ECONOMIC OUTLOOK FOR 2007-08 AND 2008-09

MARCH 2008 JEFG ROUND

(THIS REPORT INCORPORATES DOMESTIC DATA RELEASED UP TO 8 APRIL 2008 AND INTERNATIONAL DATA RELEASED UP TO 4 APRIL 2008)

OVERVIEW

While the global economy has remained relatively resilient in spite of worsening conditions in US credit markets, in the last few months financial market stresses have intensified and risk becoming self-reinforcing. At the same time, the economic slowdown in the US and abroad is placing strains on corporate and household balance sheets, and increasing the risk of a global credit crunch. As these events have continued to unfold it is now appears likely that the global economy will slow more significantly than previously anticipated. As a result, world growth is forecast to slow from 4.9 per cent in 2007 to 3¾ per cent in 2008, before staging a slight recovery in 2009

The ongoing re-pricing of risk in world financial markets sparked by the US sub-prime crisis has weakened the outlook for world economic growth, driven by a sharp slowing in the US economy, which is now expected to be in recession in mid-2008. The weakness is being led by the housing market, with February housing permits the lowest since September 1991. While the US Federal Reserve has cut official interest rates aggressively, providers of funds globally are still demanding larger risk premia, particularly for loans with longer maturities. Although some slowing in other advanced economies is expected as a result of US weakness, the outlook for the rest of the world remains largely positive, with China and India expected to continue to post rapid rates of growth over the forecast horizon. Strong growth is also expected in 'commodity economies', such as Russia and Brazil, and in the Middle East.

The international financial market turmoil has resulted in a tightening of credit conditions in Australia, as Australian banks have responded to the increased funding costs and more limited availability of credit by raising the interest rate spread on mortgage and commercial loans since the start of the year. This, coupled with a series of official rate rises from a Reserve Bank concerned about strengthening domestic demand growth and rising inflationary pressures, means that consumers and businesses face significantly higher interest rates than at December JEFG. This tightening is expected to place significant downward pressure on Australian economic growth over the forecast horizon.

Countering these moderating influences on the economy are further gains in the terms of trade expected over 2008-09 driven by higher bulk commodity prices. Expectations are for iron ore prices to rise by at least a further 65 per cent and coal prices by around 165 per cent on average from already high levels. This would see Australia's terms of trade, which has already risen by 40 per cent over the last 5 years, rise by a further 16 per cent over 2008-09, providing a huge additional stimulus to domestic incomes. Some of these gains may be the result of short term supply conditions, for example the effects of flooding on the Queensland coal industry. However, continued demand from China is likely to continue to support a high level of commodity prices in the period ahead.

On balance, these factors result in a weaker outlook for the Australian economy, with real GDP now expected to grow by 3¾ per cent in 2007-08 (¼ of a percentage point lower than December JEFG) and by 3 per cent in 2008-09 (¾ of percentage point lower than December JEFG). The slowing will principally be felt in the non-farm economy, with non-farm GDP now expected to grow by 2½ per cent in 2008-09, a downward revision of 1 percentage point from December JEFG. In contrast, the outlook for the agricultural sector has improved, with farm GDP now expected to grow by 20 per cent in 2008-09, contributing ½ of a percentage point to real GDP growth. The brighter outlook for the farm sector reflects the significant rainfall in the Eastern States over the past few months and the resultant improvement in water storage levels. Although the real economy is expected to slow significantly, the large increase in the terms of trade over 2008-09, and consequently the GDP deflator, will see an acceleration in the value of domestic production, with nominal GDP expected to grow by 9¼ per cent, the fastest since 1989-90. This will provide a significant additional boost to profits in the mining sector in particular.

The downward revision to growth incorporates the impact of higher interest rates and borrowing costs, with growth in domestic demand expected to slow from its present pace by the end of the forecast period, though still remaining solid. At a component level, interest rate rises are expected to weigh most heavily on household consumption and dwelling investment. In contrast, with strong growth in commodity prices, the mining and related sectors are expected to continue to undertake a large amount of investment over the forecast period, leading to only a minor downward revision to the outlook for business investment. While in principle stronger profits in the mining sector should provide an additional spur to investment, mining companies are likely to face capacity constraints in the short run. Sustained higher commodity prices are likely to have more influence on the duration of the current investment boom.

Table 1: Key Domestic Forecasts – March JEFG compared with December JEFG

	2006-07	2007-08		2008-09	
	Outcome	December	March	December	March
Real GDP	3.2	4	**3 3/4**	**3 3/4**	**3**
Non-farm GDP	3.9	4	**3 3/4**	**3 1/2**	**2 1/2**
Farm GDP	-22.8	1	**2**	**10**	**20**
Nominal GDP	8.2	7 1/4	**7 3/4**	**7 1/4**	**9 1/4**
Unemployment rate (a)	4.3	4 1/2	**4**	**4 1/2**	**4 3/4**
Current Account Balance (% GDP)	-5.6	-6 1/4	**-6 1/4**	**-6 1/2**	**-4 1/2**
CPI (b)	2.1	3 1/4	**3 1/2**	**2 3/4**	**3**
WPI (b)	4.0	4 1/4	**4 1/4**	**4 1/4**	**4 1/4**

(a) Average in June quarter

(b) Through the year to the June quarter

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

In line with a forecast slowing in non-farm GDP growth, employment growth is forecast to moderate in 2008-09. In through the year terms, employment is forecast to grow by 2½ per cent to the June quarter 2008, before slowing to 1 per cent in the June quarter 2009, with the unemployment rate rising to 4¾ per cent by the end of the forecast period.

CPI growth is expected to be stronger than forecast at December JEFG, driven by persistent underlying inflationary pressures, in addition to a range of specific factors, such as high oil and food prices. Headline inflation is expected to peak in the March quarter this year and ease gradually to the top of the RBA’s target band by the June quarter 2009.

The CAD is forecast to narrow sharply to 4½ per cent of GDP by 2008-09, having reached 7 per cent of GDP in the December quarter 2007. This narrowing primarily reflects higher prices received on non-rural commodity exports leading to a small balance of trade surplus in 2008-09. Partially offsetting this, higher mining profits associated with higher commodity prices in 2008-09 are expected to lead to a widening net income deficit in 2008-09, as some of these profits are remitted to foreign investors.

While the central forecasts are for a soft landing, the competing shocks create considerably uncertainty around the outlook for the Australian economy. A more marked slowing in the global economy than anticipated, particularly one that involved a slowing in China, or more severe financial market turmoil would see the Australian economy increasingly negatively affected by global conditions. On the other hand, the stimulus from the terms of trade, and the resultant boost in national income could see domestic demand fail to slow as expected, potentially leading to more persistent wage and inflation pressures.

Table 2: Domestic Economy Forecasts[(a)]

Domestic economy forecasts[(a)]

	Outcomes (b)	Forecasts			
	Year average	Year average		Through the year	
	2006-07	2007-08	2008-09	June 2008	June 2009
Panel A - Demand and output(c)					
Household consumption	3.6	4 3/4	3 1/4	4 1/2	2 3/4
Private investment					
Dwellings	2.4	2 1/2	2	3 1/2	1 1/2
Total business investment(d)	6.7	9 1/2	8 1/2	8 1/2	4 1/2
Non-dwelling construction(d)	12.4	8 1/2	5 1/2	6 1/2	3
Machinery and equipment(d)	2.9	9 1/2	11	10	4 1/2
Private final demand(d)	4.0	5 1/2	4 1/4	5	3
Public final demand(d)	4.3	4 3/4	3	4	2 3/4
Total final demand	4.1	5 1/4	4	4 3/4	3
Change in inventories(e)					
Private non-farm	0.3	1/4	- 1/4	1/4	- 1/4
Farm and public authorities(f)	-0.2	0	0	0	0
Gross national expenditure	4.2	5 1/2	3 3/4	5	2 3/4
Exports of goods and services	3.8	3	6	3	7 1/2
Imports of goods and services	8.9	11	9	11	7
Net exports(e)	-1.2	-2	-1	-2	- 1/4
Gross domestic product	3.2	3 3/4	3	3 1/4	2 3/4
Non-farm product	3.9	3 3/4	2 1/2	3 1/4	2 1/4
Farm product	-22.8	2	20	14	36
Panel B - Other selected economic measures					
External accounts					
Terms of trade	6.7	4 3/4	16	13	3 1/4
Current account balance					
$billion	-59.0	-71 1/2	-54 1/2	na	na
Percentage of GDP	-5.6	-6 1/4	-4 1/2	-5 1/4	-4 3/4
Labour market					
Employment (labour force survey basis)	2.7	2 1/2	1 1/4	2 1/2	1
Unemployment rate (per cent)(g)	4.5	4 1/4	4 1/2	4	4 3/4
Participation rate (per cent)(g)	64.8	65 1/4	65 1/4	65 1/4	65
Prices and wages					
Consumer Price Index	2.9	3	3	3 1/2	3
Gross non-farm product deflator	4.8	3 3/4	6 1/4	5 1/2	4
Wage Price Index	4.0	4 1/4	4 1/4	4 1/4	4 1/4

(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 2008 and the June quarter 2009 respectively.
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

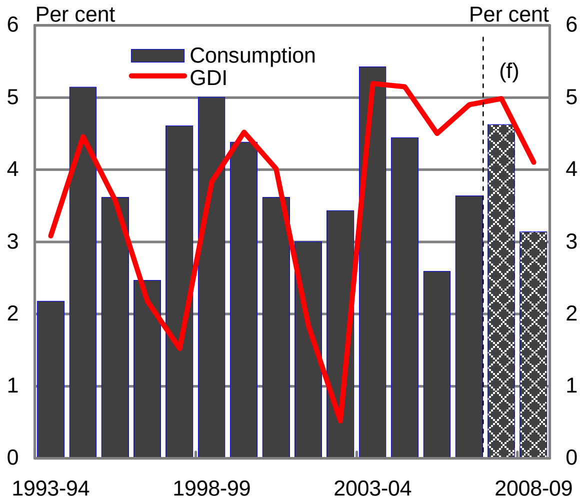
The forecasts for the domestic economy are underpinned by several technical assumptions. The exchange rate is assumed to remain around its average level of early March 2008 (a trade-weighted index of around 71 and a $US exchange rate of around 93c). Interest rates are assumed to remain unchanged at their current levels. World oil prices (West Texas Intermediate) are assumed to remain at $US105 per barrel, consistent with the average spot price in March 2008. 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

Increased borrowing costs combined with a more uncertain outlook for household wealth are expected to curb household consumption over the forecast horizon.

Consumption is forecast to grow by 4¾ per cent in 2007-08 (Chart 1), up from 4¼ per cent at December JEFG. This reflects a stronger than expected outcome for the December quarter.

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



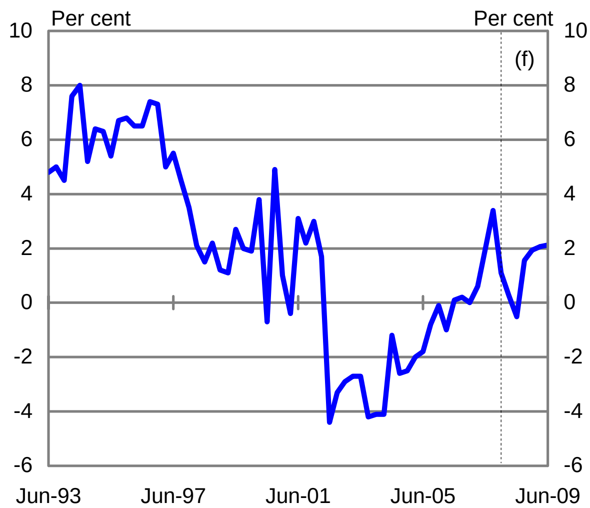
Source: ABS Cat. No. 5206.0 and Treasury.

Recent interest rate rises are expected to constrain consumption growth over the forecast horizon through the impact of higher interest payments on household budgets and by increasing the returns to saving. Additionally, recent financial market volatility in the wake of the US sub-prime mortgage crisis has created a more uncertain outlook for financial wealth, with the ASX200 falling by more than 15 per cent in the first three months of 2008. Consumer sentiment has declined sharply over this same period, with the Westpac-Melbourne Institute Index falling to its lowest level in almost 15 years.

Accordingly, consumption growth in 2008-09 has been revised down to 3¼ per cent (from 4 per cent at December JEFG).

Household disposable income is forecast to grow more strongly than consumption in 2008-09 (Chart 1), with the household sector expected to benefit from solid growth in salaries and wages, as well as strong growth in dividends associated with the rise in bulk commodity prices. Consistent with this, the household saving ratio is expected to consolidate its recovery in recent years, stabilising at around 2 per cent in 2008-09 (Chart 2).

Chart 2: Household Saving Ratio



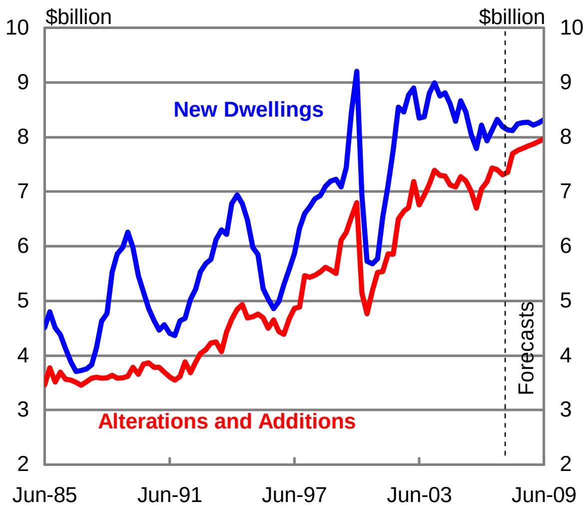
Source: ABS Cat. No. 5206.0 and Treasury.

Dwelling investment

Activity in dwelling investment is expected to be significantly weaker than at December JEFG, as successive interest rate rises weigh on this interest rate sensitive sector.

Since December JEFG, further increases in interest rates, including increases in rates independent of official rates due to the global financial market turmoil, have added around 80 basis points to the average standard variable home loan rate. The impact is expected to be felt particularly in new dwelling investment, with the nascent recovery in this sector deferred until after the forecast period, and only moderate growth expected in 2008-09 (Chart 3).

Chart 3: Dwelling investment (real)



Source: ABS Cat. No. 5206.0 and Treasury.

Recent activity in the housing market has been concentrated in alterations and additions. Investment is expected to grow steadily over the forecast period albeit at a lower rate than at December JEFG, providing some support for total dwelling investment.

Underlying demand for housing is expected to remain strong, driven partly by a high level of migration, which has been supporting strong growth in house prices. Some moderation in house price growth is expected over the forecast period, reflecting weaker actual demand, as higher interest rates make housing less affordable. Nevertheless, constrained supply is expected to see house prices continue to grow faster than consumer prices. Less affordable housing and constrained supply imply continued tightness in the rental market and a continuation of record low vacancy rates, which are leading to rising rents.

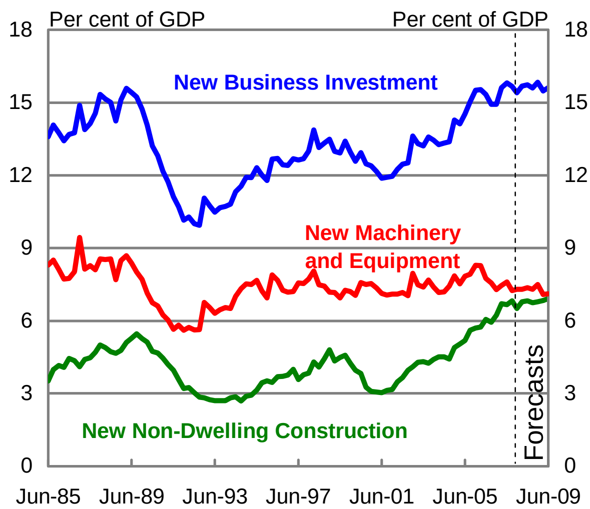
Business investment

Following an increase of more than 100 per cent over the past six years, real new business investment is expected to continue to grow strongly in the forecast period, with an expected increase of 9½ per cent in 2007-08 and 8½ per cent in 2008-09. The overall outlook for business investment remains positive with capacity utilisation rates at high levels, a strong Australian dollar and further rises anticipated for the terms of trade. However, the forecasts are marginally weaker than at the December round amid an environment of higher borrowing costs.

In addition, business sentiment has weakened in recent months with the increased uncertainty in global financial markets and weaker growth in the world economy. These factors are expected to weigh on non-mining related investment in particular, with larger mining firms somewhat insulated from higher funding costs through their ability to fund projects from strong profits.

New business investment as a proportion of nominal GDP is expected to remain high (Chart 4).

Chart 4: Business investment to GDP ratio (nominal)



Source: ABS Cat. No. 5206.0 and Treasury.

New machinery and equipment investment

Investment in new machinery and equipment is expected to increase by 9½ per cent in 2007-08 and by 11 per cent in 2008-09. This continued strength is anticipated to be supported by a strong Australian dollar and expected rises in bulk commodity prices.

The outlook for 2007-08 is broadly unchanged from the December round. The December quarter 2007 Private New Capital Expenditure Survey (CAPEX) suggests positive investment intentions, particularly in the mining and construction industries in this year.

The weaker outlook for 2008-09 reflects the impact of higher interest rates on non-mining investment and an updated civil aircraft profile.

New non-dwelling construction investment

Total non-dwelling construction investment is expected to grow by 8½ per cent in 2007-08 and by 5½ per cent in 2008-09. The forecast for 2007-08 is lower than at December JEFG, reflecting weaker-than-expected outcomes for both engineering construction and non-residential buildings.

New engineering construction investment is expected to increase by 11½ per cent in 2007-08 and by 7 per cent in 2008-09. After recording another year of double digit growth in 2006-07, investment in engineering construction fell in the first half of 2007-08. However, the outlook remains positive with activity expected to ramp up with the recent commencement of significant projects such as the Pyrenees oil field and the expansion of the Yarwun alumina refinery.

Significant projects that are expected to commence in the forecast period include the Citic Pacific iron ore mine and pellet plant, Gladstone Pacific Nickel's refinery, and the Oakajee port and rail development.

A record amount of work yet to be done remains in the pipeline, but there remains a risk that constraints arising from increased cost and labour supply pressures will delay some engineering construction investment.

Non-residential buildings investment is expected to grow by 5½ per cent in 2007-08 and 4 per cent in 2008-09. Approvals data and low vacancy rates across the country suggest continued strength in activity in the office market. In addition, approvals data also suggest solid growth in retail and wholesale construction, and emerging strength in the tourist accommodation sector.

Inventories

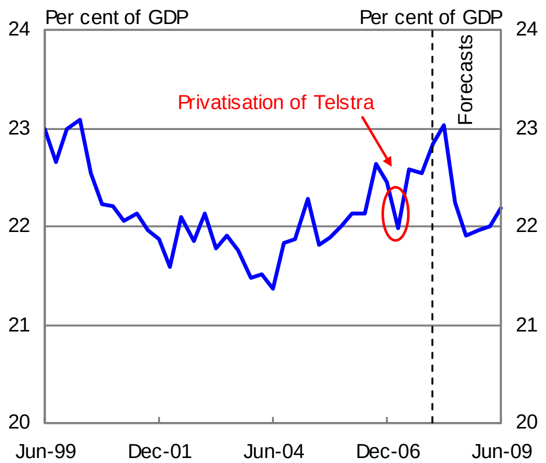
Consistent with strong growth in domestic demand over the past year, private non-farm stocks are expected to contribute ¼ of a percentage point to GDP growth in 2007-08. Conversely, the forecast slowdown in domestic demand growth in 2008-09 is expected to result in stocks detracting from GDP growth by around ¼ of a percentage point in 2008-09.

Farm stocks are expected to have a negligible effect on GDP growth over the next two years.

Public final demand

New public demand has grown broadly in line with nominal GDP in recent times but is expected to fall as a proportion of the nominal economy over the forecast horizon (Chart 5).

Chart 5: Nominal public expenditure



Source: ABS Cat. No. 5206.0 and Treasury

In real terms, new public final demand is expected to increase by 4¾ per cent in 2007-08 and 3 per cent in 2008-09, with expenditure at the State and Local level growing more strongly than at the Commonwealth level in both years (Table 3).

Table 3: Real new public expenditure

	2007-08	2008-09
Consumption		
Commonwealth	3	2½
State and Local	2½	2¾
Investment		
Commonwealth	-8½	-3
State and Local	19	5½
Total public expenditure		
Commonwealth	1¾	2
State and Local	6½	3½

Source: Treasury.

The outlook for government consumption growth in both 2007-08 and 2008-09 is weaker relative to December JEFG. The weaker forecast for 2007-08 reflects lower growth expectations for State and Local consumption, while for 2008-09 it is due to moderating Commonwealth consumption.

New public investment is expected to record strong growth in 2007-08 before moderating to 4 per cent in 2008-09. Strong State and Local investment in 2007-08 is expected to drive public investment growth of 13¼ per cent. This is stronger than forecast at December JEFG, although there is a risk that project delays may transfer some growth from 2007-08 into 2008-09.

Exports, imports and the current account deficit

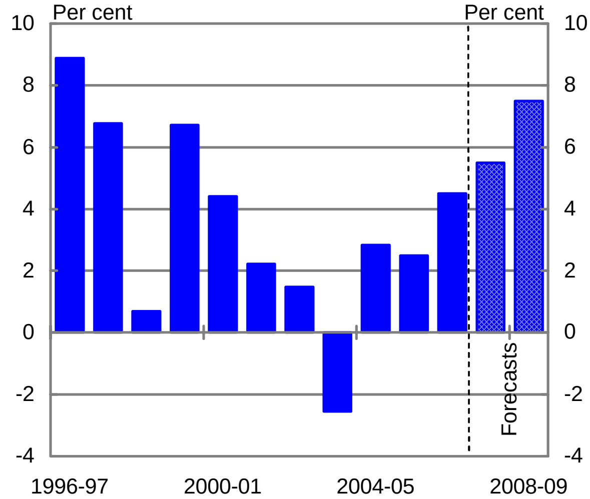
Following a 1¼ percentage point subtraction in 2006-07, net exports are expected to subtract 2 percentage points from GDP growth in 2007-08, a larger detraction than forecast at December JEFG, partly reflecting stronger-than-expected import growth in the December quarter 2007.

The expected subtraction for 2008-09 is now 1 percentage point, ¼ of a percentage point less than forecast at December JEFG in line with the lower expected domestic demand growth.

Total export growth in 2007-08 is forecast at 3 per cent and is lower relative to December JEFG, partly reflecting short term interruptions to mining activities associated with the Queensland floods. Export growth is then forecast to be 6 per cent in 2008-09, ½ of a percentage point higher than at December JEFG. This is partly attributable to a recovery in mining exports following the floods, but also reflects higher exports of rural commodities. A stronger rebound in rural exports is now expected in 2008-09 in line with a stronger recovery in the farm sector than previously expected.

Non-rural commodity exports are expected to increase by 5½ per cent in 2007-08 and by 7½ per cent in 2008-09 (Chart 6). Slower growth in coal exports in 2007-08, associated with the severe flooding in Queensland, has resulted in a downward revision to the 2007-08 forecast from December JEFG. The acceleration in non-rural commodity exports growth in 2008-09 reflects mining projects coming online following the large amount of investment undertaken in recent years, and a recovery from weather-affected export growth in 2007-08.

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



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

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. After recording solid growth of 7.3 per cent in 2006-07, iron ore export volumes are forecast to grow by 12½ per cent in 2007-08 and by 12 per cent in 2008-09. Mineral fuels are also expected to contribute strongly in 2008-09 as oil and gas projects come online.

After a weak 2008-09, the outlook for farm production has improved for 2008-09. While the strong rainfalls received across much of Eastern Australia in February came too late to affect the 2007-08 winter crop, they have dramatically improved the outlook for 2008-09. Farm production is expected to grow by 20 per cent in 2008-09, reaching around 95 per cent of the pre-drought level of 2005-06. Growth is expected to be primarily driven by an increase in the production of cereal crops such as wheat and barley. Livestock production is expected to remain relatively flat, as increased herd rebuilding largely offsets decreased livestock slaughterings.

Rural exports are forecast to fall by 9½ per cent in 2007-08, reflecting drought-affected farm production in 2006-07 and 2007-08, and low levels of farm inventories which have historically supported exports in years of below-average production. In 2008-09, the forecast for rural exports has been revised upwards in line with higher farm output, with expected growth of 12½ per cent.

While more favourable supply conditions should improve our commodity exports, other exports are expected to be adversely affected by a sustained higher exchange rate and slower world growth.

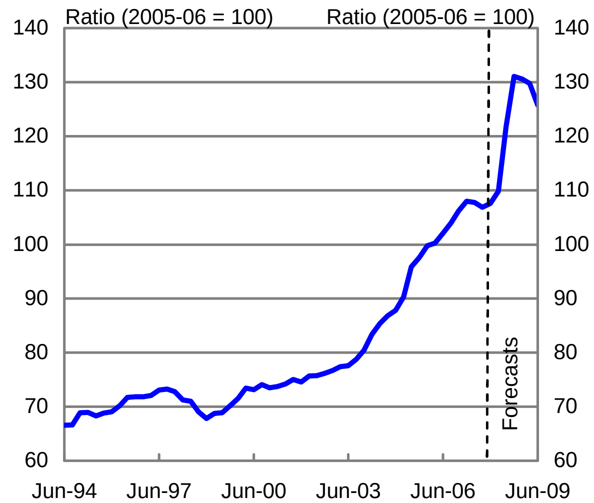
Exports of elaborately transformed manufactures are forecast to slow from growth of 7½ per cent in 2007-08 to ½ of a per cent in 2008-09. Growth in 2007-08 is stronger than forecast at December JEFG, underpinned by strong outcomes for pharmaceutical exports and motor vehicle sales. Services exports growth, while showing some strength in 2007-08, is expected to be sluggish in 2008-09.

Imports of goods and services are expected to increase by 11 per cent in 2007-08, higher than December JEFG, supported by the higher exchange rate and robust consumption and investment demand. However, an easing in domestic demand growth in 2008-09, especially in relation to household consumption, is expected to dampen import growth to 9 per cent, slightly lower than forecast at December JEFG.

Expected growth in goods imports is higher relative to the December JEFG in 2007-08, but has been revised down in 2008-09 reflecting a downward revision to domestic demand. Imports of capital goods are expected to hold up, however, in line with continued strong growth in business investment. Services imports growth is expected to be stronger in 2007-08 than at December JEFG, reflecting robust demand for outbound travel and professional services and a higher exchange rate. In 2008-09, services imports growth is expected to moderate, in line with domestic demand.

The terms of trade are forecast to increase by 4¾ per cent in 2007-08 and by 16 per cent in 2008-09, up from forecast rises of 1¾ per cent and 4½ per cent at December JEFG (Chart 7). The strong upward revisions, which follow upward revisions at December JEFG, predominantly reflect increasingly tight markets for bulk commodities, leading to very substantial increases in contract prices in 2008-09. Contract prices for Australian iron ore will increase by at least 65 per cent, while prices for metallurgical coal and thermal coal have surged by around 200 per cent and 125 per cent respectively. Strength in prices for Australia's bulk commodity exports is expected to more than offset significant expected falls in some base metal prices.

Chart 7: Terms of trade



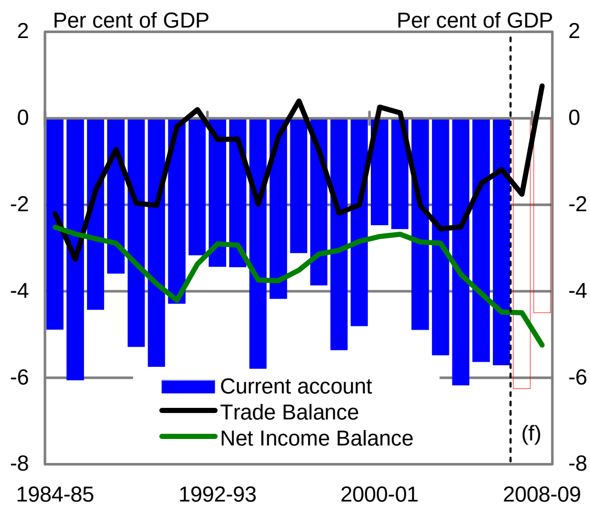
Source: ABS Cat. No. 5302.0 and Treasury.

The trade deficit is expected to widen to 1¾ per cent of GDP in 2007-08, unchanged from December JEFG, with a widening deficit in trade volumes offsetting a higher terms of trade. In 2008-09 the trade balance is expected to move into surplus, to be ¾ of a per cent of GDP, reflecting a substantial increase in export values on the back of higher bulk commodity prices.

The net income deficit (NID) as a per cent of GDP in 2007-08 is expected to remain broadly unchanged from 2006-07, before widening to 5¼ per cent in 2008-09. The widening in 2008-09 largely reflects a rising stock of net foreign debt and robust growth in corporate profits, with particularly strong growth in mining profits. However, given the current uncertainty in financial markets, the outlook for the NID is more uncertain than usual.

Reflecting these movements, the current account deficit (CAD) is expected to be 6¼ per cent of GDP in 2007-08, narrowing to 4½ per cent of GDP in 2008-09 (Chart 8). The forecast for 2008-09 is 2 percentage points of GDP narrower than at December JEFG.

Chart 8: Current account balance



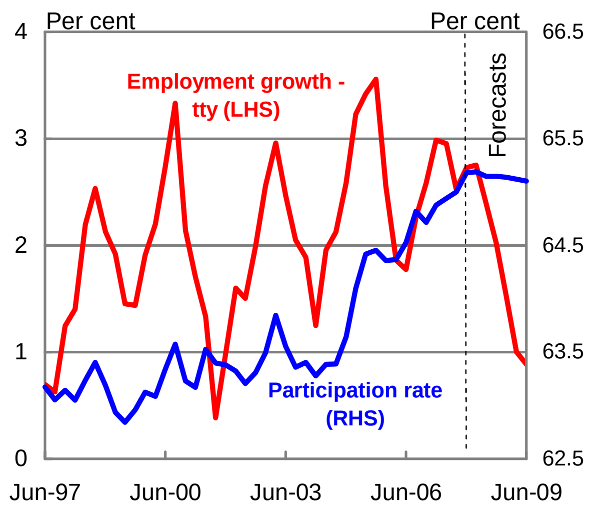
Source: ABS Cat. No. 5302.0, 5206.0 and Treasury.

Employment, wages and inflation

Labour market

Employment is forecast to grow by 2½ per cent in 2007-08, unchanged from December JEFG, before easing to 1¼ per cent in 2008-09, ½ of a percentage point lower than at December JEFG. The moderation in 2008-09 reflects a weaker forecast for non-farm GDP growth.

Chart 9: Labour market indicators



Source: ABS Cat. No. 6202.0 and Treasury

The participation rate is expected to fall slightly from the current record level of 65¼ per cent to 65 per cent by the June quarter 2009, as the supply of labour starts to respond to the easing in labour demand (Chart 9). The high participation rate in 2007-08 and the first half of 2008-09 is expected to be supported by continuing increase in skilled immigration.

The forecasts for the unemployment rate have been revised down in 2007-08 to 4¼ per cent, from 4½ per cent at December JEFG, reflecting recent low unemployment rate outcomes. The unemployment rate is forecast to increase slightly to 4¾ per cent by the June quarter 2009, in line with a moderation in employment growth towards the end of 2008-09.

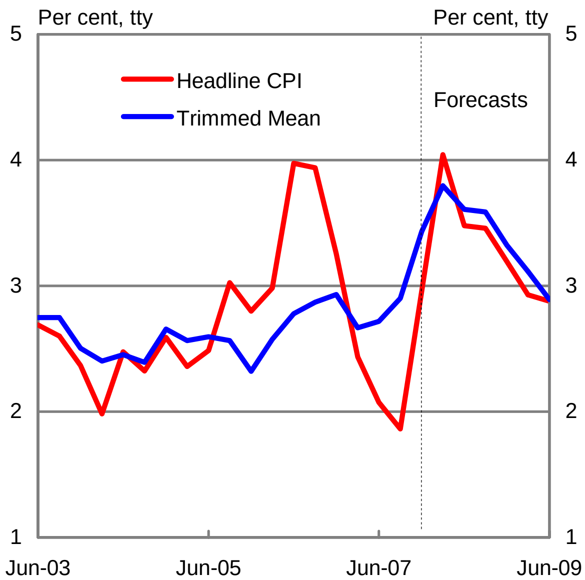
Prices

Inflationary pressures are expected to persist across the forecast horizon, with headline CPI expected to grow by 3½ per cent through the year to the June quarter 2008 and 3 per cent to the quarter June 2009. In both years this is ¼ of a percentage point higher than December JEFG. The upward revisions are largely driven by higher expected nominal unit labour costs and higher oil prices.

Inflation is expected to peak in the March quarter 2008 at 4 per cent, before easing to near the top of the RBA target band by the June quarter 2009. In the near-term, this reflects price pressures from strong nominal unit labour costs and high oil prices, as well as specific price pressures from food, housing costs and financial services. Underlying inflation is expected to follow a similar path, remaining high over the forecast period (Chart 10). The RBA's trimmed mean measure of underlying inflation is expected to peak at around 3¾ per cent in March 2008, easing to 3 per cent by the June quarter 2009, in line with slowing domestic demand and output.

Growth in dwelling rents are expected to be strong, reflecting record low vacancy rates, and growth in house purchase prices is likely to remain solid due to increasing labour and material costs. Financial services prices are also expected to grow strongly in the near term due to the combined effects of higher interest rates from continued turmoil in global financial markets and recent official interest rate rises. The price of food is expected to remain at high levels in the near-term given strong world demand and constrained domestic supply following severe drought, although the expected recovery in farm production may place downward pressure on domestic food prices.

Chart 10: Consumer price inflation



Source: ABS Cat. No. 6401.0 and Treasury.

Wages

Solid wage growth is expected across the forecast horizon, but is not forecast to accelerate, given the anticipated easing in labour market conditions. The Wage Price Index (WPI) is forecast to grow by 4¼ per cent in 2007-08 and 2008-09, with growth of 4¼ per cent through the year to both the June quarters 2008 and 2009.

There continues to be a geographical dispersion in wage growth across the economy, largely attributable to the mineral price boom since 2004. Through the year to the December quarter 2007, wages growth in Western Australia accelerated to 5.9 per cent, 2 percentage points higher than corresponding wage growth in New South Wales and Victoria. This wage divergence at the state level partly reflects strong growth in the mining and construction industries of 5.1 per cent and 4.6 per cent through the year respectively. The expected further increase in mineral export prices is likely to sustain these divergences in wages growth over the forecast horizon.

To date, rapid wages growth in the mining and construction industries has not led to a similar acceleration in other industries. The WPI has remained strong but relatively stable. However, the possibility of a spillover of wage pressure from the mining and construction industries resulting in overall faster wages growth continues to be a risk.

Outlook for the International Economy

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

	2007	2008		2009	
	Actual	Dec JEFG	Mar JEFG	Dec JEFG	Mar JEFG
United States	2.2	1 3/4	3/4	2 3/4	1 1/2
Euro Area	2.6	2	1 1/2	2 1/4	1 1/2
Japan	2.1	1 1/2	1 1/4	1 3/4	1 1/2
China	11.4	10 1/2	9 1/2	10 1/2	9 1/2
India	9.1	8 1/2	7 1/2	8	7 3/4
Other East Asia (b)	5.8	5 1/4	4 1/4	5 1/4	4 3/4
Major Trading Partners	5.1	4 1/2	3 3/4	4 3/4	4
World (c)	4.9	4 1/4	3 3/4	4 1/2	4

(a) Calculations for world and euro area growth rates use GDP weights based on purchasing power parity (PPP). Calculations for major trading partners, ASEAN-5 and the NIEs use export trade weights.

(b) Other East Asia is: Korea, Taiwan, Hong Kong, Singapore, Indonesia, Malaysia, Thailand, Vietnam and the Philippines.

(c) December JEFG country group and world estimates have been revised to incorporate the new updated PPP weights. This has reduced these estimates by around 1/2 per cent.

Source: National statistical publications, IMF and Treasury.

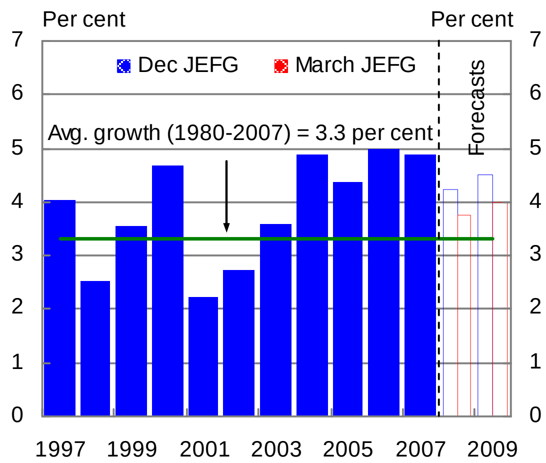
World outlook and risks

Initial expectations for the US sub-prime crisis were that its economic impact would be limited to a short stagnation in the US and a very mild slowdown in the global economy. This viewpoint was based on the belief that co-operation between the Fed and other central banks – mainly European – would be able to contain the financial market stress and shelter the real economy from any negative effects.

While the global economy has remained relatively resilient in spite of worsening conditions in US credit markets, in the last few months financial market stresses have intensified and risk becoming self-reinforcing. At the same time, the economic slowdown in the US and abroad is gathering pace, placing strains on corporate and household balance sheets, and increasing the risk of a global credit crunch.

As these events have continued to unfold it now appears likely that the global economy will slow more significantly than previously anticipated. As a result, world growth is forecast to slow from 4.9 per cent in 2007 to 3¾ per cent in 2008, before staging a slight recovery in 2009 (see Table 1 and Chart 1).

Chart 1: World GDP growth



Source: IMF and Treasury.

Inflation has continued to rise, with headline and core measures exceeding comfort levels in many economies. This reflects a combination of higher energy and food prices and limited spare capacity. However, as the pace of growth eases, we expect lower energy prices and the emergence of spare capacity in some economies to curb inflation pressures later in the year.

After growing strongly in the middle of last year, the US economy ended 2007 on a soft note. Since then, the economic environment has worsened, becoming particularly unfavourable for consumers. Declining employment, an energy-driven rebound in inflation, falling house and equity prices and a substantial tightening in lending conditions will all combine to dampen consumption. As a result, we now expect the US to experience a mild recession in 2008.

Emerging economies have been broadly resilient, so far, although some slowing of growth in export and industrial production has been evident. Growth has been broad based across Latin America, Africa, emerging Europe, and developing Asia. In 2008 and 2009, rising household consumption, strong infrastructure investment, high commodity prices and capital inflows are expected to continue to provide support to the expansion in emerging economies.

Moreover, strong fiscal positions in most countries and the accumulation of large foreign exchange reserves will provide governments with a buffer to counter any protracted slowdown in the external environment. Nevertheless, with a deteriorating outlook for the US the growth outlook for emerging economies has been revised down slightly.

The Chinese economy posted another stellar performance for 2007, recording its fastest rate of growth in over a decade. Urbanisation and infrastructure development have continued to drive this rapid expansion, and has fuelled a boom in energy and raw materials prices which has also benefited major commodity-exporting emerging economies.

The risks to the global outlook are substantial and have increased. The current turmoil in global financial markets is becoming more than just a problem of liquidity in key funding markets. It is increasingly a reflection of deep-seated balance sheet fragilities amongst some of the world's major financial institutions, and its effects are likely to be broader, deeper and more protracted than was previously anticipated.

The virtual collapse of US investment bank Bear Stearns in March, and the opening of additional emergency funding mechanisms by the Fed, has highlighted the potential for current market disruptions to morph into a systemic financial crisis. Had Bear Stearns been forced to declare outright bankruptcy, the effect on broader financial markets would have been significant and far reaching.

The Fed has demonstrated that it is alert to the seriousness of the situation by taking a series of extraordinary policy actions to address liquidity shortages in key funding markets and to maintain financial system stability. Expanding its emergency lending facilities to include investment banks as well as commercial banks should help to limit the potential for another investment bank to suffer a liquidity crisis of the type that led to the Bear Stearns situation.

Nevertheless, it is likely that further policy actions will be needed over the near term. As underlying economic conditions in the US weaken – perhaps substantially – a wider deterioration in credit quality beyond subprime mortgages is expected.

This will put added pressure on the capital and funding positions of systemically important financial institutions, and will further restrain their ability (and willingness) to extend credit to households and businesses.

Moreover, there is the potential for this contraction in credit to become self-reinforcing, leading to a more severe and protracted deterioration in US economic conditions. If such a scenario were to materialise the implications for world economic growth would be significant.

To date, the large emerging economies of Asia and Latin America have been only modestly affected by developments in advanced economy financial markets. In fact, there is potential for increasing concerns about asset quality in advanced economies to foster – not depress – capital flows to these emerging economies as investors look for new opportunities, fuelling greater-than-expected credit growth and domestic demand in these economies.

Growth risks related to inflation and the oil market have intensified, despite the slowing growth outlook. World oil prices have remained well elevated, reaching record highs in nominal and real terms in mid-March 2008. These increases can be attributed to a larger than expected fall in global crude oil inventories, weakness in the US dollar, and a range of adverse geopolitical pressures. Oil market fundamentals remain tight, and with the risk for potential supply disruptions, there is a risk that oil prices could increase further, unless there is a significant softening in demand from emerging countries.

Food prices, a significant contributor to inflation in many emerging economies, are also expected to remain high this year. Grain prices have sustained strong gains in recent months, driven by poor harvests and rising consumption. While forecasts for more favourable seasonal conditions in most producer countries will be beneficial to this year's production, increased use of grain in bio-fuels may counteract some of the downward price impacts from this supply response.

Country summaries

The US economic outlook has worsened significantly in recent months, with downside risks to growth having increased substantially. Given deteriorating consumer confidence and the extraordinary stress in financial markets, a US recession is now expected. As a result, US GDP growth is now forecast to be ¾ per cent in 2008, down 1 percentage point since December JEFG. In 2009, a modest rebound in growth is expected, with GDP forecast to grow by 1½ per cent.

US domestic demand is likely to contract in early 2008, with outright declines in consumption expected up until the December quarter. Consistent with this, retail sales have declined in real terms in four of the past five months to February, while consumer sentiment has weakened sharply. Increasing softness in the labour market is also expected to restrain consumption, with private employment having contracted in each of the three months to February. For 2008 as a whole, consumers may face further house and equity price falls, tighter credit conditions and high energy costs.

Moreover, tighter credit conditions and weaker business sentiment are likely to restrain business investment over 2008 and into 2009. In addition, the housing sector is likely to continue to detract from growth until at least early 2009. Nevertheless, net exports are expected to remain solid, with exports boosted by solid trading partner growth and a softer dollar, while weaker domestic demand should restrain imports.

Risks to US growth remain skewed to the downside. A significant concern is the risk of a downward spiral in confidence and activity caused by renewed strains in financial markets and the ongoing housing contraction. Moreover, should households take the opportunity to aggressively increase savings, then growth will also be slower than expected, which could dampen the projected rebound in 2009.

US authorities have acted to support growth. The Federal Reserve has aggressively cut interest rates and taken a series of extraordinary steps to boost liquidity, despite some concerns about inflation risks. The US Administration has announced a fiscal stimulus package (of 1 per cent of GDP), which should bolster household spending and growth in the second half of 2008.

The outlook for the Japanese economy has softened since December JEFG as a result of the weakening external environment. After growing by 2.1 per cent in 2007, growth is expected to ease to 1¼ per cent in 2008, as a gradual pick-up in consumption and recovery in housing investment only partly offset moderating business investment and exports. Growth is expected to pick up to 1½ per cent in 2009 as the global outlook improves.

The outlook for the Chinese economy is for continued strong growth although at a somewhat more moderate rate than previous outcomes. The economy grew by 11.4 per cent in 2007, the fastest rate of growth in 13 years. The forecasts for 2008 and 2009 have been revised down to 9½ per cent. The downward revision reflects a weakening in the export sector due to an expected slowdown in developed economies.

However, with strong investment, and rising incomes, domestic consumption is expected to maintain its rapid growth. Furthermore, the government has ample financial reserves to support domestic growth should the US slowdown have a more serious adverse impact than is currently anticipated.

Nevertheless, a further acceleration in inflation poses a threat to the outlook. Until recently, the increase in inflation has been largely contained to food prices. However, price pressures appear to be more broadly based with core measures now ticking-up.

Notwithstanding a downward revision to our 2008 forecast, the Indian economy is expected to continue to grow at a strong pace of 7½ per cent. The downward revision reflects a greater-than-expected effect of monetary policy tightening, and an anticipated moderation in India's exports as global growth slows.

The outlook for growth in India in 2009 is for 7¾ per cent. It is expected that as the global economy recovers and domestic consumption picks up, supported by fiscal stimulus in the 2008-09 budget and significant increases to public wages, growth should improve.

The outlook for the rest of East Asia has deteriorated since December JEFG as a result of a weaker external environment. Growth in the rest of East Asia has been revised down by 1 percentage point to 4¼ per cent in 2008. Growth in 2009 has been revised down by ½ of a percentage point to 4¾ per cent.

In the NIEs, growth is forecast to ease to 3¾ per cent in 2008 before accelerating slightly to 4¼ per cent in 2009. The moderation in growth in 2008 largely reflects slowing US demand for the region's exports. In addition, growth in domestic demand is expected to ease in 2008 in line with weaker export growth.

Growth is also expected to ease in the ASEAN-5[1] economies to 5 per cent in 2008, before picking up to 5½ per cent in 2009. Domestic demand is expected to underpin growth in 2008 as exports moderate in line with weaker global growth. Growth is expected to pick up in 2009 with a modest rebound in exports and solid growth in domestic demand.

Following two consecutive years of strong growth, the euro area is forecast to slow to 1½ per cent in 2008. The outlook reflects weakening domestic demand as well as a less supportive external environment. Risks remain to the downside, with the possibility for further adverse financial market developments and the potential for emerging economies to be more adversely affected by developments in the US.

The outlook for New Zealand has deteriorated in recent months as indications of weakness in the domestic economy have coalesced. Growth is forecast to slow to 1½ per cent in 2008, reflecting ongoing weakness in the housing market, sluggish consumer spending, weak consumer sentiment and the prospect of continued drought. The Reserve Bank of New Zealand is likely to maintain its tight monetary policy stance in the short term to combat inflationary pressures generated by high commodity prices and persistent capacity constraints. Growth is expected to recover to 2¼ per cent in 2009, assisted by monetary easing and fiscal stimulus in the 2008-09 budget.

[1] ASEAN-5 consists of Indonesia, Malaysia, the Philippines, Thailand and Vietnam.