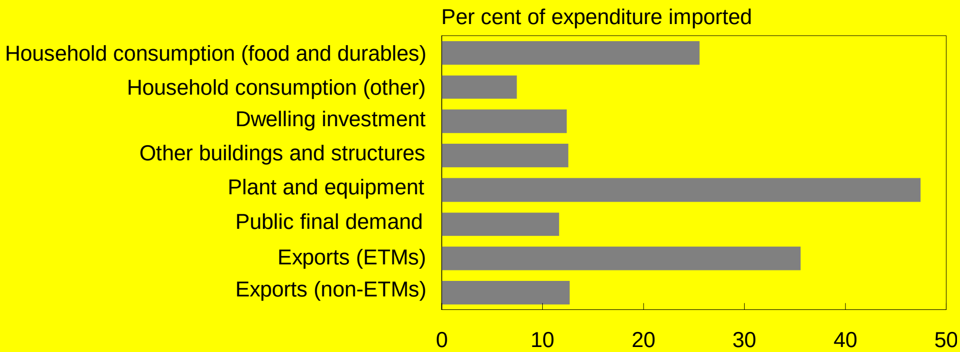
The recent weakness in imports partly reflects the significant fall in the Australian dollar which, by increasing the relative price of imports, would have led to the substitution of domestically produced for imported goods and services.

Another part of the explanation relates to the composition of demand. Import intensity varies between components of demand. For example, plant and equipment investment and ETM exports are import-intensive, while dwelling investment tends to be produced locally (Chart B).

While economic growth is expected to be broadly similar in 2001-02 and 2002-03, the composition of growth is expected to change. In 2001-02, economic growth is expected to be largely driven by dwelling investment, while investment in plant and equipment and ETM exports should remain weak. As a result, the composition of demand should see relatively subdued growth in imports.

In 2002-03, plant and equipment investment and ETM exports are forecast to pick up strongly, while dwelling investment is expected to fall slightly. As a consequence, relatively strong growth in imports is expected.

Chart B: Import intensity by category of final demand



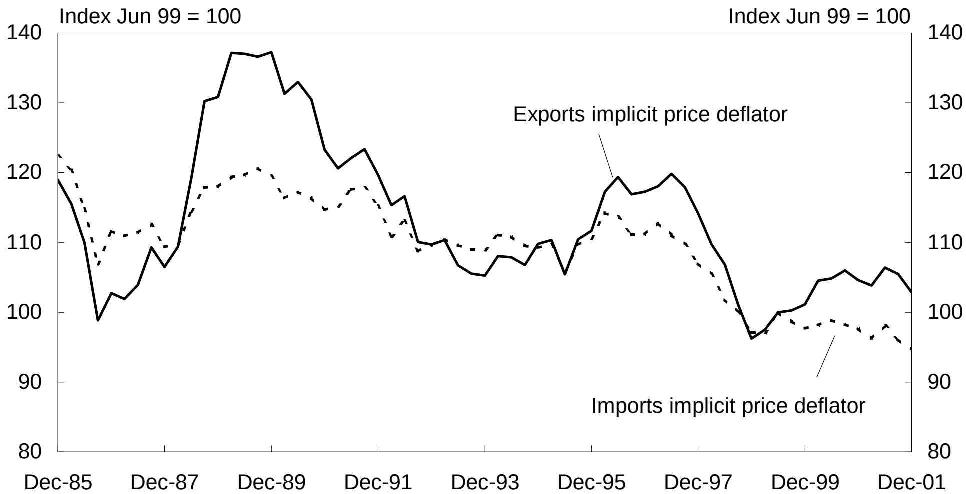
Source: ABS Cat. No. 5209.0 and Treasury.

The terms of trade

In currency neutral (Special Drawing Rights (SDR)) terms, Australia's non-rural commodity export prices — as measured by the Reserve Bank of Australia's commodity price index — are expected to increase moderately in 2002-03, following solid growth in 2001-02. The recovery in world growth is expected to underpin increases in the price of many commodities, particularly base metals and mineral fuels. However, while tight supply is expected to support a moderate rise in the negotiated contract price for coking coal, the negotiated contract prices for the other bulk commodities are expected to be more subdued after strong increases in 2000-01.

Following strong growth in 2001-02, aggregate rural prices, in SDR terms, are expected to maintain their current high levels in 2002-03, with increased world agricultural production over the period ahead expected to be broadly matched by the recovery in global demand. Moderately lower export prices for beef and veal are expected to be offset by higher world prices for wool as world production falls against a pick up in consumption in apparel markets. These high prices, combined with the expected rise in farm production in 2002-03, should see farm incomes rise further after reaching well above previous historically high levels in 2001-02 (see Box 3).

Chart 14: Export and import prices in SDR terms



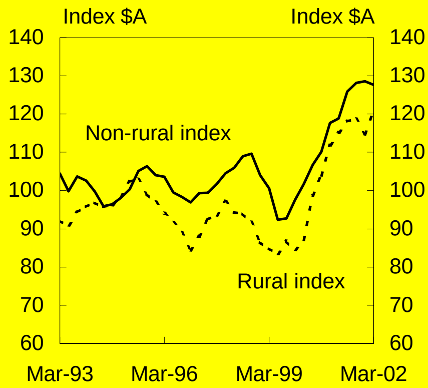
Source: ABS Cat. No. 5302.0 and 5206.0.

Australia's import prices are expected to decline slightly in 2002-03. In SDR terms, Australian import prices have fallen over the last decade at a rate of around 2 per cent per year (Chart 14). A large part of the fall in import prices can be explained by substantial falls of around 16 per cent per annum in the SDR prices of ICT goods. The trend decline of import prices is expected to continue in 2002-03.

Box 3: Booming conditions in Australia's rural and resource sectors

The Australian dollar prices of rural and non-rural commodities have risen very strongly over the past two years to reach record high levels (Chart A). This has reflected higher world prices for many commodities which, together with the lower Australian dollar, has increased the returns on Australian commodity exports.

Chart A: Commodity price index



Source: RBA.

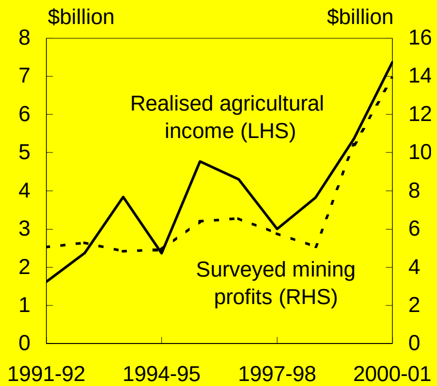
Australian miners and farmers have reacted to these price rises by increasing production and sales. Between 1999 and 2001 the volume of rural and resource commodity production has increased by 7 per cent and the volume of commodity exports has increased by 10 per cent.

Higher prices and production have seen incomes rise to record high levels. Agricultural income has almost doubled over the past two years, while mining profits have almost tripled (Chart B).

High levels of production have also stimulated growth in employment in these sectors. In the year to the March Quarter 2002, mining employment grew by 10 per cent and agricultural employment grew by 5 per cent. These employment outcomes were markedly stronger than the 1.8 per cent growth for Australia as a whole over this period.

Profitable rural and resource conditions have also underpinned strong investment growth. Investment in agricultural machinery picked up by around 30 per cent in the year to the December quarter 2001, while mining investment increased by around 50 per cent over this period.

Chart B: Farm and mining income



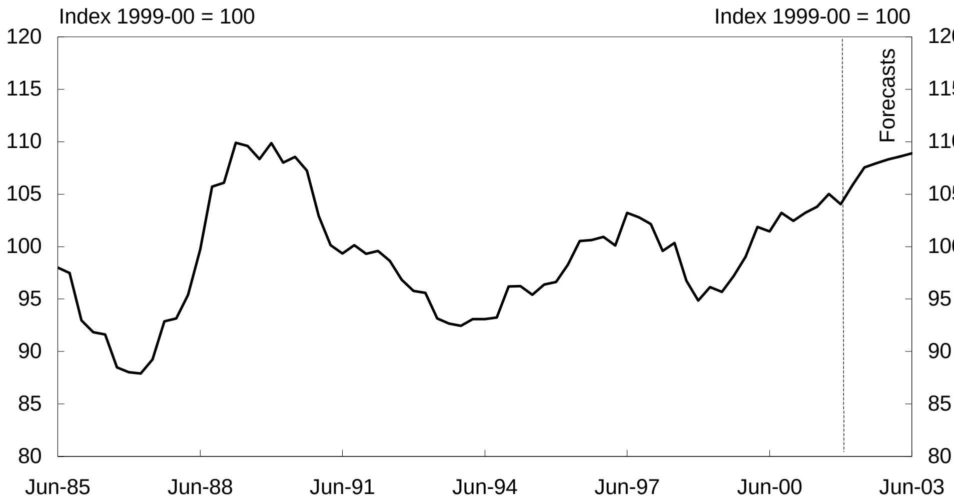
Source: ABS Cat. No. 5206.0 and 5676.0.

Further strong investment growth is expected in these sectors over the coming period, especially in the mining sector (Box 1).

Strong investment growth will lead to higher production in Australia's rural and resource sectors, strengthening exports and employment over the forecast period. This will provide further support to rural and regional incomes.

Reflecting these forecast trends in export and import prices, the terms of trade is expected to increase by 2¼ per cent in 2001-02, to be around the highest level in a decade. A further increase in the terms of trade of 2¾ per cent is expected in 2002-03 (Chart 15). An increase in Australia's terms of trade during a period of slow global growth is very unusual by historical experience and this issue is discussed in more detail in *Budget Statement 4*.

Chart 15: Terms of trade



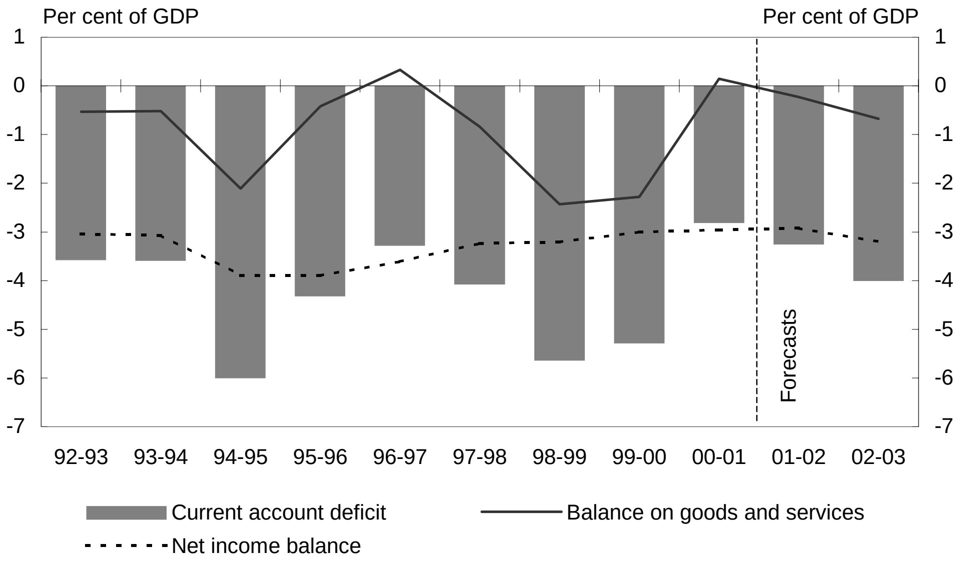
Source: ABS Cat. No. 5206.0 and Treasury.

The current account deficit

The CAD is forecast to widen slightly in 2001-02 to 3¼ per cent of GDP, up from 2.8 per cent of GDP in 2000-01, the lowest annual level in 20 years. The increase in the CAD is expected to be driven mainly by the return to a trade deficit in volume terms, only partially offset by a rise in the terms of trade. In 2002-03, the CAD is expected to widen further, to around 4 per cent of GDP, driven by an increase in the trade deficit in volume terms and a slight increase in the net income deficit (NID), more than offsetting the impact of a further rise in the terms of trade (Chart 16). However, at these forecast levels, the CAD would remain moderate, below its average level as a share of GDP during the 1990s and well below earlier peaks of around 6 per cent of GDP.

Growth in the NID has continued to be modest in recent years, reflecting both the generally low level of world and Australian interest rates, and the sharp narrowing of the differential between Australian and world interest rates. This has seen the NID decline gradually to slightly less than 3 per cent of GDP in 2001-02. With the recent modest increase in world interest rates, the net income balance is expected to widen marginally, increasing to around 3¼ per cent of GDP in 2002-03.

Chart 16: Contributions to the current account deficit



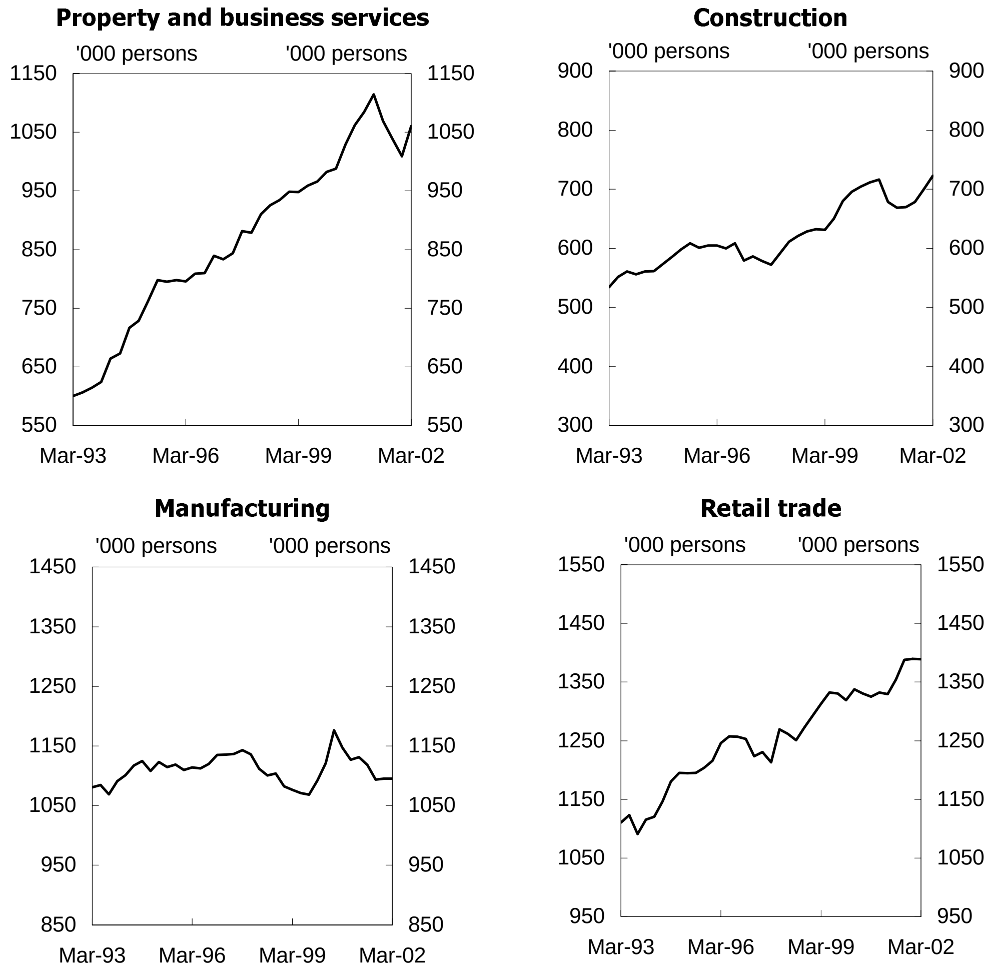
Source: ABS Cat. No. 5302.0 and 5206.0 and Treasury.

LABOUR MARKET, WAGES AND PRICES

Labour market

Conditions in the labour market are expected to strengthen over 2002-03, with employment growth forecast to be around 1¾ per cent in both year-average and through-the-year terms. The outlook for strengthening employment growth in 2002-03 reflects ongoing robust GDP growth and continued moderate wages growth. The moderation in the labour market following the completion of Y2K-related expenditure, the Olympics and the development of new systems associated with the introduction of *The New Tax System* has now run its course. This has seen a rebound in employment in property and business services in the March quarter 2002 (Chart 17), which augurs well for the employment outlook. However, in line with the expected moderation in the labour-intensive construction sector, some softness in labour market outcomes from mid 2002 is expected in the construction sector and the construction-related part of the manufacturing sector.

Chart 17: Employment for selected sectors



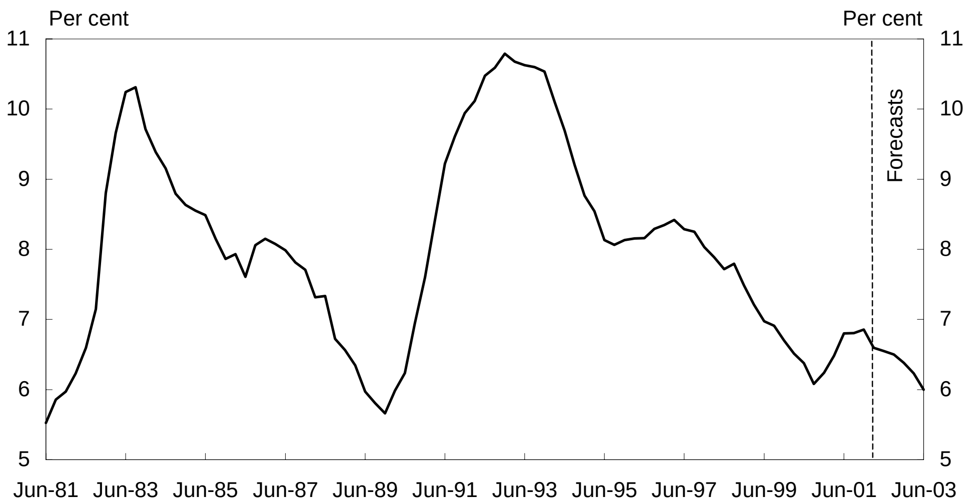
Source: ABS Cat. No. 6291.0.40.001.

The improved labour market outlook follows likely employment growth of around 1 per cent in 2001-02. The lagged effects of the recent strong GDP growth began to flow into employment growth toward the end of 2001 and early 2002. Total employment grew by 1.1 per cent in the year to April 2002. This growth was concentrated in part-time employment, which grew by 4.9 per cent over this period, while full-time employment fell slightly. The strong growth in part-time employment reflected, in part, strong growth in those industries that typically employ a relatively large proportion of part-time employees, in particular retail and the other service sectors.

The major job advertisement series, vacancy series and business surveys all point to employment growth continuing at a solid rate in the months ahead, with higher employment growth anticipated across a range of sectors. Nevertheless, labour market data have been particularly volatile over the last year or so, making it difficult to assess the strength of the labour market.

In line with this improved outlook for employment, the unemployment rate (Chart 18) is expected to decline slightly over the forecast period, and to average around 6¼ per cent in 2002-03 as a whole and to be 6 per cent in the June quarter of 2003. However, monthly labour market data may vary significantly around these averages. Provided that economic growth remains robust, an unemployment rate below 6 per cent is achievable over the medium term, although outcomes will be influenced by the pace and extent of future labour market and welfare reforms. Ongoing employment growth and further reductions in the unemployment rate are likely to encourage higher labour force participation over the period ahead, with the participation rate expected to average around 63¾ per cent over the forecast period, up from 63.4 per cent in April 2002. However, given the volatility in estimates of labour force participation over recent months, some uncertainty remains around this forecast and hence the forecast for the unemployment rate.

Chart 18: The unemployment rate



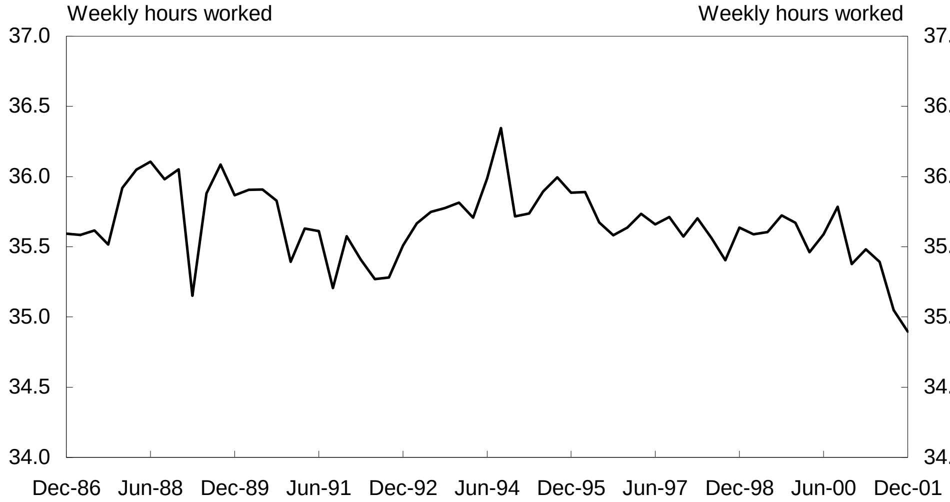
Source: ABS Cat. No. 6202.0 and Treasury

After reaching a cyclical low in 2000-01, labour productivity growth (on a heads basis) is set to rebound strongly in 2001-02, before moderating to rise by around 1¾ per cent in 2002-03, in line with longer run average growth rates. Measured labour productivity growth in 2002-03 is expected to be supported by the forecast very strong growth in business investment, which will tend to lift the potential output of the existing labour force.

Wages

Wages growth in 2001-02 has been very moderate to date, consistent with the relatively soft labour market conditions experienced during 2001. A sharp decline over the course of 2001 in average weekly hours worked also put downward pressure on aggregate wages during this period (Chart 19).

Chart 19: Average weekly hours worked



Source: ABS Cat. No. 1364.0.15.003.

Average earnings on a national accounts basis (AENA) is expected to grow by 3¼ per cent in 2001-02, with growth in the second half of the financial year picking up as labour market conditions improve and as the decline in average weekly hours worked over the course of 2001 is unwound in 2002.

Growth in AENA is expected to increase to 4¼ per cent in 2002-03. Abstracting from the increase in the superannuation guarantee charge on 1 July 2002, AENA is expected to grow by 3¾ per cent in 2002-03. This increase in wages growth reflects the improvement in employment growth and unemployment levels and an expected increase in average weekly hours worked to around trend levels. The Australian Industrial Relation Commission's (AIRC) Safety Net Review of Wages (the 'Living Wage Case') decision to increase all award rates by $18 per week will also put upward pressure on wages growth.

The pace of the pick up in economic activity and the timing of its impact on the labour market represents a key uncertainty to the wages outlook. In addition, the extent to which the AIRC's decision flows through to workers on non-award wages could also represent a further pressure on wages growth.

Prices

In 2001-02, the CPI is expected to increase by around 2¾ per cent in year-average terms. However, several temporary and seasonal factors have played an important role in the CPI outcomes for the year to date. On the upside these include: a large increase in fruit and vegetable prices in the December quarter 2001 (up 10.2 per cent); and seasonal influences in the March quarter 2002 relating to a number of items including pharmaceuticals (up 11.4 per cent) and education (up 4.7 per cent). In addition, airline levies arising from the collapse of Ansett and the events of 11 September 2001 have also had an upward impact on the CPI. Insurance premiums have also risen, partly attributable to the collapse of HIH. Partly offsetting these increases was a large decline in the price of petrol in the September quarter 2001 (down 8.3 per cent).

Looking ahead, a range of near term upward price pressures are evident, such as higher petrol prices and insurance premiums. One insurance component not directly captured by the CPI is business insurance — the magnitude and timing of these increases and their indirect effect on the CPI is uncertain. Nevertheless, increases in wage costs remain well contained. In addition, various core measures of inflation showed a more moderate increase in the March quarter 2002 than over recent quarters, and recent measures of upstream price pressures have also been very subdued.

The headline CPI is forecast to increase by around 2¾ per cent in 2002-03 in year-average terms and around 2½ per cent through the year, within the medium-term target band of 2-3 per cent. Although economic growth is forecast to be robust in both 2001-02 and 2002-03, this follows very subdued growth of 1.9 per cent in 2000-01, with some build up in excess capacity in the economy at that time most evident in a rising unemployment rate. The robust growth forecast in 2001-02 and 2002-03 will allow this spare capacity to be taken up gradually, rather than necessarily resulting in a build up of inflationary pressures. This seems to be consistent with the current relatively moderate underlying inflationary pressures in the economy. Labour productivity, which grew by a strong 2.3 per cent in year-average terms in 2001 (on an hours basis), is expected to increase solidly over the forecast period. Moderate wages growth, combined with solid expected increases in productivity, should see nominal unit labour cost increases — the key driver of inflation over the medium term — remain subdued. In addition, import prices should be subdued as world prices are expected to remain steady, and the exchange rate has appreciated somewhat over recent months — both of these factors should assist to ease inflationary pressures.

There are some key uncertainties surrounding the inflation outlook. The ongoing effect of reduced competition in some markets, particularly in air travel and insurance, is difficult to quantify. The stronger economic environment could also create an opportunity to re-build margins following the decline in the exchange rate over the last two years. Should this occur, and/or other short-term price pressures feed into inflationary expectations (and then wages), it could have an impact on underlying inflationary pressures. The extent to which the recent strong rise in world oil prices is sustained and leads to higher petrol prices is also a risk to the inflation outlook.

Part IV: Uncertainties

The uncertainties surrounding both the international and domestic economic outlooks have generally declined since late 2001 and are now more evenly balanced, although there is still uncertainty about the pace of the world recovery.

On the international front, the recovery in the US is expected to be moderate because of the absence of pent up demand, over capacity in some sectors, various financial constraints and lingering global weakness, particularly in Japan. It is possible, however, that these factors will be less of a drag on growth than currently anticipated. Still high prospective returns on technology investments and process innovations may see stronger investment than currently expected with positive flow on effects to other parts of the economy. The current accommodative monetary and fiscal settings may also provide a stronger stimulus to the economy than currently anticipated if current uncertainties were to dissipate quickly.

There are also some downside risks to the US economy. Ongoing weakness in corporate profitability and heightened uncertainty surrounding corporate governance issues in the wake of the Enron collapse could delay the expected recovery in investment. In addition, an increase in uncertainty, due for example to the impact on employment security of adverse labour market developments or a resurgence of international tensions, could see spending falter and a weaker recovery than currently anticipated. Higher than expected oil prices could also slow recovery. There is also a risk that some of the imbalances built up in the 1990s, including household and corporate sector debt and highly-valued equity prices may need to be unwound, slowing the pace of recovery. There also remains an ongoing issue of the sustainability of the US current account and, by extension, the stability of G-3 (US, Japan and Euro area) exchange rates.

Economic conditions in Japan have worsened over the past year and a further period of weakness is anticipated in the forecasts. However, continuing deflation, writedowns of bank capital and uncertainties about the extent of non-performing loans have added to the risk that the financial system will be unable to adequately cope with further weakness in the economy. Monetary and fiscal policy options are limited. While the most likely outcome for Japan is that it will slowly work through its current problems without a major financial crisis, there is a risk that a further deterioration in economic and financial conditions will put additional pressure on fragile banking and corporate sectors, increasing financial system instability.

The possibility of a weaker recovery in the US and/or financial instability in Japan poses a substantial risk to the East Asian region. Strong trade and investment linkages would transmit the weakness to the East Asian economies, and increase the possibility of financial instability in the region.

Turning to domestic economic activity, there is some uncertainty around the expected depth of the downturn in the dwelling sector. While a sharp decline in new dwelling construction is expected in 2002-03, as the additional FHOS is phased out and the stock of excess supply in some segments of the market is reduced, overall conditions remain supportive of solid growth in alterations and additions. Nevertheless, there is a risk that activity in alterations and additions could moderate as new dwelling construction declines, leading to a larger decline in dwelling investment than presently forecast. This in turn would have negative implications for employment growth and household consumption, particularly for the consumption of durable goods.

On the other hand, the business investment intentions data reported by the ABS in the latest capital expenditure survey point to some upside risks to the forecasts for business investment and in turn import growth in 2002-03.

The stronger domestic economic environment, combined with reduced competition in some markets (such as insurance, telecommunications and airlines), could also create an opportunity for firms to re-build margins following the decline in the exchange rate over the last two years. Should this occur, particularly in conjunction with other short-term price pressures, it could have an impact on underlying inflationary pressures.

In addition, the recent increase in oil prices to well over the assumed price of $US23 per barrel underlying the forecasts, which is being driven mainly by concerns about the conflict in the Middle East, also presents risks to both the international and domestic forecasts. If the oil price remains well above the assumed level for an extended period of time, then confidence both domestically and internationally could decline, and other more discretionary expenditures may be lower than forecast. In addition, there is a risk that if higher petrol prices were sustained, it could feed into ongoing inflation.