ECONOMIC OUTLOOK FOR 2008-09 AND 2009-10

SEPTEMBER 2008

(THIS REPORT INCORPORATES DOMESTIC AND INTERNATIONAL DATA RELEASED UP TO 25 SEPTEMBER 2008)

Overview

Although both the Budget and June round forecasts implied some slowing in the Australian economy, recent data indicates that the downturn is likely to be deeper in the short-term than previously anticipated.

The outlook for household consumption and dwelling investment has deteriorated significantly, more than offsetting a stronger outlook for business investment and net exports. As a result, real GDP is now forecast to grow by 2 per cent in 2008-09, down from 2½ per cent forecast at June. In 2009-10, the outlook remains broadly unchanged, with GDP expected to grow by 2¾ per cent - a recovery but still below trend.

Our forecasts still represent a 'soft landing' in the face of considerable economic headwinds. The majority of the slowing is in the non-farm economy, with the farm sector still expected to rebound as at the June round. However, lower than expected rainfall in the critical month of August poses a downside risk.

These forecasts have been prepared against the backdrop of one of the most significant upheavals on global financial markets in recent history, as the fallout from the sub-prime crisis in the United States continues to unfold. Following the collapse of a number of large investment banks in the United States, the outlook for the global financial system has deteriorated significantly since June. While it is now clear that the collapse in confidence in the United States financial system is far more serious than previously thought, the ability of a planned bail-out to restore confidence has yet to be tested. As such, the impact of the crisis on economic growth in advanced and emerging economies remains very unclear, and the ensuing financial market volatility remains a considerable risk to the outlook.

The turmoil is flowing through to the Australian economy in our forecasts for household consumption, investment and the external sector. It has also been reflected in significant volatility in exchange rates and oil prices. The $US exchange rate, having traded close to parity in the middle of the year lost around 20 per cent in the month of September and had traded as low as 78c before recovering some ground. Oil prices have shown similar volatility, trading from a high of around $140 to levels below $100 in September.

This volatility has made the selection of appropriate assumptions to underpin the forecasts particularly difficult for this round. As such, oil prices and the $US exchange rate are assumed to be $US 106 and 84 cents respectively over the forecast period, around their current levels. The assumptions chosen represent a 25 per cent fall in $US oil prices, and a 12 per cent depreciation of the Australian dollar against the $US since June. These changes have significant effects on our forecasts, and the future path of both these aggregates represents a key area of uncertainty for the outlook.

Table 1: Key Domestic Forecasts – September compared with Budget and June informal

	2007-08	2008-09			2009-10	
	Outcome (a)	Budget	June	Sept	June	Sept
Real GDP (b)	3.7	2 3/4	2 1/2	2	2 3/4	2 3/4
Nominal GDP (b)	8.1	9 1/4	9	9	6	5 3/4
Employment (b)	2.7	1 1/4	1 1/2	1 1/2	1 1/4	1 1/4
Unemployment rate (d)	4.2	4 3/4	4 3/4	5	5 1/4	5 1/4
CPI (c)	4.5	3 1/4	3 1/2	3	2 3/4	2 3/4
Underlying inflation (c)	4.4	3 1/4	3 1/2	3 1/2	2 3/4	2 3/4
WPI (b)	4.2	4 1/4	4 1/4	4 1/4	4	4

(a) Calculated using original data.

(b) Year average

(c) Through the year growth rate to the June quarter.

(d) June quarter

Source: ABS Cat. No. 5206.0, 6345.0, 6401.0, 6202.0 and Treasury.

Business investment is expected to remain strong, although this masks a divergence in expectations at a sectoral level. Mining investment is expected to remain strong, bolstered by a large amount of work already in the pipeline and a lower reliance on credit due to strong profits. In contrast, non-mining investment is expected to slow, hampered by a weaker outlook for the economy and the reduced availability of credit. In view of recent financial market developments, lack of availability fo credit represents a key downside risk to the outlook for business investment.

As the economy continues to slow, employment growth is forecast to ease further in 2008-09 and 2009-10. Following growth of 2.5 per cent through the year to June 2008, employment is forecast to slow to 1 per cent in the year to the June quarter 2009, before growing by 1¼ per cent to the June quarter 2010, below growth in the labour force. As such, the unemployment rate is expected to increase to around 5¼ per cent by end of the forecast horizon. The participation rate is expected to remain around its current level of 65¼ per cent over the forecast horizon, supported by still strong rates of skilled migration.

The decline in world oil prices since the June round, coupled with a slowing economy, is expected to help further ease inflationary pressures over the forecast horizon. Headline CPI is now expected to peak at 4¾ per cent through the year to the September quarter 2008, but to return within the target band sooner, growing by 3 per cent through the year to the June quarter 2009 and 2¾ per cent through the year to the June quarter 2010. Underlying inflation will take longer to ease, and is forecast to be 3½ per cent through the year to the June quarter 2009. The inflation forecasts are sensitive to assumptions about the exchange rate and oil prices. As such, volatility in these variables presents a degree of uncertainty around these forecasts.

The current account deficit (CAD), having peaked at 7 per cent of GDP in the March quarter 2008, is expected to narrow sharply, averaging 4 per cent of GDP in 2008-09 and 2009-10. While this is driven primarily by the sharp increase in non-rural commodity prices we have already seen, it is being bolstered by stronger growth in exports than previously expected as capacity comes on-line, and weaker growth in imports as the exchange rate and slowing domestic demand play their part. These small trade surpluses are expected to be partially offset by higher remittances of mining profits to foreign investors and rising net interest payments from a higher stock of foreign debt.

Table 2: Domestic economy forecasts[a]

	Outcomes (b)	Forecasts			
	Year average	Year average		Through the year	
	2007-08	2008-09	2009-10	June 2009	June 2010
Panel A - Demand and output(c)					
Household consumption	3.9	1 1/4	2 1/4	1 1/4	2 1/2
Private investment					
Dwellings	1.5	- 1/2	3 1/2	-1 1/2	5 1/2
Total business investment(d)	11.7	9	5	6 1/2	4 1/2
Non-dwelling construction(d)	10.7	3 1/2	1	3	4
Machinery and equipment(d)	11.7	13	6 1/2	8 1/2	4
Private final demand(d)	5.2	2 1/2	3	2 1/4	3 1/4
Public final demand(d)	4.7	3 1/2	2 3/4	1	3 1/2
Total final demand	5.1	2 3/4	3	2	3 1/2
Change in inventories(e)					
Private non-farm	0.2	- 1/4	0	0	0
Farm and public authorities(f)	0.1	0	0	0	0
Gross national expenditure	5.4	2 1/2	3	2	3 1/2
Exports of goods and services	4.1	6	5 1/2	6	5
Imports of goods and services	12.2	7 1/2	5 1/2	4 1/2	6 1/2
Net exports(e)	-2.0	- 1/2	- 1/4	0	- 1/2
Gross domestic product	3.7	2	2 3/4	2	3
Non-farm product	3.7	1 3/4	2 3/4	1 1/2	3
Farm product	7.3	15	7	28	3
Panel B - Other selected economic measures					
External accounts					
Terms of trade	5.8	16 1/4	0	5 1/4	-2 1/2
Current account balance					
$billion	-68.2	-47 3/4	-52 1/4	na	na
Percentage of GDP	-6.0	-4	-4	-3 3/4	-4 3/4
Labour market					
Employment (labour force survey basis)	2.7	1 1/2	1 1/4	1	1 1/4
Unemployment rate (per cent)(g)	4.2	4 3/4	5 1/4	5	5 1/4
Participation rate (per cent)(g)	65.2	65 1/4	65 1/4	65 1/4	65 1/4
Prices and wages					
Consumer Price Index (h)					
- headline	4.5	4	2 3/4	3	2 3/4
- underlying	4.4	4	3	3 1/2	2 3/4
Gross non-farm product deflator	4.2	7	3	4 3/4	2 1/4
Wage Price Index	4.2	4 1/4	4	4 1/4	4

(a) Percentage change on preceding year unless otherwise indicated.

(b) Calculated using original data.

(c) Chain volume measure.

(d) Excluding second-hand asset sales from the public sector to the private sector, and adjusted for the privatisation of Telstra.

(e) Percentage point contribution to growth in GDP.

(f) For presentation purposes, changes in inventories held by privatised marketing authorities are included with the inventories of the farm sector and public marketing authorities.

(g) The estimates in the final two columns are the forecast rates in the June quarter 2009 and the June quarter 2010 respectively.

(h) Through the year growth rate to the June quarter for 2007-08.

Source: Australian Bureau of Statistics (ABS) Cat. No. 5206.0, 5302.0, 6202.0, 6345.0, 6401.0, unpublished ABS data and Treasury.

Outlook for the domestic economy

The forecasts for the domestic economy are underpinned by several technical assumptions. The exchange rate is assumed to remain around levels observed at the time of writing (a trade-weighted index of around 66 and a $US exchange rate of around 84c). Interest rates are assumed to remain unchanged at their current levels. World oil prices (Tapis) are assumed to remain at around $US 106 per barrel. The farm sector forecasts are based on an assumed return to average seasonal conditions in the remainder of the forecasting period, but take into account the effects of sustained drought conditions in the preceding period.

Household consumption

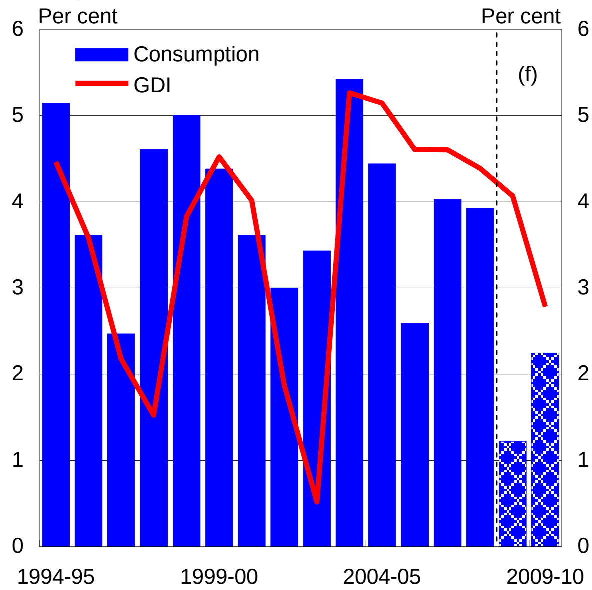
The outlook for household consumption has deteriorated significantly since the June round, with the continued impact of increased borrowing costs combined with a weaker outlook for household wealth expected to curb household consumption over the forecast horizon.

Consumption is forecast to grow by 1¼ per cent in 2008-09 (Chart 1), down from 2¾ per cent at the June round. This follows a weaker than expected outcome in the June quarter which saw the first quarterly fall since 1993.

Despite some positive news for the sector, most notably softer fuel prices and the 25 basis point cut in interest rates in September 2008, negative effects are expected to dominate the outlook over 2008-09. This includes a weaker and more uncertain outlook for wealth, driven by recent developments in global financial markets and subdued growth in house prices. The continuing effects of high interest rates and lower confidence are also likely to continue to weigh on growth. Despite some recent improvement, the consumer sentiment index has remained below 100 for the longest period since the early 1990s recession.

Consumption is forecast to experience a modest recovery in 2009-10. This reflects the fundamentals of solid growth in household income – supported by the 2008-09 and 2009-10 personal income tax cuts – and the assumption of no further increases in borrowing costs. Consumption growth in 2009-10 has been revised to 2¼ per cent, down from 2¾ per cent in June, with the extent of the recovery limited by a rising unemployment rate and lower expectations for wealth.

Chart 1: Household consumption and gross disposable income (real)

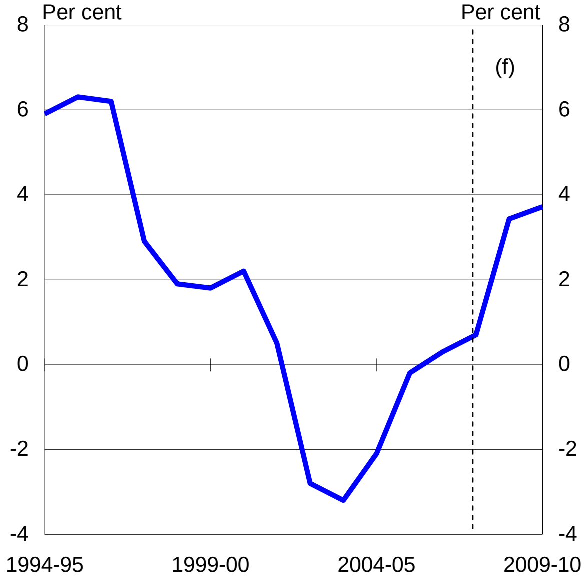


Source: ABS Cat. No. 5206.0 and Treasury.

Household disposable income is expected to grow significantly more than consumption in 2008-09 (Chart 1), reflecting weak consumer confidence and an expectation that households will seek to repair balance sheets following falls in the financial markets.

As a result the household saving ratio is expected to continue its recovery of recent years (Chart 2).

Chart 2: Household Saving Ratio



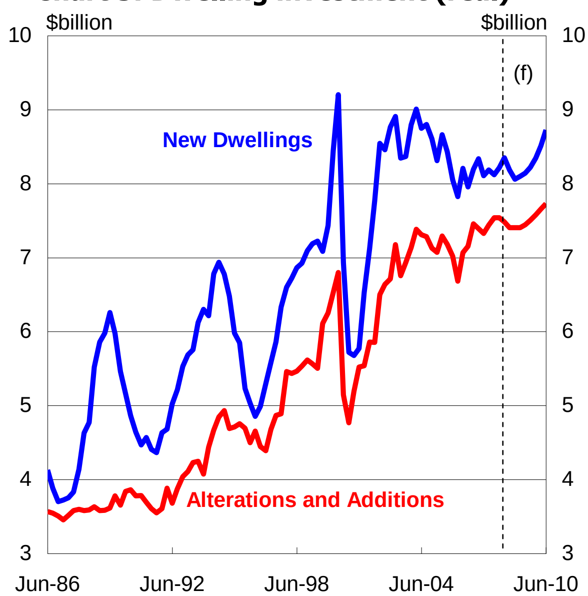
Source: ABS Cat. No. 5206.0 and Treasury.

Dwelling investment

The outlook for the residential construction sector has weakened since the June round. The impact of higher interest rates continues to weigh on the sector, with recent partial data around housing finance and building approvals supporting this view.

The outlook for both new dwelling investment and alterations and additions has weakened and both components are now expected to decline by 1 per cent in 2008-09. (Chart 3).

Chart 3: Dwelling investment (real)



Source: ABS Cat. No. 5206.0 and Treasury.

Despite the weak outlook for dwelling investment in the medium term, fundamental forces in the housing market suggest stronger activity in the longer term. With the population growing at the fastest rate in almost 20 years driven by record levels of migration, underlying demand for housing remains strong.

New dwelling investment is expected to grow by 3½ per cent in 2009-10, reflecting strong underlying demand, as well as more attractive rental yields for investors as rents continue their rapid growth. Investment in alterations and additions is also expected to pick up in 2009-10, growing by 2½ per cent.

Business investment

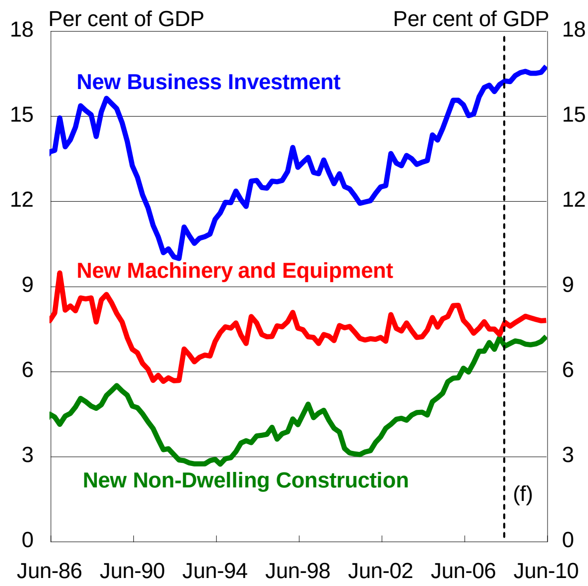
New business investment is expected to increase by 9 per cent in 2008-09 and 5 per cent in 2009-10, up slightly from the June round. Record prices for key non-rural commodities and momentum from projects (both mining and non-mining) that have already commenced are expected to support growth. However, the soft domestic outlook and tighter credit conditions are expected to temper investment in the non-mining sectors over the forecast period, particularly in non-residential building. In contrast, larger mining and ancillary firms are expected to be largely insulated from higher funding costs because of their more robust profit outlooks and lower gearing ratios. However, tight credit conditions are a key downside risk to business investment.

Investment growth is expected to slow in 2009-10 but will remain at a high proportion of GDP over the forecast period (Chart 5).

Total non-dwelling construction investment is expected to grow by 3½ per cent in 2008-09 and 1 per cent in 2009-10.

New engineering construction investment is expected to increase by 5½ per cent in 2008-09 and 4 per cent in 2009-10. Investment is expected to be supported by mining-related activity, spurred by high non-rural commodity prices and a record amount of projects in the investment pipeline. However, materials and labour shortages and increased input costs remain risks to scheduled project commencements.

Chart 4: Business investment to GDP ratio (nominal)



Source: ABS Cat. No. 5206.0 and Treasury.

There are significant risks around **non-residential building** investment. Investment is expected to pick up in the near term as current projects, especially in office construction, feed activity. However, the softer consumption outlook is expected to slow growth in the retail component, and tightening credit conditions paired with softer jobs growth are expected to weaken activity in the office market. As a result, investment is expected to fall by 1½ per cent in 2009-10.

Investment in new **machinery and equipment** is expected to grow by 13 per cent in 2008-09 and 6½ per cent in 2009-10. The third estimate of CAPEX investment intentions for 2008-09 implies very strong investment growth, particularly in the mining sector. However, these investment intentions have been discounted, to some extent with the recent deterioration in business conditions, particularly for the non-mining sectors expected to weigh on investment.

Public final demand

In real terms, new public final demand in 2008-09 is forecast to grow by 3½ per cent, unchanged from June.

Growth is expected to ease to 2¾ per cent in 2009-10, ½ of a percentage point lower than at the June round, reflecting lower growth in new public investment particularly at the state and local level.

Table 3: Real new public expenditure

	2008-09	2009-10
Consumption		
Commonwealth	2 1/2	2 1/2
State and local	2 3/4	2 1/4
Investment		
Commonwealth	3 1/2	3 1/2
State and local	7	3 1/2
Total public expenditure	3 1/2	2 3/4

Source: Treasury

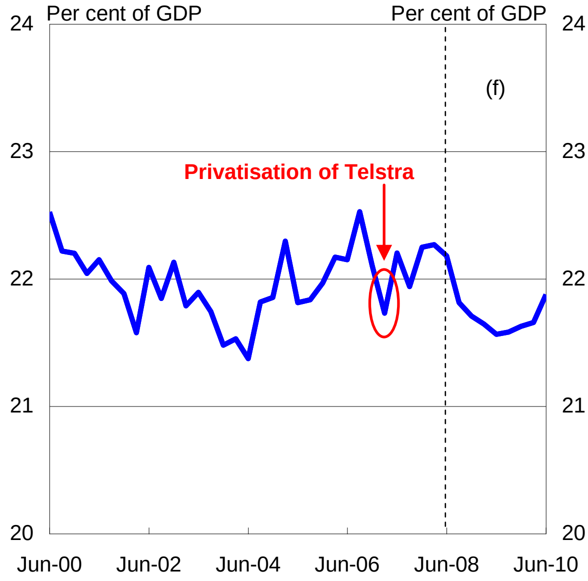
Commonwealth and State and local consumption are expected to ease over the forecast horizon.

Public investment is expected to remain strong but with growth moderating over the forecasting period. New public investment is expected to grow by 6½ per cent in 2008-09 and 3½ per cent in 2009-10, following strong growth of 10¼ per cent in 2007-08.

Strong State and local investment is still expected to drive public investment over the forecast horizon. Compared to June, the forecast for both years is weaker, mostly reflecting an expected moderation in new investment growth from Queensland and New South Wales. Further project delays and tighter global credit conditions remain a risk to the investment profile, given existing capacity constraints.

Nominal public demand has grown broadly in line with nominal GDP in recent times but is expected to fall as a proportion of the economy over the forecast horizon (Chart 6).

Chart 5: Nominal public expenditure



Source: ABS Cat. No. 5206.0 and Treasury.

Exports, imports and the current account deficit

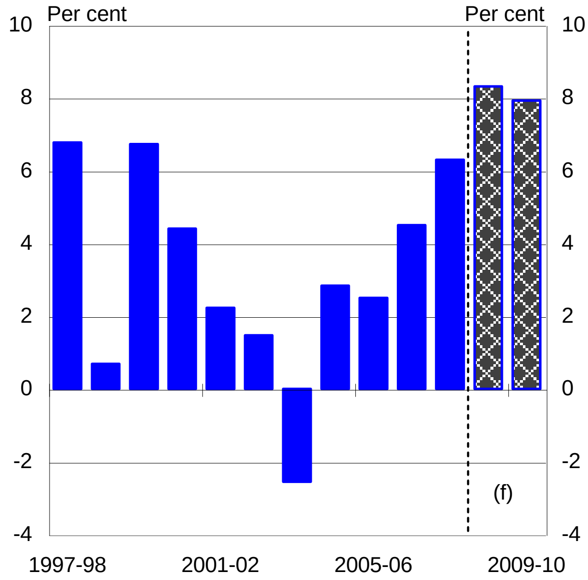
Uncertainty around the global outlook will continue to present risks for the external sector. Stronger commodity export volumes and prices, together with weaker imports in a slowing economy, are expected to produce a trade surplus and reduce the current account deficit.

Net exports are expected to subtract ½ a percentage point from GDP growth in 2008-09, ¾ of a percentage point lower than at the June round. Net exports are expected to subtract ¼ of a percentage point in 2009-10. The changes reflect an improved outlook for non-rural commodity exports and slower import growth associated with weakness in household consumption.

Total **export** volumes are expected to grow by 6 per cent in 2008-09 and 5½ per cent in 2009-10, with commodity exports expected to account for over 80 per cent of total export growth.

Following the significant amount of investment in recent years, mining projects are expected to come online throughout the forecast horizon, supporting a significant boost in **non-rural commodity exports.** Volumes are expected to increase by 8½ per cent in 2008-09 and by 8 per cent in 2009-10, the fastest rates of growth in over a decade (Chart 7).

Chart 6: Non-rural commodity exports (year average)



Source: ABS Cat. No. 5302.0 and Treasury.

By component, growth in iron ore exports is expected to contribute significantly to non-rural commodity export growth over the forecast period, as new entrants join existing producers to ramp up production. Mineral fuels and coal are also expected to contribute strongly in 2008-09 as oil and gas projects come online, and infrastructure upgrades and the arrival of key machinery and equipment improve coal chain performance.

Farm production is expected to rebound by 15 per cent in 2008-09, the same as at June. However, lower than expected rainfall during August means that ongoing rainfall during the spring crop growing season will be critical. Contingent on average seasonal conditions continuing, farm production is forecast to increase by a further 7 per cent in 2009-10.

The recovery in farm production, coupled with high international food prices is expected to see a boost to rural exports which are forecast to grow by 12 per cent in 2008-09 and 9 ½ per cent in 2009-10.

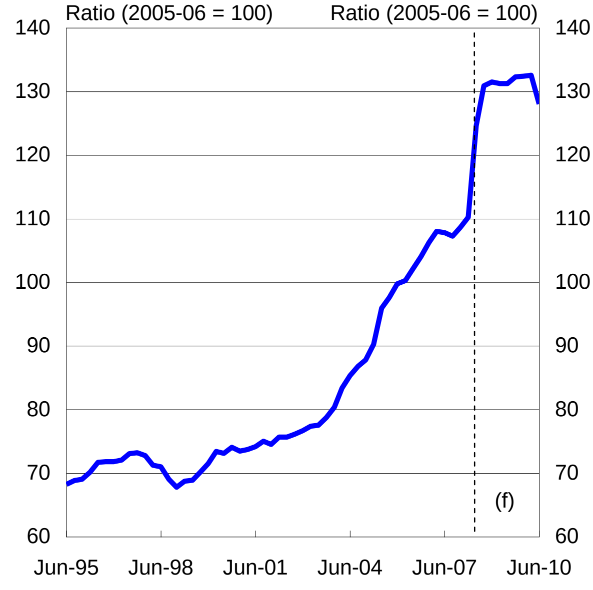
The negative influence of slowing world growth is expected to offset the boost from a weaker exchange rate for elaborately transformed manufactures (ETM) and service exports. ETM exports growth is expected to slow substantially to just 1 per cent in 2008-09 before rising to 1½ per cent in 2009-10. Growth in **services exports** is also expected to ease to 4½ per cent in 2008-09 and 2 per cent in 2009-10.

Imports of goods and services are expected to grow by 7½ per cent in 2008-09, before easing to 5½ per cent growth in 2009-10, as domestic demand continues to moderate. Compared with June, the current forecasts are 2 percentage points lower for 2008-09, reflecting a weaker outlook for domestic consumption.

The **terms of trade** are forecast to increase by 16¼ per cent in 2008-09, remaining flat in 2009-10. This is broadly consistent with June, with a weaker Australian dollar assumption translating to both stronger export prices and stronger import prices. The significant improvement in the terms of trade in 2008-09 is driven by high contract prices for Australia's bulk commodity exports – iron ore (up by around 85 per cent), metallurgical coal (up more than 200 per cent), and thermal coal (up by 125 per cent).

Current strong demand for commodities and constrained global supply should continue to support a high level of prices. However, there is considerable uncertainty regarding the future path of commodity prices.

Chart 7: Terms of trade



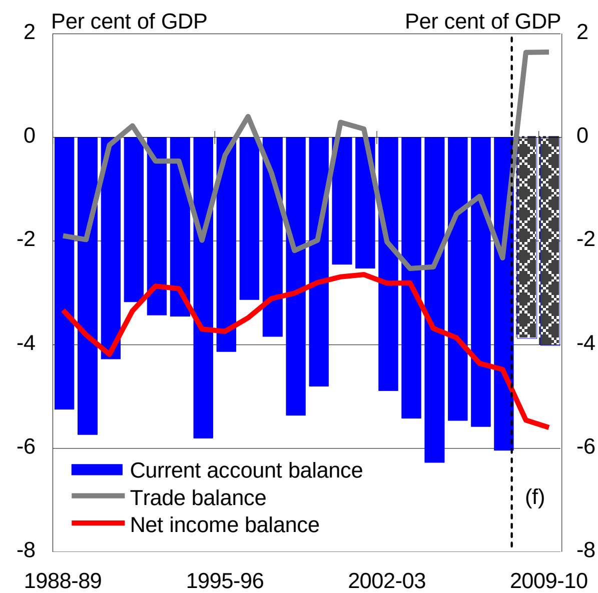
Source: ABS Cat. No. 5302.0 and Treasury.

The **trade balance** is expected to register a surplus of 1½ per cent of GDP in 2008-09 and 2009-10, 1¼ percentage points stronger than the June forecasts, largely reflecting substantial increases in bulk commodity prices and to a lesser extent, the weaker $AUS, which boosts the value of non-rural commodity prices denominated in $US.

The **net income deficit** (NID) as a per cent of GDP is expected to widen to 5½ per cent in 2008-09 and 5¾ per cent in 2009-10. The widening largely reflects strong growth in mining profits, and rising net interest payments from a higher stock of net foreign debt.

The **current account deficit** (CAD) is expected to narrow to 4 per cent of GDP in 2008-09, and remain largely unchanged in 2009-10. This is a greater narrowing of the CAD than was forecast at June JEFG, primarily due to the stronger forecasts for the trade surplus over the forecast period (Chart 9).

Chart 8: Current account balance



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

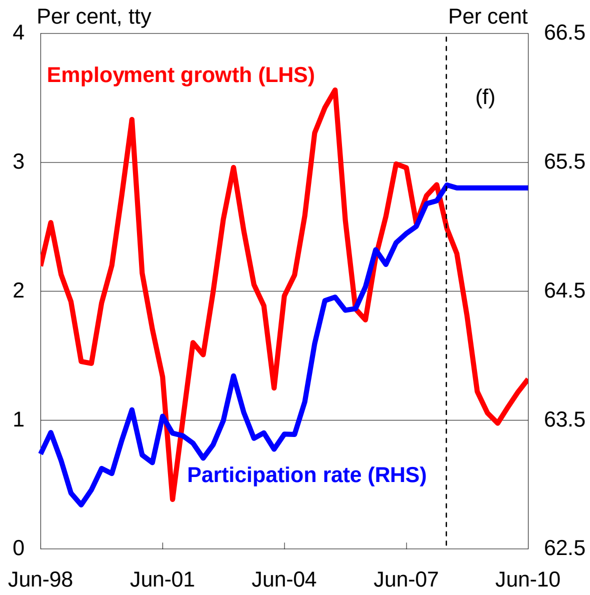
Employment, wages and inflation

Labour market

Employment growth is forecast to ease further, compared to the June round, in line with the weaker economic outlook.

Employment is now expected to grow by 1 per cent through the year to June 2009, before rising to 1¼ per cent by June 2010.

Chart 9: Labour market



Source: ABS Cat. No. 6202.0 and Treasury.

The **participation rate** is expected to remain at around current record levels of 65¼ per cent over the forecast horizon, despite an easing in labour demand. High rates of participation from skilled migrants are expected to support the overall participation rate.

With the labour force already expected to grow more strongly than employment, the **unemployment rate** is now expected to increase to 5 per cent by June 2009, rising to 5¼ per cent by June 2010.

The expectation that immigration levels will remain high, despite an easing labour market, reflects the dichotomy between mining-related and other sectors of the economy. High commodity prices are likely to support continued strong demand for labour from mining-related sectors, particularly for skills that are in short supply in Australia. At the same time, relatively weak growth in demand from households is expected to dampen general labour market conditions. The net effect is that overall employment growth is not expected to be sufficient to absorb new labour force entrants.

Prices and Wages

Wages

The outlook for **wages growth** remains unchanged from June with growth expected to remain elevated in the near term but not to accelerate. Some of the pressure in the labour market is expected to ease due to the weaker outlook for the economy, lowering the risk of excessive wage increases in 2008-09. The easing in GDP growth over the estimates period is expected to result in slower wage growth by 2009-10.

The WPI is expected to grow by 4¼ per cent through the year to the June quarter 2009 and by 4 per cent through the year to the June quarter 2010.

Although wage pressure has been strong since 2005, WPI outcomes have remained contained at or below 4¼ per cent annual growth. Well anchored inflation expectations linked to highly credible monetary policy are likely to have played a role in containing wage growth through this period. Survey based measures of inflation expectations are now starting to decline.

Other measures of wage growth are forecast to grow in line with the WPI, with Average Weekly Earnings and earnings on a National Accounts basis forecast to grow by 4¼ per cent in the year to June 2009 and by 4 per cent to June 2010.

Prices

Forecasts of underlying inflation are broadly unchanged from the June round, with the effects of a weaker economy offset by higher import prices and higher nominal unit labour costs. Underlying inflation is expected to grow by 3½ per cent through the year to June 2009 and by 2¾ per cent through the year to June 2010.

Headline **inflation is** forecast to be lower due to lower expected oil prices. Headline consumer prices are forecast to grow by

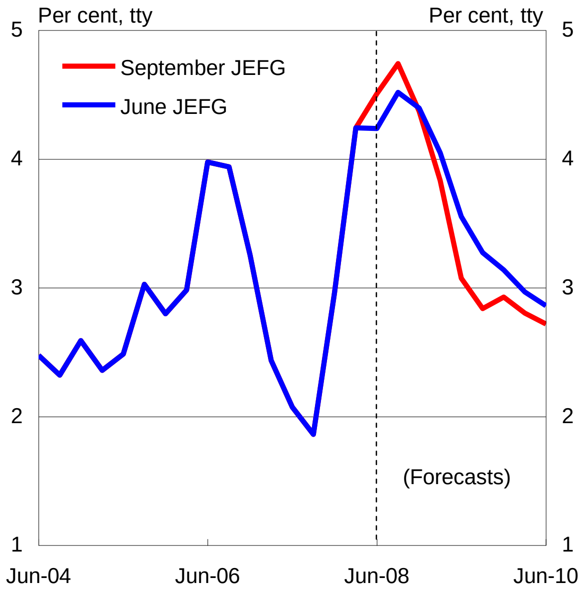
3 per cent through the year to the June quarter 2009 and 2¾ per cent through the year to the June quarter 2010.

Nominal unit labour costs are expected to be slightly higher compared to the June round forecasts, driven mostly by a decline in productivity growth as GDP growth slows. Higher import prices are also expected to contribute to inflation as will rents.

Australian dollar oil prices are assumed to be lower over the forecast period compared to the June round, with a fall in the USD oil price outweighing the decline in the exchange rate.

The inflation forecasts are sensitive to changes in assumptions about the exchange rate and oil prices. As such, volatility in these variables presents a degree of uncertainty around these forecasts.

Chart 10: Consumer price inflation



Source: ABS Cat. No. 6401.0 and Treasury.

OUTLOOK FOR THE INTERNATIONAL ECONOMY

Table 1: International GDP growth forecasts[(a)]

	2007	2008		2009		2010	
	Actual	June	Sept JEFG	June	Sept JEFG	June	Sept JEFG
United States	2.0	3/4	1 1/2	1 1/4	1	2 3/4	2 1/4
Euro Area	2.7	1 3/4	1 1/4	1 1/2	1	2	1 3/4
Japan	2.1	1 1/4	3/4	1 1/2	1	1 3/4	1 1/2
China	11.9	10	10	9 1/2	9 1/4	10	9 3/4
India	9.3	7 3/4	7 3/4	7 3/4	7	8	7 1/2
Other East Asia [(b)]	5.9	4 3/4	4 1/2	4 3/4	4 1/4	5 1/4	5 1/4
Major Trading Partners	5.2	4	3 3/4	4	3 1/2	4 1/2	4 1/4
World	5.0	4	4	4	3 1/2	4 1/2	4 1/2

(a) Calculations for World and euro area growth rates use GDP weights based on purchasing power parity (PPP). Calculations for Major Trading Partners and Other East Asia use export trade weights.
(b) Other East Asia is: Korea, Taiwan, Hong Kong, Singapore, Indonesia, Malaysia, Thailand, Vietnam and the Philippines.
Source: National statistical publications, IMF and Treasury.

World outlook and risks

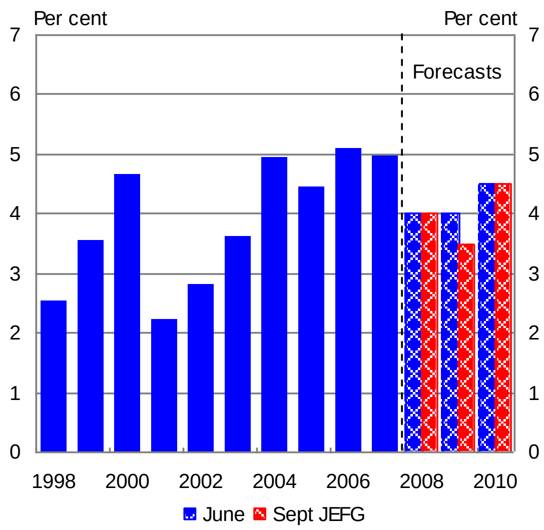
The world economy is facing its most difficult set of circumstances in many years as the credit crisis deepens and commodity prices remain at historically high levels. World growth is slowing markedly, following more than four years of rapid expansion, while inflation has risen to rates not seen in a decade, especially in emerging economies.

While growth in the global economy exceeded expectations during the early stages of 2008, it is now forecast to slow more severely through the second half of the year, with only a gradual recovery expected towards the end of 2009. Global GDP growth is expected to slow from 5 per cent in 2007 to 4 per cent and 3½ in 2008 and 2009 respectively, before reaccelerating toward 4½ per cent in 2010 (Table 1).

Recent weeks have seen a re-escalation of financial market turmoil as losses by major financial institutions have forced asset sales, placed downward pressure on asset prices and further impaired balance sheets. This chain of events has resulted in the failure and consolidation of a number of financial institutions in recent weeks.

The US Federal Reserve and other major central banks have acted to accommodate a sharp increase in demand for liquidity. In addition, US authorities have outlined a US$700 billion plan to remove troubled mortgage-related assets from the system and restore confidence to financial markets. However, despite concerted efforts, the crisis of confidence continues as concerns about the counterparty risk of large banks remains significantly elevated.

Chart 1: World GDP growth



Source: IMF and Treasury.

Financial institutions continue to hoard liquidity for precautionary reasons and concerns over the future solvency of their counterparties. Consistent with this, premiums charged on three month inter-bank loans relative to (essentially risk-free) overnight indexed swap rates have increased significantly over the past few weeks.

Moreover, the cost of insuring against bank default has also spiked, with credit default swap spreads indicating unusually high perceived risk of default amongst systemically important financial institutions.

These recent developments, if maintained, represent a significant downside risk to the global growth outlook. Advanced economies now face a period of growth well below trend, due to the ongoing strains in credit markets, high oil prices and weakening external demand.

In contrast, notwithstanding some moderation in export growth, economic momentum has remained robust in emerging economies, underpinned by strong domestic demand which has been largely unaffected by the financial markets turmoil to date.

The most immediate impact of recent financial market turbulence on emerging economies has been the sharp falls recorded in equity markets, most notably in Russia, which suspended stock exchange trading on 17 September amid the worst market falls since the country's 1998 financial collapse.

However, there is little apparent threat to these economies from tightening liquidity conditions or financial insolvency. Emerging market financial sectors remain underdeveloped, with credit intermediation largely occurring through domestic banks, which use significant domestic deposit bases. This is a predominantly closed loop, unexposed to more sophisticated financial products issued on global markets.

While there may be an indirect effect of the financial turmoil through confidence, the primary issue for emerging economies will be the slowing pace of growth in advanced economies, particularly for smaller emerging economies with a higher dependence on exports.

Signs of slowing growth have been most pronounced for those East Asian economies most closely linked to the global manufacturing cycle, including the NIE's[1], the Philippines, Thailand, and to a lesser degree, India. Headwinds to activity have also intensified for Emerging Europe and Latin America, due to their exposure to euro area and US demand respectively.

Economies such as China and India have stronger underlying domestic growth momentum which is expected to continue over the forecast horizon, albeit, moderating to a slower pace.

Notwithstanding slowing activity in 2008, global headline inflation has risen to its highest rate since the late 1990s, propelled by the surge in key commodity prices. While in advanced economies headline inflation has risen sharply, emerging economies have experienced much stronger increases. This has been largely driven by significant increases in food prices, although recent falls in these prices will provide some respite.

Oil prices, having reached record highs in July, have fallen sharply to levels not seen since the start of 2008. This significant decline largely reflects a marked change in market sentiment due to weak growth outturns for a number of developed economies in the June quarter and concerns about the impacts of recent financial market turmoil on the global growth outlook. Sustained strong demand growth (driven by the acceleration of growth in emerging economies), a sluggish supply response and declining inventories all contributed to the earlier surge in prices.

Similarly, prices of major food commodities rose by almost 70 percent in the year to June 2008, but have moderated more recently. Looking ahead, commodity prices are likely to remain well elevated and highly sensitive to changes in demand and supply fundamentals, particularly as inventories remain at very low levels.

Country summaries

The **US** economic outlook for 2009 and 2010 has softened since June, despite a firmer outlook for growth in 2008. Given an earlier-than-expected boost from the fiscal stimulus package and a strong first half net exports performance, the 2008 growth forecast has been revised up ¾ of a percentage point to 1½ per cent. However, the 2009 growth forecast is down a ¼ percentage point to

[1] The NIEs consist of Hong Kong, Korea, Singapore and Taiwan

1 per cent, while growth in 2010 has been revised down ½ a percentage point to 2¼ per cent.

With unemployment rising, and absent any further boost from the fiscal stimulus package, domestic demand is expected to contract in the second half of 2008, resulting in a shallow recession. Retail sales and real consumption spending have both fallen in recent months, consistent with our forecast for a moderate contraction in consumption through into early 2009. The bleak outlook is reinforced by the fact that consumers face further house price falls, weaker equity market returns, tighter borrowing conditions, high energy costs and deteriorating employment prospects.

In the face of continued housing market weakness, residential investment is not expected to stabilise until the second half of 2009. Meanwhile, tighter credit conditions and weaker business sentiment are likely to restrain business investment into 2009.

Given recent financial market disturbances, and the potential flow-through from the further deterioration in credit quality, notable downside risks to growth remain. Export growth could also soften in the wake of weaker trading partner growth and a firmer US dollar. However, inflation risks seem to have moderated, despite continuing concerns about commodity prices and a widening federal budget deficit. We expect core inflation to ease through 2009 due to falling capacity utilisation and rising unemployment. Financial markets have priced in the possibility of a moderate easing in official interest rates by early 2009.

Growth in the **Chinese** economy is expected to moderate but remain strong over the forecast horizon. Steady growth in investment and accelerating consumption growth will be partially offset by slowing export growth due to the weak global environment. After growing at 11.9 per cent in 2007, the fastest rate in 13 years, we expect growth to moderate to 10 per cent in 2008 and 9¼ per cent in 2009 before increasing moderately to 9¾ per cent in 2010.

With headline inflation easing over the past few months, Chinese authorities have cut benchmark lending rates and the reserve requirement ratio to help support growth. Furthermore, it is understood that the Chinese government is considering an economic stimulus package to bolster domestic growth.

The impact of the current financial turmoil on China is uncertain due to the lack of transparency with regards to its financial investments. However, it has been reported that China has the largest holdings of bonds in Fannie Mae and Freddie Mac (a fifth of its foreign reserves).

The outlook for the **Japanese** economy has softened considerably in recent months, reflecting a weakening external environment and worsening terms of trade. Demand for Japan's exports has begun to show signs of weakness and high food and energy prices have reduced business profitability, real household incomes and consumption. However, in contrast to a number of other advanced economies, Japan has not been materially affected by the turmoil in global financial markets, sustaining only small sub-prime related losses.

Forecast GDP growth for Japan has been lowered to ¾ per cent in 2008, down ½ of a percentage point. Growth in 2009 is forecast to be 1 per cent, down ½ of a percentage point, reflecting the likelihood that investment and exports will remain subdued due to the expected protracted global recovery. Moreover, there is a distinct possibility that Japan will experience a recession this year.

The outlook for growth in **India** has continued to deteriorate since June. Growth in 2009 is forecast to be 7 per cent, down ¾ of a percentage point, with 7½ per cent growth forecast in 2010, down ½ a percentage point. Domestic demand is beginning to labour under the weight of high inflation and the sustained slowdown in advanced economies. Heightened global risk aversion is also reducing levels of foreign investment, one of the key positive elements of India's recent economic performance. Growth is not expected to pick up again until 2010 as inflation eases and global conditions begin to improve.

Growth is expected to ease in the **ASEAN-5** economies to 5¼ per cent in 2008 and 5 per cent in 2009. Exports are expected to moderate in line with weaker trading partner growth resulting in negative income effects on domestic demand. Growth is expected to pick up in 2010 to 6 per cent as the region benefits from a recovery in the external environment. The current turmoil in financial markets poses a risk to growth in the region. Although financial markets in the region are more prudentially sound and better placed to manage volatility since the 1997-98 Asian Financial Crisis, markets still face heightened risk aversion and are vulnerable to changes in investor sentiment.

Growth in the newly industrialised economies (**NIEs)** is forecast to moderate to 4 per cent in 2008 and 3¾ per cent in 2009. Slower growth in major trading partner economies is expected to dampen export growth. In addition, growth in domestic demand is expected to ease in line with weaker export growth and high food and energy prices. Current financial market developments are a downside risk to growth in the NIEs. While the direct impact of the global financial turmoil has so far been small, indirect effects have been notable as equity prices have declined, volatility has increased, spreads on external debt have widened and currencies, such as the Korean won, have depreciated sharply. Growth is expected to pick up in the second half of 2009 and into 2010 as exports rebound in line with an expected recovery in global growth and domestic demand. Growth in the NIEs is expected to reach 4¾ per cent in 2010.

The outlook for the **euro area** has deteriorated since June. We expect growth to slow sharply to 1½ per cent in 2008 and 1 per cent in 2009, before staging a modest recovery in 2010. Export growth is expected to slow significantly reflecting weak global demand. Consumption growth is expected to remain subdued reflecting weak real income growth, while investment is expected to grow only modestly as tighter credit conditions weigh on businesses.

Growth in **New Zealand** is forecast to slow to 0.5 per cent in 2008, with a significant housing market correction, high mortgage rates, financial market strains and surging food and fuel prices having led to broad weakness in confidence, consumption and investment. While the Government's tax cuts, continued easing in monetary policy and a depreciating NZ dollar should help to spur growth next year following a projected 2008 recession, the recovery is expected to be gradual, with growth of 1.5 per cent projected for 2009.