CHAPTER 1: ECONOMIC CONDITIONS AND OUTLOOK

- Forecast economic growth in Victoria in 2006-07 has been revised down to 2.75 per cent, predominantly reflecting the impact of drought conditions on agricultural output. Growth in the non-farm economy is expected to be consistent with Budget projections.
- The Victorian labour market has been strong in 2006, with a lower unemployment rate and a higher labour force participation rate. The forecast for employment growth in 2006-07 has been revised up to 2.25 per cent.
- Inflationary pressures have intensified since the Budget, with the 2006-07 forecast for CPI inflation revised up to 3.25 per cent.

ECONOMIC OVERVIEW

The world economy

Global economic conditions remained robust in the first half of 2006, with most economies recording growth in line with, or stronger than, expectations. This has seen a slight upgrading of world economic growth forecasts, with the International Monetary Fund (IMF) raising the expected growth in the world economy in its September *World Economic Outlook* to 5.1 per cent in 2006 (from 4.9 per cent) and 4.9 per cent in 2007 (from 4.7 per cent). Private sector forecasters surveyed by Consensus Economics have also revised up their outlook for the world economy over the past six months.

The US economy has been expanding for five years and inflation has edged up because of diminishing excess capacity and high energy prices. Growth has started to slow primarily in response to past interest rate increases and a weaker housing market.

China has been growing rapidly, and although measures have been put in place to limit the pace of expansion, the IMF is still expecting double-digit growth to continue in 2006 and 2007. China's expansion is supporting growth in the rest of the East Asian region, including Japan, where the recovery is looking increasingly entrenched, and should be sustained by solid domestic demand.

European economic growth has increased in 2006, supported by stronger growth in Germany, France and the United Kingdom, and some one-off events, such as the soccer World Cup. It can also be attributed to improved business confidence, stronger corporate balance sheets and rising employment. Growth is expected to slow in 2007, with some dampening effects on consumer spending from the increase in the value added tax in Germany and the effects of rising interest rates.

A major feature of the world economy has been the uplift in inflationary pressures. While largely driven by oil and other commodity price rises, there is also evidence of increases in underlying inflation as economies reach capacity constraints and inflationary expectations rise. This has seen most of the major central banks move towards tighter monetary policy.

Australian economy

Despite solid growth in domestic demand, Australian gross domestic product (GDP) growth eased in the first half of 2006, to be 1.9 per cent over the year to the June quarter 2006. There is evidence at the national level that strong demand (from strong employment and income gains), coupled with supply constraints, has meant that inventories have been run down and imports have absorbed much of this excess demand. Strong demand also appears to have flowed through to higher inflation.

As a result of this easing in GDP growth, the Consensus Economics forecast for Australia has been revised down to 2.8 per cent in 2006. With a potential rebuilding of inventories and strong domestic activity, it is expected that Australian growth will pick up to 3.3 per cent in 2007. However, these forecasts will need to be reviewed in light of the more recent downgrading of prospects in the agricultural sector. The Australian Bureau of Agricultural and Resource Economics (ABARE) estimates that the drought will reduce economic growth in Australia by around 0.7 percentage points from what would otherwise have been achieved.

In contrast to the GDP data, the national labour market has been performing strongly, with employment growing by 2.7 per cent over the year to September 2006. This has been associated with an historically low unemployment rate and a record high participation rate.

Consumer price inflation increased significantly to 3.9 per cent over the year to September. Although there were several temporary influences behind this result, it also appears that inflation is becoming more broadly based. Citing the impact of higher upstream price pressures and rising underlying inflation, the Reserve Bank of Australia (RBA) increased official interest rates in August 2006 by 25 basis points, following a similar rise in May. The RBA also lifted its forecast of underlying inflation, which is expected to remain at the upper end of the Bank's target range over the next two years.

Victorian economy

Victorian state final demand growth moderated in the first half of 2006. This reflected slower business investment growth, offset to some extent by stronger growth in consumer spending. However, broader measures of output show stronger growth in the first half of 2006, due to a recovery in exports and an easing in imports.

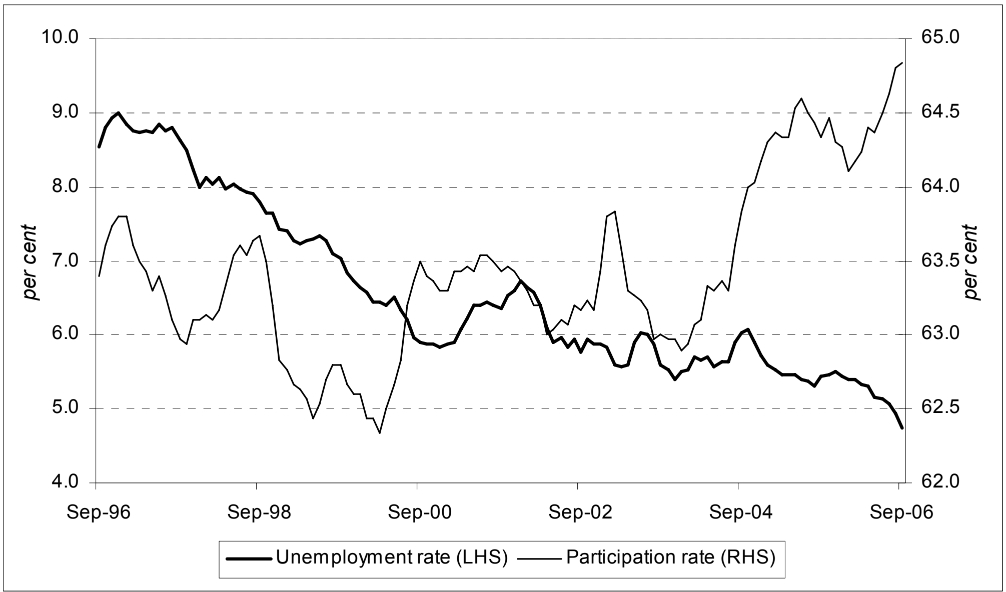
As foreshadowed in the 2006-07 Budget, consumer spending growth has experienced a modest recovery, with strong growth in employment and income offsetting the effects of higher interest rates and petrol prices. Although dwelling investment posted a rise in the June quarter, it remains lower over the year and recent interest rate rises are likely to contribute to further near-term softness. Business investment has been a key driver of growth in Victoria, growing by 6.5 per cent over the year to the June quarter. Despite a high exchange rate and a highly competitive environment, net merchandise exports have contributed to Victorian output growth in the past two quarters. Merchandise exports have risen, particularly for meat products, dairy, beverages and pharmaceutical goods, and merchandise import growth has slowed.

Despite the more moderate growth in Victorian state final demand in 2006, the labour market has performed strongly, posting positive gains in employment in each month so far of 2006. This is the longest sustained rise in monthly Victorian employment since consistent data commenced in 1978, and has been associated with a lower unemployment rate as well as higher labour force participation (Chart 1.1). The high participation rate appears to be reflecting a combination of higher skilled migration, delayed retirement and a buoyant labour market encouraging more people into the labour force. Rising labour force participation is also likely to have acted as a moderating influence on wage growth.

Recent population data have also been positive for Victoria, with continued strong gains from overseas migration. This has contributed to population growth in Victoria of 1.3 per cent over the past year, the highest yearly growth rate in almost five years.

Inflationary pressures have intensified since the Budget, with Melbourne recording inflation of 3.4 per cent over the year to September 2006. While recent movements have been driven in particular by petrol prices and the impact of Cyclone Larry on fruit prices, the rise in inflation has been broad-based. Underlying inflation has increased to around 3 per cent, consistent with an economy reaching capacity.

Chart 1.1: Victorian participation and unemployment rates (three-month moving average)



Source: Australian Bureau of Statistics

VICTORIAN ECONOMIC OUTLOOK

Revised projections for the Victorian economy are presented in Table 1.1. These projections assume constant exchange rates, and that oil prices follow the path implied by oil futures contracts.

Forecast growth of Victorian gross state product (GSP) in 2006–07 has been revised down to 2.75 per cent, predominantly reflecting the impact of drought conditions on agricultural output. Growth in the non-farm economy is expected to be consistent with Budget projections. The drivers of non-farm growth in 2006-07 are expected to be a modest improvement in consumption growth and smaller falls in dwelling investment and net exports, partly offset by slower business investment growth. In the out-years, GSP growth is expected to return to around trend rates of 3.25 per cent.

Victoria's agricultural sector has been adversely affected by the intensifying drought conditions. According to the Bureau of Meteorology, rainfall deficiencies have been observed across much of Victoria during winter and spring. Water shortages are particularly severe in western and north-western parts of Victoria. In addition, the US National Oceanic and Atmospheric Administration has observed the re-occurrence of El Niño conditions. As a result, farm output is likely to be significantly lower than envisaged at Budget time. According to ABARE, Victorian winter crop production in

2006-07 is expected to be only about a quarter of that observed in 2005-06. Cattle slaughterings are likely to rise because of limited feed and water, and Dairy Australia forecasts that Victorian milk production will fall by 8.4 per cent in 2006-07. Also, frosts in late September are likely to result in noticeably lower fruit production.

Table 1.1: Victorian economic projections [(a)]

(Projections in the 2006–07 Budget, where different, are in parentheses.)

	2005-06 Actual	2006-07 Forecast	2007-08 Forecast	2008-09 Forecast	2009-10 Forecast
Real gross state product	2.50	2.75	3.25	3.25	3.25
		(3.25)	(3.50)		
Employment	1.7	2.25	1.25	1.25	1.25
	(1.50)	(1.25)	(1.50)		
Unemployment rate [(b)]	5.3	5.00	5.25	5.25	5.25
	(5.50)	(5.50)			
Wage price index [(c)]	3.8	3.75	3.50	3.50	3.50
	(3.75)	(3.50)			
Consumer price index	3.1	3.25	2.50	2.50	2.50
	(3.00)	(2.50)			
Population [(d)]	1.30	1.10	1.10	1.10	1.10
	(1.10)	(1.00)	(1.00)	(1.00)	(1.00)

Sources: Australian Bureau of Statistics, Department of Treasury and Finance

Notes:

(a) Year-average per cent change on previous year unless otherwise indicated. Real gross state product and population figures for 2005-06 are estimates, not actuals. All economic projections are rounded to the nearest 0.25 percentage point, except population projections which are rounded to the nearest 0.1 percentage point.

(b) Year-average level, per cent.

(c) Total hourly rate excluding bonuses.

(d) June quarter, per cent change on previous June quarter.

Outside the farm sector, growth is projected to be solid. Consumer spending is expected to show modest improvement in 2006-07, supported by the strong labour market and income tax cuts. However, consumers are likely to remain cautious in view of the potential for further interest rate rises, which are likely to squeeze discretionary spending power because of high levels of household debt.

Recent interest rate rises, by adversely affecting housing affordability, are likely to have delayed the recovery in dwelling investment. A recovery is nonetheless expected towards the end of 2006-07, driven by pent-up demand. Recent dwelling commencements have been running below underlying demand requirements, rental vacancy rates have fallen to very low levels and rents are rising strongly.

Although the growth in business investment is likely to moderate, it should remain an important driver of economic growth. There are substantial levels of non-residential construction, including engineering work, in the pipeline. The current environment is still conducive to continued growth of business investment, with a robust global economy, high capacity utilisation, and strong business profitability and balance sheets.

Net merchandise exports have been positive for output growth in the first of half of 2006, and this momentum provides some support for continued improvement into 2006-07. Despite this, it is still expected that net exports will detract marginally from growth in 2006-07. The minerals commodity boom, by contributing to a high exchange rate and the reallocation of labour and capital to mineral-rich regions, may continue to place pressure on Victoria's non-mineral exports. Victoria's agricultural exports are also likely to be adversely affected by drought conditions.

The labour market outlook remains positive for 2006-07, with recent strong data leading to an upward revision to forecast employment growth to 2.25 per cent, and a downward revision to the unemployment rate. In the out-years, employment growth is expected to slow from recent above-trend rates to be more in line with growth of the working population, and the unemployment rate is expected to settle around 5.25 per cent. One noticeable feature of the labour market has been the large rise in the labour force participation rate, which should be supported over the forecast period by demographic and policy changes.

Population projections have also been raised, in line with recent developments that show stronger net overseas migration, less outflow via interstate migration and a rising birth rate.

Wage growth is projected to be moderate over the forecast period. This is despite the low unemployment rate and reports that firms are having difficulty finding suitable labour. Some of the moderating influences are coming from the rising participation rate, well-anchored inflation expectations as well as increased competition from labour in developing economies. Nonetheless, wage pressures remain a risk to the economic outlook.

Inflationary pressures have built up over the past six months, and the 2006-07 inflation forecast has been lifted to 3.25 per cent. This reflects the impact of recent stronger-than-expected inflation and signs of heightened input cost pressures. Although most of these effects are likely to have washed out by 2007-08, the broad-based nature of the rise in underlying inflation, the tight labour market and evidence of capacity constraints suggest that the risks to inflation lie on the upside.

ECONOMIC RISKS

The economic projections are sensitive to several upside and downside risks. The main downside risks stem from intensifying drought conditions and possible wage and inflationary pressures resulting in further interest rate rises. Also, any major disruption to world economic growth would impact on the national and Victorian economy. These are discussed in Chapter 3, *Statement of Risks.*