

SECRETARY'S TALKING POINTS – BRIEFING OF INDEPENDENTS (17 NOVEMBER)

UPDATE ON OUTLOOK – MYEFO

- Last week the Government released the Mid-year economic and fiscal outlook (MYEFO).
- The purpose of the MYEFO – as defined by the Charter of Budget Honesty – is to publish information to enable an assessment of the Government's fiscal performance against its fiscal strategy
- The MYEFO shows that despite global uncertainty and the impact of a higher dollar on revenues, the budget remains on track to return to surplus in 2012-13.
- MYEFO delivers a tightening in fiscal policy stance of 4½ per cent of GDP over three years – fastest fiscal consolidation in more than 40 years
- The Government has kept to its fiscal strategy of keeping real spending growth to less than 2 per cent a year. In addition, all new spending in the MYEFO, including the Government's election commitments, have been fully offset.
- Once the Budget has returned to surplus, the Government plans to maintain the 2 per cent cap on real spending growth, on average, until the budget surplus is at least 1 per cent of GDP.

ECONOMIC OUTLOOK

The Australian economy is in a strong position. Real GDP is now growing at around its trend rate. Over 375,000 jobs have been created in the past year and the unemployment rate has fallen to 5.4 per cent. Underlying inflation has moderated to around a five year low, and is within the target band. The outlook is for the Australian economy to strengthen further in 2010-11 and 2011-12, driven by a strong mining sector and business investment.

Slide One: World GDP growth

World economic growth is expected to remain at or above 4 per cent in the next few years, with most economies outside the euro zone expected to return to around trend growth rates by 2012.

Slide Two: World GDP growth

However, there is a divergence in growth performance and prospects between the advanced and developing economies. The emerging economies of Asia are expected to grow strongly, while growth in major advanced economies is expected to remain relatively weak – with areas such as the euro area and Japan not expected to return to their pre-crisis level of economic activity within the forecast period.

Slide Three: Fiscal stimulus deduction from real GDP growth

While fiscal stimulus contributed to Australian GDP growth in 2009-10, it is expected to detract from growth after that. Stimulus is forecast to detract one percentage point from growth in 2010-11 and ½ of a percentage point in 2011-12.

Slide Four: Exchange rates

The exchange rate has appreciated significantly in recent months. This reflects the relatively strong outlook for the Australian economy and our high terms of trade. The dollar's appreciation is also symptomatic of US dollar weakness, reflecting the second round of quantitative easing by the US Federal Reserve and market perceptions that the US economic outlook has softened.

Slide Five: Key interest rates

Interest rates are a little above their long-term average levels.

Slide Six: Real GDP growth over the forward estimates period

We are forecasting growth of 3¼ per cent in 2010-11 and above trend growth of 3¼ per cent in 2011-12. The economy is expected to return to capacity within the forecast period.

Slide Seven: Contributions to GDP growth

The Australian economy grew by 2.3 per cent in the 2009-10 financial year. The MYEFO forecasts are for growth of 3¼ per cent in 2010-11 and 3¾ per cent in 2011-12.

- **Household consumption** is expected to grow by 4 per cent in 2010-11, and 3½ per cent in 2011-12 – reflecting solid growth in employment and wages, recent increases in wealth from rising asset prices, and high levels of consumer confidence.
- **Dwelling investment** is forecast to grow by 4½ per cent in 2010-11 and 3 per cent in 2011-12.
- **New business investment** is expected to recover in 2010-11, led by several major engineering construction projects - including the Gorgon LNG project.
- **Public final demand** is expected to grow by 1½ per cent in 2010-11, before falling by ¼ of a per cent in 2011-12 – reflecting the withdrawal of fiscal stimulus.
- **Exports** volumes are expected to grow by 7 per cent in 2010-11 and 5 per cent in 2011-12. Commodity exports are expected to grow in both 2010-11 and 2011-12, reflecting robust growth in the Asian region and an expected increase in Australian production capacity.

Slide Eight: Bulk commodity prices

Bulk commodity spot and contract prices have moved markedly since the start of the year. While iron ore contract prices have declined in the December quarter, they remain over 100 per cent higher than the same time last year. Hard coking coal contract prices have also declined in the

December quarter, but are still more than 50 per cent higher through the year. Thermal coal contract prices are set on a Japanese fiscal year (JFY) basis. Contract prices for JFY2010 are around 40 per cent higher than JFY2009 contract prices.

Slide Nine: Long run terms of trade

The terms of trade are forecast to rise by 15½ per cent in 2010-11, underpinned by high prices for Australia's non-rural bulk commodity exports. Record levels of steel production in China earlier in the year led to historically high iron ore contract prices for the September quarter 2010. December quarter contract prices, while lower, also remain well above historical levels. The terms of trade are expected to decline by 4½ per cent in 2011-12, as significant increases in global mining capacity place downward pressure on non-rural commodity prices.

In the projection period the terms of trade are projected to decline by a total of around 20 per cent over a 15-year period, settling just above their 2005-06 level. This reflects an expectation that current levels of commodity prices will not be sustained in the longer term, as increases in supply bring down prices over time.

Slide Ten: Mining investment and exports

Mining firms are expected to invest around \$55 billion in 2010-11 – far above the average level of mining investment before the mining boom.

This is expected to result in a significant increase in future mining exports, and in particular for iron ore, coal and LNG.

Slide Eleven: Net lending

The current account deficit reflects that Australia's national investment exceeds national savings. Australia's level of gross saving is around the OECD average. However, our level of investment is above average – in large part due to the current mining boom.

Slide Twelve: Australian employment and investment

Sustained high commodity prices are leading to a structural change in the economy.

Employment in the mining and construction sectors has markedly increased. Mining and construction investment has also increased as a share of GDP, while manufacturing investment has been constant as a share of GDP.

Slide Thirteen: Unemployment rate

The unemployment rate is expected to continue to fall, reaching 4¾ per cent by the end of 2010-11 and 4½ per cent by the end of 2011-12. Employment is expected to grow by 2½ per cent through the year to the June quarter 2011 and 2 per cent through the year to the June quarter 2012, consistent with the strong outlook for activity.

Slide Fourteen: Inflation rate

Inflation is expected to rise over the forecast horizon, reflecting the strength in domestic demand, a buoyant labour market and anticipated increases in administered prices. Underlying and headline measures of inflation are expected to be 2¾ per cent through the year to the June quarter 2011 and 3 per cent through the year to the June quarter 2012.

FISCAL OUTLOOK

- Budget on track to return to surplus in 2012-13, despite impact of higher dollar
 - Surplus of \$3.1 billion (0.2 per cent of GDP) in 2012-13 – slightly less than PEFO (\$3.5 billion), but stronger than expected at Budget (\$1 billion).
- MYEFO delivers a tightening in fiscal policy stance of 4½ per cent of GDP over three years – fastest fiscal consolidation in more than 40 years.
 - This year, the fiscal consolidation is 1.3 per cent of GDP in 2010-11. Budget deficit for 2010-11 of \$41.5 billion (3.0 per cent of GDP), slightly higher than PEFO.
 - This consolidation is being driven roughly equally by a reduction in spending as a share of GDP and an improvement in revenues associated with the strengthening economy
- Net debt is now expected to peak at 6.4 per cent of GDP (\$94.4 billion) in 2011-12.
 - This is up from around 6 per cent of GDP at Budget and PEFO. The increase is due to a change in Future Fund assets from fixed income assets (which reduced net debt) to equity (which is not included in net debt).
 - Net debt is projected to return to zero in 2018-19 – same as Budget & PEFO.
- Tax receipts have been revised down by \$9.7 billion over the four years to 2013-14 since PEFO, largely due to higher dollar.
- Receipts still down on pre-crisis levels (2008-09 Budget) by: \$30 b in '10-11; \$8 b in 11-12, and \$7 b in 12-13.
- Total payments have decreased by \$6.5 billion over the four years to 2013-14 since the PEFO.
- Stimulus has been subtracting from growth since the start of this year – it will reduce growth by 1 percentage point in 2010-11 and ½ percentage point in 2011-12.

International Comparison

- Australia continues to have a substantially stronger fiscal position than any of the major advanced economies.
 - Australia's forecast deficit of 3.0 per cent of GDP in 2010-11 is well below the 9.3 per cent of GDP average for the major advanced economies in 2010.
 - Australia will return its budget to surplus in 2012-13, sooner than any of the major advanced economies. In addition, the major advanced economies are expected to remain in collective deficit by an average of 6.0 per cent of GDP in 2012.
 - The average net debt level in the major advanced economies, measured for all levels of government, is estimated to be 74.5 per cent of GDP in 2010 rising to an average of 90 per cent of GDP in 2015, 14 times higher than the expected peak in Australia's net debt of 6.4 per cent of GDP.