ECONOMIC OUTLOOK FOR 2008-09 AND 2009-10

DECEMBER 2008

(THIS REPORT INCORPORATES DOMESTIC AND INTERNATIONAL DATA RELEASED UP TO 12 DECEMBER 2008)

OVERVIEW

There has been a significant deterioration in the outlook for the global and domestic economies since MYEFO. Most of the major advanced economies are now in, or on the brink of, recession. The risk of Australia following the rest of the world into recession has risen significantly.

Data released since MYEFO confirm that the US, Japan, Germany, the euro area and New Zealand are in recession, and the Bank of England and Bank of Canada have stated that their respective economies are entering recession. It has also become clear that emerging economies are far from being immune from the global financial crisis. China and India, while continuing to support world growth, are showing increasing signs of slowing. Shortly after the publication of MYEFO, the IMF downgraded its forecasts for world growth in 2009 from 3 per cent to 2.2 per cent, projecting the first contraction in collective advanced economy GDP in the post-war period.

The weaker world outlook, and particularly the weaker outlook for China, has seen commodity prices fall. The price of oil has fallen further from the $US68 per barrel assumed at MYEFO to around $US45. Other commodity prices have also fallen significantly and we expect contract renegotiations for iron ore and coal due around April next year to see US dollar price falls in the order of 40 to 50 per cent.

The turnaround in commodity prices is expected to cause a significant unwind of the mining investment boom of the last few years. The effects on investment will be exacerbated by continued difficulties in credit markets, with Australian firms unlikely to be able to fund investment at the levels of recent years.

With the recent relentless run of bad news on the global and domestic economies, we are yet to see the full impact of the global financial crisis, creating uncertainty as to the extent and timing of the trough in world growth. The forecasts assume a modest recovery in global conditions in late 2009 and early 2010. The forecast recovery turns on the assumption that the considerable policy stimulus being applied around the world begins to have traction by the latter half of next year.

The deterioration in global conditions runs the risk of dragging the Australian economy into recession. The December JEFG forecasts suggest an economy very close to this point. However, fiscal and monetary policy responses to date, in addition to the depreciation of the exchange rate and the fall in petrol prices, are keeping expectations of growth positive.

Real GDP growth in 2008-09 has been revised down from 2 per cent at MYEFO to 1¼ per cent. In 2009-10, real GDP growth has been revised down from 2¼ per cent to ¾ per cent. Through 2009, quarterly GDP is forecast to grow at 0.1 or 0.2 per cent. Given difficulties in forecasting specific quarters and the usual statistical error, any combination of these quarters could turn out to be negative.

Downward revisions to business investment and mining export volumes are the largest contributors to the revisions to growth, reflecting weaker world demand for commodities and more difficult financing conditions.

Household consumption has moderated a little further since MYEFO in response to additional falls in wealth and lower consumer confidence. Households are expected to continue to rebuild savings in response to falling asset prices and uncertainty about further falls. However, the Economic Security Strategy is expected to bolster consumption in the December and March quarters. Lower interest rates and fuel prices will also support consumption over the forecast period.

Table 1: Key Domestic Forecasts – December compared with MYEFO and Budget

Key aggregates

	2007-08	2008-09			2009-10	
	Outcome (a)	Budget	MYEFO	Dec	MYEFO	Dec
Real GDP (b)	3.7	2 3/4	2	1 1/4	2 1/4	3/4
Nominal GDP (b)	8.2	9 1/4	7 3/4	6 1/4	3	3/4
Employment (b)	2.7	1 1/4	1 1/4	1	3/4	- 1/2
Unemployment rate (d)	4.3	4 3/4	5	5 1/2	5 3/4	6 1/2
CPI (c)	4.5	3 1/4	3 1/2	2 1/2	3	2 3/4
Underlying inflation (c)	4.4	3 1/4	3 1/2	3 3/4	3	2 3/4
WPI (b)	4.2	4 1/4	4 1/4	4	4	3 1/2
Terms of trade (b)	5.1	16	10 3/4	7 1/2	-8 1/2	-10 3/4

(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.

Housing investment is expected to remain weak in the short term (growing at ½ a per cent in 2008-09) in light of recent data on building approvals and housing finance. However, recent interest rate falls are expected to support a recovery in housing investment in 2009-10, with forecast growth of 7½ per cent. In line with recent market expectations, an additional 100 basis points of interest rate cuts is assumed over coming months, with all of the cuts flowing through to mortgage interest rates.

Public sector demand is expected to hold up, supported by the COAG package and recent announcements in relation to infrastructure. Less than a third of GDP growth in 2007-08 was attributable to the public sector. Around four fifths of the growth in GDP is expected from the public sector in 2008-09 and 2009-10.

A weaker economy has led to downward revisions to employment growth, with unemployment expected to rise to 5½ per cent by June 2009 and 6½ per cent by June 2010. Higher unemployment will be a drag on household consumption in 2009-10. Were the unemployment rate to rise more rapidly, this would imply lower household consumption and GDP growth than forecast.

The terms of trade is forecast to decline further since MYEFO, with an expected fall of 10¾ per cent in 2009-10 reflecting falls in most commodity prices but in particular iron ore and coal. Export volumes growth has been revised back significantly, from 6½ per cent to 2 per cent in 2008-09 and from 5½ per cent to 1½ per cent in 2009-10. Cutbacks to iron ore and coal production in response to weaker demand from the Chinese steel sector are the main contributors to lower export growth. The current account deficit is expected to widen from 4¼ per cent in 2008-09 to 5¾ per cent in 2009-10 as both lower export volumes combined with lower prices cause the trade balance to move into significant deficit.

Inflation pressures are expected to ease, with headline and underlying inflation expected to fall to 2¾ per cent through the year to June 2010. Wage pressures are expected to ease in line with the weakening labour market. Slower demand growth is also expected to ease inflation pressures over the forecast period. Operating against these effects are higher import prices flowing from the depreciation of the exchange rate. Headline inflation will be low in the short term as a result of the recent sharp falls in fuel prices.

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	3.7	1 1/4	3/4	1 1/4	1
Private investment					
Dwellings	1.4	1/2	7 1/2	-1	13
Total business investment(d)	14.2	3 1/2	-9 1/2	-7 1/2	-5
Non-dwelling construction(d)	11.2	-1	-13 1/2	-12 1/2	-7
Machinery and equipment(d)	16.0	6	-10	-6 1/2	-7
Private final demand(d)	5.5	1 1/4	- 3/4	-1	3/4
Public final demand(d)	4.6	4 3/4	3	3 3/4	2
Total final demand	5.3	2	0	0	1
Change in inventories(e)					
Private non-farm	0.2	0	0	1/4	0
Farm and public authorities(f)	0.0	0	0	0	0
Gross national expenditure	5.5	2	0	1/4	3/4
Exports of goods and services	4.3	2	1 1/2	-1 1/2	3 1/2
Imports of goods and services	12.7	5	-1 1/2	-3	2
Net exports(e)	-1.9	- 3/4	3/4	1/4	1/4
Gross domestic product	3.7	1 1/4	3/4	3/4	1
Non-farm product	3.6	1	3/4	1/4	1
Farm product	8.5	11	5	19	5
Panel B - Other selected economic measures					
External accounts					
Terms of trade	5.1	7 1/2	-10 3/4	-11 3/4	1 1/2
Current account balance					
$billion	-70.2	-52 1/4	-70 1/4	na	na
Percentage of GDP	-6.2	-4 1/4	-5 3/4	-6	-5 1/2
Labour market					
Employment (labour force survey basis)	2.7	1	- 1/2	0	- 1/4
Unemployment rate (per cent)(g)	4.2	4 3/4	6 1/4	5 1/2	6 1/2
Participation rate (per cent)(g)	65.2	65 1/4	64 3/4	65	64 1/2
Prices and wages					
Consumer Price Index (h)					
- headline	4.5	3 1/2	2 1/2	2 1/2	2 3/4
- underlying	4.4	4 1/4	2 3/4	3 3/4	2 3/4
Gross non-farm product deflator	4.4	5 1/4	- 1/4	1/4	2 3/4
Wage Price Index	4.2	4	3 1/2	3 3/4	3 1/2

(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

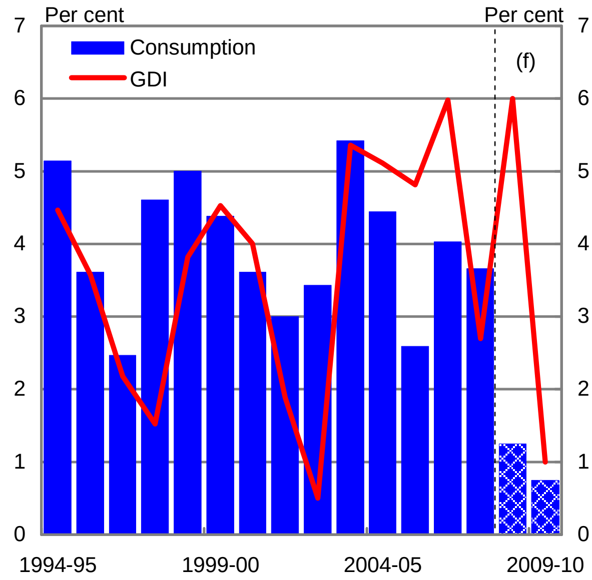
The forecasts for the domestic economy are underpinned by several technical assumptions. The exchange rate is assumed to remain around levels observed at the time of writing (a trade-weighted index of around 54 and a $US exchange rate of around 66c). Interest rates are assumed to decline broadly in line with market expectations which suggest a cash rate of 3.25 per cent by March 2009. World oil prices (Tapis) are assumed to remain at around $US 50 per barrel. The farm sector forecasts are based on an assumed return to average seasonal conditions over the forecasting period, but take into account the effects of sustained drought conditions in the preceding period.

Household consumption

The outlook for household consumption remains very weak following flat outcomes in the June and September quarters. Real household consumption is forecast to grow by 1¼ per cent in 2008-09 (Chart 1), down from 2 per cent at MYEFO. Significant falls in household wealth and general uncertainty around the global outlook have sapped consumer confidence and are expected to further curb consumption over the forecast horizon. The share market has continued to fall since its peak in late 2007, with the S&P ASX 200 plunging a further 25 per cent since the 15 September collapse of Lehman Brothers. House prices also declined by around 2 per cent over the June and September quarters.

On the positive side, the implementation of the Government's Economic Security Strategy will increase household income by $8.7 billion and is expected to boost consumption particularly over the next two quarters. Households have also experienced significant falls in petrol prices (down around 35 per cent since the July 2008 peak) combined with a 300 basis point cut in official interest rates since August 2008 and an additional 100 basis points of cuts has been priced in by markets.

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

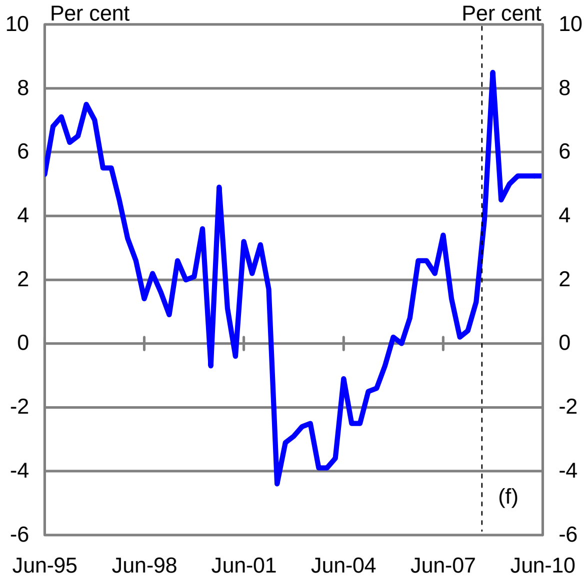


Source: ABS Catalogue Number 5206.0 and Treasury.

Household consumption is expected to grow by just ¾ per cent over 2009-10, as the boost from the Economic Security Strategy unwinds and rising unemployment weighs on consumption.

Tighter credit conditions may also limit households' spending. There are already signs that households are paying down their debt. Moreover, as asset prices have fallen sharply, household wealth has declined. As a result, the household saving ratio (as measured in the household income account) is expected to continue its recovery over the forecast period as households rebuild their balance sheets (Chart 2).

Chart 2: Household saving ratio

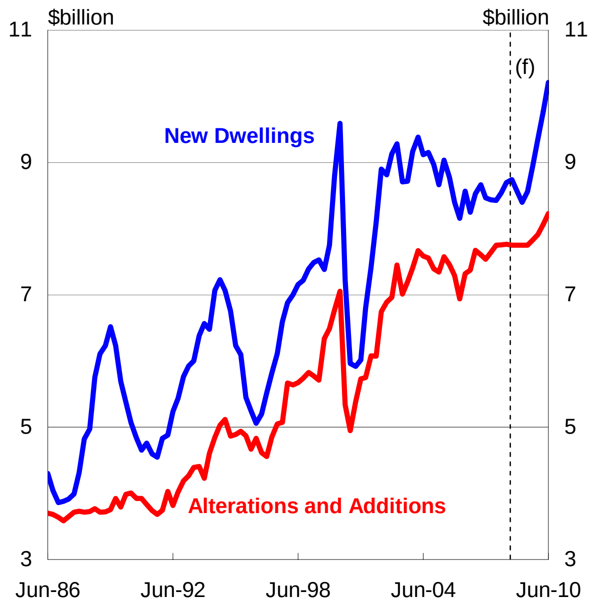


Source: ABS Catalogue Number 5206.0 and Treasury.

Dwelling investment

The outlook for the residential construction sector has improved since the MYEFO. The recent cuts in interest rates provide strong support for dwelling investment, particularly in 2009-10 (Chart 3).

Chart 3: Dwelling investment (real)



Source: ABS Cat. No. 5206.0 and Treasury.

The outlook for new dwelling investment and alterations and additions has improved and both components are expected to grow by ½ of a per cent in 2008-09. The weak outlook for 2008-09 is confirmed by recent partial data on housing finance and building approvals which indicate continuing weakness in the short-term.

Despite the weak outlook for dwelling investment in 2008-09, fundamental forces in the housing market will support activity in the longer term. Strong population growth and underlying demand for housing combined with expansionary monetary policy and the stimulus from the First Home Owners Boost are expected to support dwelling investment.

Reflecting this strong underlying demand, the new dwellings component of investment is expected to drive a rebound in total dwelling investment, with growth of 11½ per cent in 2009-10, Investment in alterations and additions is also expected to pick up in 2009-10, growing by 3½ per cent.

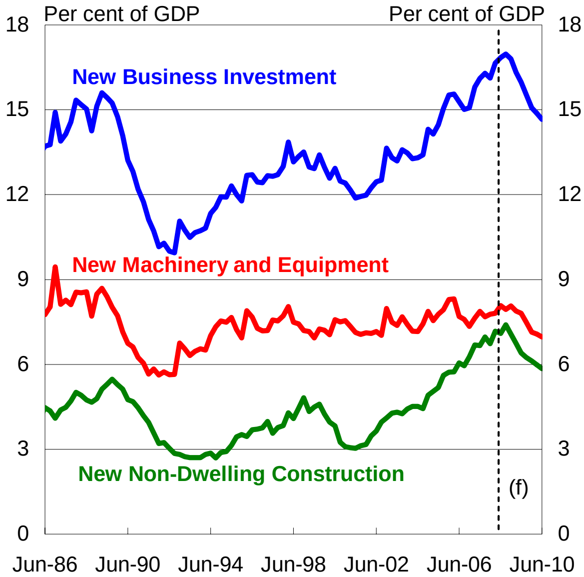
The risks facing the forecasts include sustained weakness in investor sentiment, the possibility of further declines in house prices and tighter credit conditions. While credit appears to be readily available for owner-occupiers, investors may have greater difficulty finding finance.

Business investment

New business investment is expected to increase by 3½ per cent in 2008-09 and fall by 9½ per cent in 2009-10, significantly weaker than MYEFO. Expected sharp declines in non-rural commodity prices and the softer domestic outlook, are expected to substantially slow investment over the forecast horizon. Business investment as a share of GDP is expected to ease following recent record highs although it is expected to remain slightly above the long run average (Chart 4).

New engineering construction investment is expected to increase by 6 per cent in 2008-09 reflecting the existing pipeline of work. Sharply weaker global demand for non-rural commodities combined with extremely tight credit conditions have significantly increased the risks that projects will be delayed or cancelled. In addition, there are very few new projects entering the project pipeline. As a result, new engineering construction is expected to fall by 16½ per cent in 2009-10.

Chart 4: Business investment to GDP ratio (nominal)



Source: ABS Cat. No. 5206.0 and Treasury.

There are also substantial risks around the non-residential building investment outlook. Non-residential building is expected to be weaker than at MYEFO and is forecast to fall by 7½ per cent in 2008-09 and 10½ per cent in 2009-10. Tighter credit conditions, softer employment growth and increased supply from near-term building completions are expected to significantly weaken activity in the office market while a softer consumption outlook is expected to weaken activity in the retail sector.

Investment in new machinery and equipment is expected to grow by 6 per cent in 2008-09 before falling by 10 per cent in 2009-10. The fourth estimate of CAPEX investment intentions for 2008-09 implies strong investment growth, particularly in the mining sector. However, these investment intentions have been discounted, to some extent, with low levels of business confidence, tight credit conditions and weaker demand expected to weigh on investment.

Public final demand

In real terms, new public final demand is forecast to grow by 4¾ per cent in 2008-09 – up from 3½ per cent at MYEFO – reflecting additional spending contained in the COAG and the Nation Building packages.

Growth is expected to ease to 3 per cent in 2009-10, ¼ of a percentage point higher than MYEFO.

Table 3: Real new public expenditure

	2008-09	2009-10
Consumption		
Commonwealth	3	3
State and local	3 1/2	2
Investment		
Commonwealth	14 1/2	4 1/2
State and local	10	4 3/4
Total public expenditure	4 3/4	3

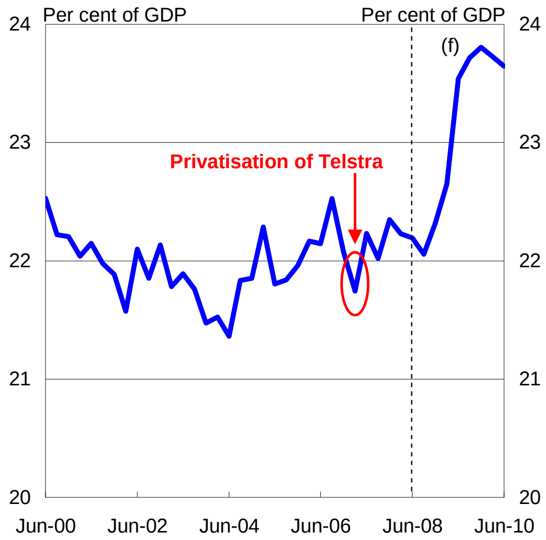
Source: Treasury.

The outlook for total government consumption in 2008-09 (3¼ per cent growth) is slightly higher than at MYEFO, reflecting stronger consumption at both Commonwealth and State and Local levels. In 2009-10, government consumption is expected to moderate to 2½ per cent.

Growth in new public investment is also expected to increase compared to MYEFO. Total new public investment is expected to grow by 10¾ per cent in 2008-09 and 4¾ per cent in 2009-10, following strong growth of 9½ per cent in 2007-08. Stronger Commonwealth, State and Local investment is expected to flow from the COAG and Nation Building packages.

New public demand has grown broadly in line with nominal GDP in recent times but is expected to increase 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.

Exports, imports and the current account deficit

Since MYEFO the global outlook has continued to deteriorate, which has resulted in significant downward revisions to the forecasts of the external sector. The collapse in the global economy over the past few months has been dramatic, with G7 economies now expected to slip into recession and demand in China showing clear signs of slowing sharply. A trade deficit is now expected in 2008-09, largely reflecting weaker export volumes and lower prices for commodity exports.

Net exports are expected to subtract ¾ of a percentage point from GDP growth in 2008-09, and contribute ¾ of a percentage point in 2009-10. Compared with MYEFO, the expected subtraction for 2008-09 is ¼ of a percentage point larger, reflecting decreased expectations for export growth due to weakness in major trading partner demand.

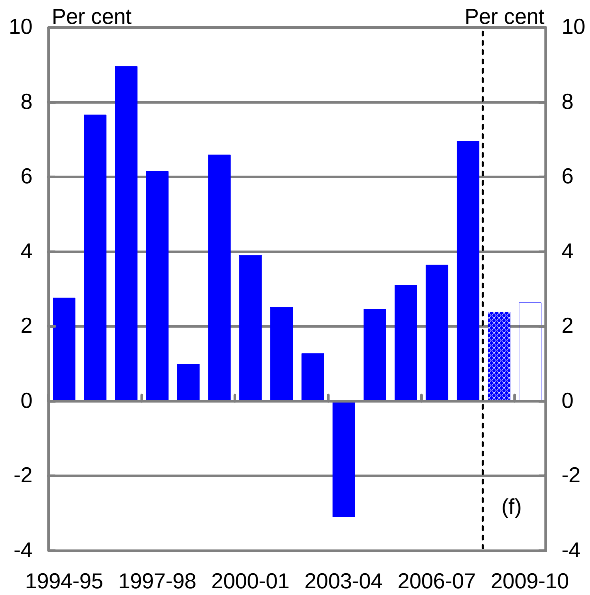
Total export volumes are expected to grow by 2 per cent in 2008-09 and by 1½ per cent in 2009-10. Compared with MYEFO, the current forecasts are 4½ percentage points lower in 2008-09 and 4 percentage points lower in 2009-10.

Non-rural commodity export volumes are expected to contract over the remainder of 2008 and into early-2009, weighed down by a slump in raw materials demand. Slowing industrial activity, a deterioration in the automotive sector and a weakening investment climate have combined to bring about significant reductions in global steel production. As a result, in recent weeks major mining companies have announced significant reductions in export volumes of iron ore and coal. These cutbacks are expected to continue through until mid-2009, when a recovery in the Chinese steel sector and rebuilding of inventories is expected to begin.

In addition, the demand collapse in the second half of 2008 is also making it extremely difficult for producers to justify expanding capacity. There have already been several examples of producers delaying planned expansions in reaction to the slump in prices and tightening credit availability, and we expect to see many more project delays and even cancellations in the coming months.

Non-rural commodity volume growth is now expected to moderate to 2½ per cent in both 2008-09 and 2009-10, from 7 per cent in 2007-08 (Chart 6).

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



Source: ABS Cat. No. 5302.0 and Treasury.

Farm production is expected to rebound by 11 per cent in 2008-09, slightly lower than forecast at MYEFO due to weaker-than-expected rainfall during Spring.

Contingent on average seasonal conditions, farm production is forecast to increase by a further 5 per cent in 2009-10.

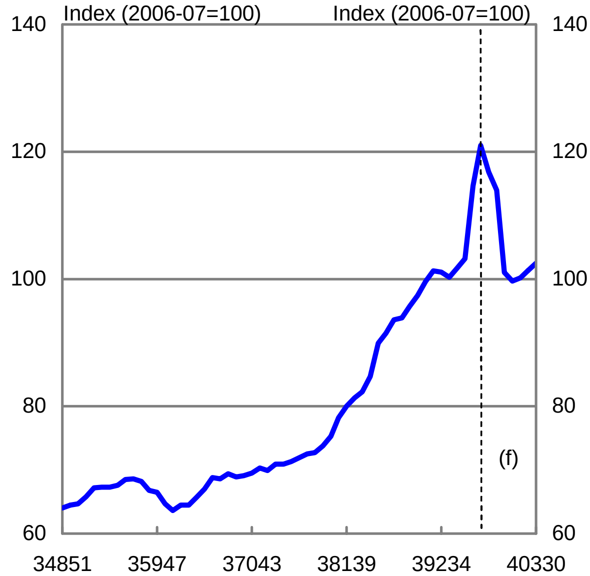
The recovery in farm production is expected to boost rural exports, which are forecast to grow by 9 per cent in 2008-09 and a further 9 per cent in 2009-10.

Sharply lower world growth is expected to more than offset the boost from a weaker exchange rate for elaborately transformed manufactures (ETM) and service exports. ETM exports are now expected to contract by 1½ per cent in 2008-09 and by a further 3 per cent in 2009-10. The decline in ETM exports is expected to be driven by car exports, where the outlook has deteriorated rapidly following the sudden collapse in demand in key export markets, particularly the United States. Growth in services exports is also expected to ease to 5½ per cent in 2008-09 before contracting by 2 per cent in 2009-10.

Imports of goods and services are expected to grow by 5 per cent in 2008-09, before contracting by 1½ per cent in 2009-10, as domestic demand continues to moderate. Compared with MYEFO, the current forecasts are 2 percentage points lower for 2008-09 and 5 percentage points lower in 2009-10, largely reflecting a significantly weaker outlook for domestic business investment which has a large imported component and the impact of the depreciation of the exchange rate on volumes.

The terms of trade are forecast to increase by 7½ per cent in 2008-09, before decreasing by 10¾ per cent in 2009-10. This further downward revision from MYEFO is due to the continued deterioration in commodity demand and sharp falls in spot prices for all major non-rural commodity exports. Contract prices for Australia's bulk commodity exports are all expected to fall significantly – iron ore (down by 50 per cent), metallurgical coal (down by 50 per cent), and thermal coal (down by 40 per cent). In addition, base metal prices have also come under significant pressure in recent months and are likely to remain at much lower levels. There is still considerable uncertainty regarding the future path of commodity prices over the next few months.

Chart 7: Terms of trade



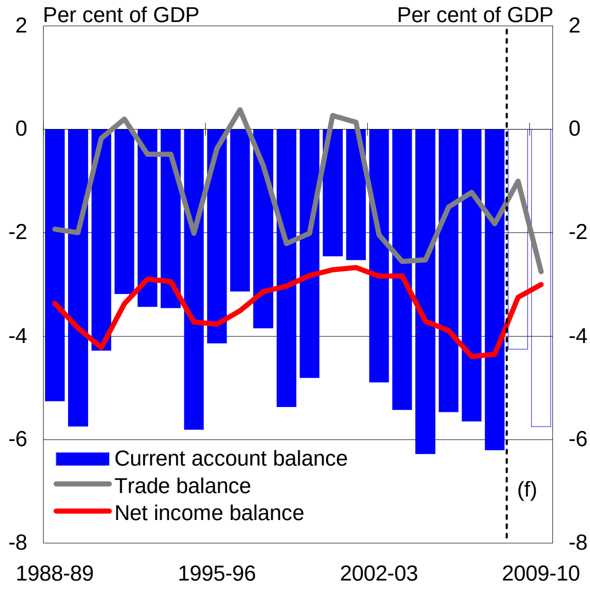
Source: ABS Cat. No. 5302.0 and Treasury.

The trade balance is expected to record a deficit of 1 per cent of GDP in 2008-09 and 2¾ per cent of GDP in 2009-10. The change to a deficit in 2008-09 and the further deterioration of the deficit in 2009-10 relative to MYEFO reflects lower export volumes and prices outweighing lower import values.

The net income deficit (NID) as a per cent of GDP is expected to narrow to 3¼ per cent in 2008-09 and 3 per cent in 2009-10. The narrowing largely reflects weaker growth in mining profits over the forecast horizon commensurate with lower prices for coal and iron ore exports, along with lower net interest payments on the stock of net foreign debt due to lower global interest rates.

The current account deficit (CAD) is expected to narrow to 4¼ per cent of GDP in 2008-09 before widening to 5¾ per cent of GDP in 2009-10. These movements of the CAD are similar to that forecast at MYEFO, with a forecast narrowing of the NID being offset by the expected widening of the trade deficit (Chart 8). From a savings and investment perspective, gross investment is forecast to decline as a share of GDP over the forecast horizon. Gross savings is forecast to rise in 2008-09 as households seek to rebuild their balance sheets, before declining in 2009-10 as corporate savings fall in line with reduced profitability.

Chart 8: Current account balance



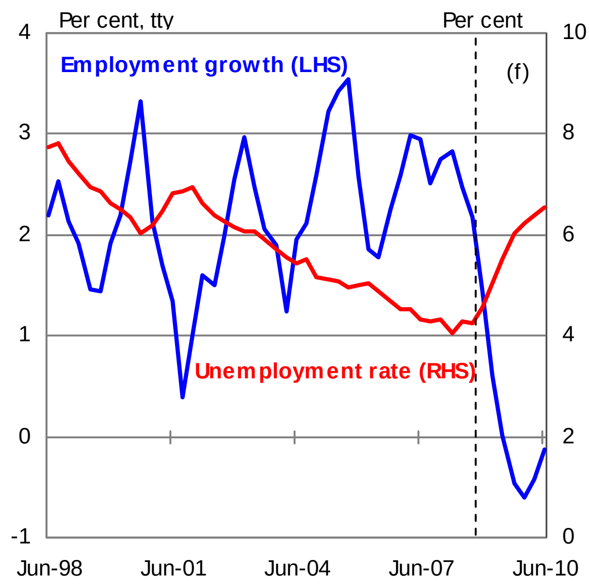
Source: ABS Cat. No. 5302.0, 5206.0 and Treasury.

Employment, wages and inflation

Labour market

Labour market conditions are expected to decline compared to MYEFO, in line with the weaker outlook for economic growth. Employment is expected to contract through the remainder of 2008-09 into 2009-10.

Chart 9: Labour market



Source: ABS Cat. No. 6202.0 and Treasury.

The participation rate is expected to remain high at 65 per cent by the June quarter 2009, before easing to 64½ per cent by the June quarter 2010. This reflects an expected easing in net overseas migration levels, and weaker employment prospects as the labour market begins to slow.

With employment anticipated to contract, the unemployment rate is now expected to rise to 5½ per cent by the June quarter 2009, and to 6½ per cent by the June quarter 2010.

Prices and Wages

Wages

The outlook for wages is for more moderate growth than was expected at MYEFO, in line with the weaker outlook for the economy and the labour market. Lower business and consumer confidence and recent falls in inflation expectations are expected to reduce upward pressure on wage growth in the near term, while the forecast increase in the unemployment rate will start to influence wage growth towards the end of the forecast period.

The WPI is expected to grow by 3¾ per cent through the year to the June quarter 2009 and by 3½ per cent through the year to the June quarter 2010.

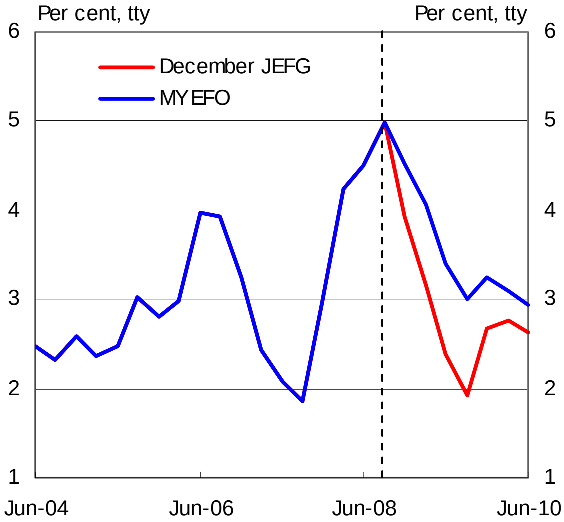
Prices

Headline inflation forecasts have declined since MYEFO, driven by lower oil prices and weaker domestic demand. Headline consumer prices are forecast to grow by 2½ per cent through the year to the June quarter 2009 and 2¾ per cent to June 2010.

Forecasts of underlying inflation are broadly unchanged from MYEFO except towards the end of the forecasting period. Underlying inflation is expected to grow by 3¾ per cent through the year to June 2009 and 2¾ per cent through the year to June 2010.

Inflation is expected to fall in line with weaker GDP growth and easing wages pressures. Australian dollar oil prices are assumed to be lower over the forecast period compared to MYEFO, which is expected to have a significant near-term impact on headline inflation.

Chart 10: Headline Consumer Price Index



Source: ABS Cat. No. 6401.0 and Treasury.

Table 3: International GDP growth forecasts(a)

	2007	2008		2009		2010	
	Actual	MYEFO	Dec JEFG	MYEFO	Dec JEFG	MYEFO	Dec JEFG
United States	2.0	1 1/4	1 1/4	0	-1 1/2	2	1 1/4
Euro Area	2.6	1 1/4	1	1/4	-1	1 1/2	1
Japan	2.4	1/2	0	1/2	-1 1/4	1 1/2	1 1/4
China	11.9	9 3/4	9 1/4	8 1/2	7	9 1/4	9
India	9.3	7 3/4	7 3/4	6 3/4	6	7 1/4	6 1/2
Other East Asia (b)	5.9	4 1/4	4	3 1/2	1 1/2	4 3/4	4
Major Trading Partners	5.3	3 1/2	3 1/4	3	1 1/4	4	3 1/2
World	5.0	3 3/4	3 1/2	3	1 1/4	4	3 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.

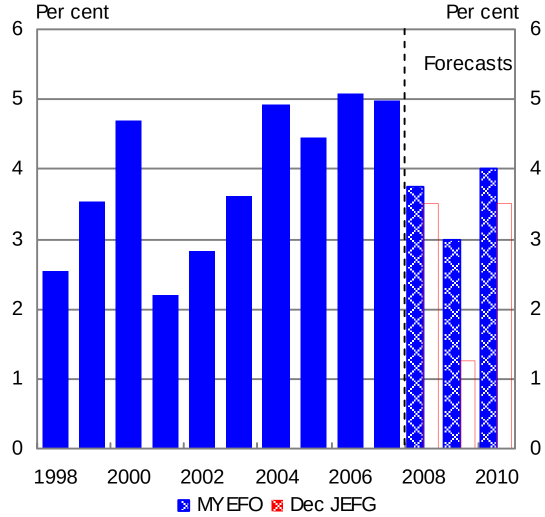
World outlook and risks

Global economic prospects have deteriorated further over the past month as the effects of the global financial crisis filter through more forcefully to the real economy. The financial crisis has undermined business and consumer confidence and has pushed many economies across the globe into recession. Over the past month, indicators of business confidence have fallen precipitously and consumer confidence remains low, suggesting that the slowdown already in train is set to intensify into the first half of 2009.

In recognition of the dramatic downshift in these sentiment indicators, as well as recent partial indicators of economic activity, growth forecasts for 2009 have been marked down for every country (Table 3). Global GDP growth is now expected to weaken from 3½ per cent in 2008 to just 1¼ per cent in 2009. In comparison to the MYEFO forecast, the 2008 growth forecast has been revised down by ¼ of a percentage point, while the 2009 growth forecast has been revised down by a far more substantive 1¾ percentage points (Chart 11).

The financial market turmoil that began in August 2007 morphed into a full-blown crisis during September and October of this year. The main catalyst for the dramatic intensification in financial market volatility was the collapse of US investment bank Lehman Brothers in mid-September.

Chart 11: World GDP growth



Source: IMF and Treasury.

Measures of global financial market stress spiked sharply in the days following this event. Central banks injected unprecedented amounts of liquidity into their financial systems and governments around the world implemented policies involving the recapitalisation of systemically-important financial institutions, depositor protection and support for interbank lending.

These extraordinary policy responses have led to a moderation in the extreme level of risk aversion that characterised financial markets in September and October, although the global financial system remains under significant stress and remains vulnerable to further disruptions. While indicators of stress in global money and credit markets have moderated recently, liquidity remains scarce as asset price deflation has caused financial institutions to write-down illiquid assets, hoard liquid assets and aggressively deleverage balance sheets.

The first phase of this financial deleveraging process, driven by the decline in both asset values and lending to borrowers at the risky end of the spectrum is currently well advanced. With global growth slowing sharply and financial conditions remaining difficult, there is a general consensus that much higher corporate default rates as well as higher losses on securities and loans will eventuate. Against this background, the capital positions of systemically-important financial institutions will continue to remain under pressure.

The global financial system will continue to face significant challenges over 2009. Policymakers will need to remain alert to the ongoing risks posed by further balance sheet adjustments in the financial sector, and also ensure that monetary and fiscal policies provide needed insurance against downside risks to the real economy.

While policymakers have reacted aggressively to the financial crisis, at this stage, it is too early to fully gauge the effectiveness of these measures. Efforts by policymakers to ease and contain the crisis in funding markets, and in the process minimise the adverse feedback loop between economic activity and financial market tightening, constitutes the key precondition for an eventual recovery.

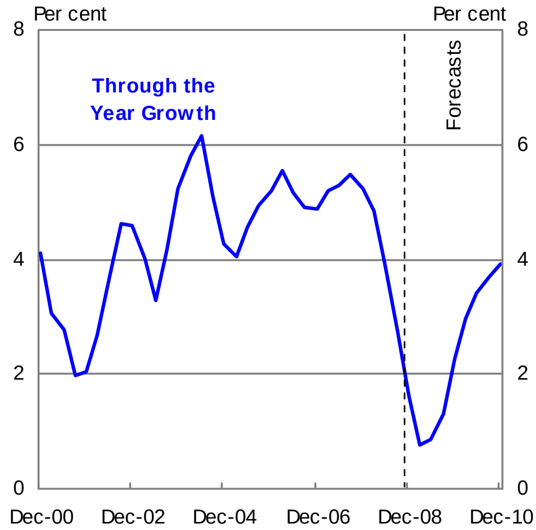
Reflecting the sharp retrenchment in domestic private demand, and the potential for further slowing, governments around the globe have enacted substantial economic stimulus packages, and further packages, most notably in the US, are likely to be announced over the next few months. Coupled with this stimulus, central banks across the globe have delivered substantial monetary policy easing, and further easing appears likely, including through non-conventional means, such as quantitative easing.

As the world economy enters into a deep downturn, commodity prices have continued to retreat. From a peak of almost US$150 per barrel in mid-July, oil prices have plunged under the weight of collapsing energy demand and a far bleaker economic outlook, to be currently trading around US$43 per barrel. Together with the fall in other commodity prices, inflation is set to fall markedly in the period ahead.

While the forecasts are downbeat over prospects for 2009, the risk to growth still remain titled to the downside. If recent actions on the part of policymakers are ineffective, and should sentiment among firms and households remain at depressed levels, then global growth outcomes are likely to be downgraded further.

Should such a scenario unfold, then the risks to growth in 2010, where global and MTP growth is projected to rebound to 3½ per cent, would clearly be to the downside. However, despite the apparent rebound in growth in 2010, growth is only projected to grow modestly through late 2009 and into 2010, and notably, remain below trend for virtually all economies. Chart 12 illustrates this point, which shows that, over the forecast horizon, MTP growth is set to remain below levels achieved over the past few years. Therefore, embedded in these forecasts is only a gradual return to trend growth.

Chart 12: MTP GDP growth



Source: IMF and Treasury.

Country summaries

The US economic outlook has softened considerably since MYEFO, due to further financial market turmoil and worsening economic conditions. Given the bleak outlook, our 2009 forecast has been downgraded by 1½ percentage points to -1½ per cent, and our 2010 forecast by ¾ percentage points, to 1¼ per cent. Recent economic indicators, together with the National Bureau of Economic Research's announcement that the US recession began in December 2007, implies that this recession is going to be deep and protracted.

The labour market has continued to deteriorate, with payrolls falling sharply and the unemployment rate increasing. Consistent with this, consumers have cut spending severely, with consumption detracting significantly from growth in the September quarter and retail sales declining. Given that households in the US face rising cash flow and balance sheet strains due to falling house prices, weak equity returns, tighter access to credit and rising unemployment, consumption is expected to remain weak through most of 2009.

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

While contracting domestic demand will constrain imports, the much weaker external outlook poses risks for exports contribution to GDP growth in coming quarters. Export growth is likely to soften in the wake of further notable output contractions expected in advanced economies and a stronger US dollar.

However, inflation risks have moderated, given weaker economic activity and lower commodity prices. Core inflation is expected to ease through into 2009 due to falling capacity utilisation and rising unemployment. In December, the US Federal Reserve cut official interest rates, and established a target range for the federal funds rate of 0 to 0.25 per cent. The Fed also committed to keeping the Fed Funds rate at low levels for an extended period of time and to consider ways of using its balance sheet to further support credit markets and economic activity.

The outlook for China has continued to deteriorate since MYEFO as a result of the global slowdown. The Chinese economy is now expected to grow by 9¼ per cent in 2008 and 7 per cent in 2009, before recovering to 9 per cent in 2010. Slower global demand will put downward pressure on China's exports, while investment growth is expected to moderate due to a weakening property market. In 2010, exports and investment are expected to pick up, in line with a recovery in major trading partner growth.

Faced with a slowing economy, Chinese authorities have changed their policy stance to one of 'appropriately loose monetary policy' and 'proactive fiscal policy'. Chinese authorities have lowered reserve requirement ratios and aggressively reduced interest rates, reducing the 1 year nominal lending rate by a total of 189 basis points since September. Authorities have also introduced a substantial fiscal stimulus package of RMB 4 trillion (nearly US$600 billion), to be spent over two years although the true extent of new spending in theis package remain unclear. Nonetheless, the package should provide considerable support to China's investment growth, particularly in the second half of 2009 into 2010.

The Japanese economy has now joined a number of major economies in recession. Demand for Japanese exports has slumped in recent months, reflecting both a weaker external environment and the rapid appreciation of the yen, and business investment is falling sharply. Although Japanese banks and corporations have not been significantly affected by sub-prime losses, Japanese equity markets have experienced sharp falls, with negative flow-on effects for business and consumer confidence. Consumption continues to provide limited support to growth, despite moderating inflation.

Our GDP growth forecast has been lowered to zero per cent in 2008, down ½ of a percentage point since MYEFO. GDP is forecast to contract by 1¼ per cent in 2009, down 1¾ percentage points, reflecting a significant worsening in the expected depth and duration of the global slowdown. The Japanese economy is expected to post a gradual recovery from mid-2009 but to remain below trend in 2010.

The Indian economy continues to slow in line with slowing world growth. Industrial and service sectors, already labouring under high input costs, have now begun to suffer from significant declines in domestic and major trading partner demand.

Indian firms are also experiencing difficulty accessing sources of finance to fund their expansion as foreign investment had been retreating rapidly, reflected by sharp falls on India's major equity markets.

Our forecast for 2008 remains unchanged since MYEFO at 7 ¾ per cent, reflecting the slow petering out of India's strong domestic growth momentum. In 2009 and 2010 however, growth is set to slow sharply and has been revised down to 6 per cent and 6 ½ per cent.

Growth in the ASEAN-5 has deteriorated since MYEFO as waning external demand and the effects of the global financial crisis impact on the real economy. GDP is forecast to grow at 5½ per cent in 2008, before weakening to 3¼ per cent in 2009 as exports continue to ease in line with moderating major trading partner growth and investment slows due to increased borrowing costs and reduced access to funds from heightened risk aversion. Growth is expected to pick up towards the end of 2009 and into 2010, though is predicated on a recovery in the external environment.

Growth in the NIEs has deteriorated sharply amid a deepening global financial crisis. GDP growth is expected to weaken from 3 per cent in 2008 to ½ per cent in 2009. Given their close trade and financial integration with the rest of the world, the NIEs are expected to be hardest hit in Asia, and this is reflected in the 2½ percentage point downgrade since MYEFO for the 2009 growth forecast. Taiwan, Singapore and Hong Kong are expected to contract in 2009.

Exports have contracted substantially for each economy and forward-looking indicators also point to a marked slowdown in export momentum. The deterioration in the growth outlook has prompted governments to implement fiscal stimulus packages in an effort to bolster consumer and business confidence.

The outlook for the euro area has deteriorated significantly since MYEFO. GDP is forecast to grow by 1 per cent in 2008 before contracting by 1 per cent in 2009. The euro area is only expected to stage a modest recovery in the second half of 2009, conditioned primarily on improvements in financial markets conditions. The deceleration in growth is expected to be led by business investment, particularly as export growth weakens in line with slowing world demand. Consumption growth is expected to remain subdued reflecting a fall in confidence, deteriorating employment prospects and a rise in household savings. Growth is only projected to reach 1 per cent in 2010.

Growth prospects for the UK have also deteriorated markedly. GDP is forecast to grow by ¾ per cent in 2008, contract by 1½ per cent in 2009 before recovering to grow by 1 per cent in 2010. The slowdown in 2009 will be broad based, though is expected to be led by deceleration in investment as a result of tighter credit conditions and lower internal and external demand.

The outlook for New Zealand has also been revised down. With the economy in recession for most of this year, annual average growth is expected to slow to ¾ of a per cent in 2008, and to be flat in 2009. While interest rate reductions and further tax cuts are expected to provide some support, the ongoing housing market correction, tight credit conditions and financial market strains continue to place significant pressure on household consumption, business activity and confidence, while the expected slowing of global growth has compromised earlier prospects of an export-led recovery in 2009.