2 ECONOMIC PERFORMANCE AND OUTLOOK

FEATURES

- **The global economy is experiencing its most severe financial crisis since the 1930s, with global GDP now widely expected to contract in 2009 for the first time in 60 years. Economic activity in Queensland's major trading partners is expected to decline by 3% this calendar year.**
- **As a result, economic growth in Queensland is estimated to slow to ½% in 2008-09, with the economy forecast to contract marginally, by ¼%, in 2009-10. In addition to a decline in exports, growth in consumption is forecast to ease due to lower household wealth. High interest rates for much of 2008, as well as weak investor confidence, are also forecast to lower dwelling investment.**
- **The slight fall in economic activity in 2009-10 reflects a peaking in the private investment cycle. After tripling over the past eight years, business investment is forecast to fall 17% in 2009-10, largely due to a scaling back in commercial and mining construction. Partly offsetting this, public infrastructure spending is forecast to rise sharply, reflecting State and Federal Government initiatives.**
- **Growth is forecast to return in 2010-11, albeit to a modest 2¾%. This would represent the third successive year of below-trend growth, as a slow global recovery initially tempers an upturn in exports. Growth in consumer spending is forecast to improve, as balance sheets are strengthened, while solid population growth should eventually drive a sharp rise in housing investment.**
- **Benefiting from significant investment in capacity in previous years, economic growth is projected to accelerate to 4½% in 2011-12 and reach its decade average of 4¾% in 2012-13, as the global economic recovery gathers pace.**
- **In line with subdued economic activity, employment is forecast to fall ¾% in 2009-10 and recover by 1¼% in 2010-11. With labour force growth forecast to continue to exceed jobs growth, the year-average unemployment rate is forecast to rise to 6½% in 2009-10 and peak at 7¼% in 2010-11.**

This chapter presents the economic context within which the 2009-10 State Budget has been prepared. It overviews developments in Queensland's external environment in light of the financial crisis, including the contraction now expected in major trading partner economies and the national outlook. The chapter summarises the economic performance of, and outlook for, Queensland over 2008-09 to 2012-13, and provides detailed estimates for 2008-09 and forecasts for sectors of the economy in 2009-10. In line with the Australian Government, the chapter for the first time provides forecasts for an additional year, detailing the drivers of the economic recovery in 2010-11. The chapter also outlines key risks to economic growth over the forecast period.

EXTERNAL ENVIRONMENT

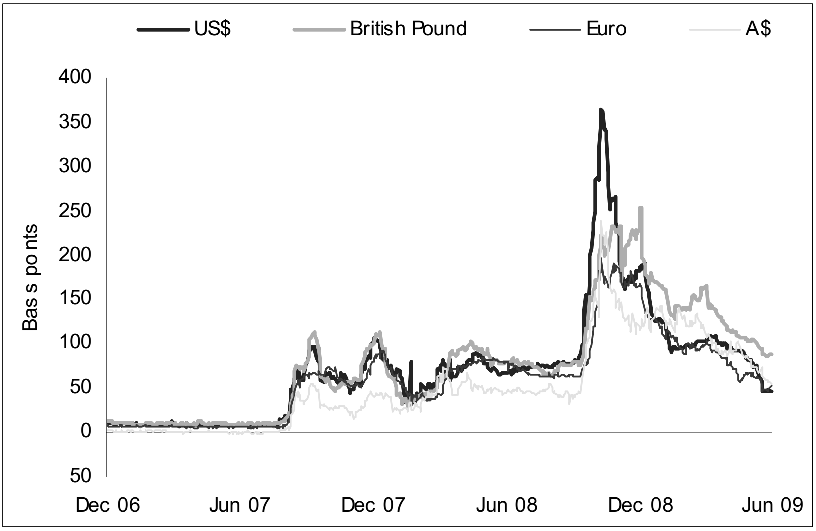
International conditions

The global economy is experiencing its most severe financial crisis since the 1930s. This has undermined activity throughout developed and developing economies with such severity and synchronicity that global gross domestic product (GDP) in 2009 is now widely expected to contract for the first time in 60 years. A negative feedback loop between credit markets and global economic activity is also evolving, raising considerable uncertainty regarding the depth of the recession, as well as the timing of an eventual recovery.

The global financial crisis intensified from mid-September 2008, when investment bank Lehman Brothers filed for bankruptcy. This led to a rapid escalation in perceived counterparty risk and thus a reluctance by the financial sector to lend funds. As a result, interbank interest rate spreads widened from already-elevated levels (see Chart 2.1). These developments also prompted an acute deterioration in consumer and business sentiment, as well as significant falls in equity and commodity prices.

Financial market conditions, equity values and commodity prices have all recovered somewhat since late 2008, aided by various policy responses from governments and central banks. However, ongoing concerns about further write downs across the banking sector and a deteriorating economic outlook continue to impair credit markets and overall sentiment. In its April 2009 *Global Financial Stability Report*, the International Monetary Fund (IMF) estimated total write downs to reach US$4.1 trillion, of which approximately US$1.9 trillion were yet to be realised by banks, while in its latest *World Economic Outlook*, the IMF forecast the global economy to contract 1.3% in 2009.

Chart 2.1
Interbank interest rate spreads[1]



Note:
1. Three month London Interbank Offered Rate less three month Overnight Indexed Swap rate.
Sources: Reuters, Bloomberg and Queensland Treasury.

A subdued outlook, combined with funding constraints, has led businesses globally to cut investment, run down inventories and scale down operations. This has been most pronounced in advanced economies in Europe and Asia. Industrial production over the year to April 2009 fell by more than 30% in Japan, around 20% in Taiwan, Germany and Spain and around 10% in the US and Korea, while over the year to March 2009, industrial production fell more than 20% in Italy and more than 10% in the UK.

Lower industrial activity in advanced economies has also affected large commodity exporters, with reduced demand suppressing both export volumes and prices. The resulting sharp contraction in international trade is widely expected to persist this year, with the IMF forecasting export volumes from developed and developing economies to fall 13.5% and 6.4% respectively in 2009.

Household wealth has fallen in many economies due to lower equity and house prices, while a deteriorating labour market has reduced job security, undermining sentiment and spending. As at early June 2009, stock markets in the US and UK remained 40% and 35% below their 2007 highs respectively, while house prices in these countries have fallen 31% and 18% from their peak. The US unemployment rate has risen from 4.4% in early 2007 to 9.4% in May 2009, while the IMF forecasts the average unemployment rate of advanced economies to rise 2.3 percentage points to 8.1% in 2009, and to 9.2% in 2010.

Queensland's major trading partners' GDP is forecast to contract by 3% in 2009, larger than the fall in world GDP expected by the IMF (see Table 2.1). This is partly due to the recession in Japan, which accounts for a larger share of the State's exports relative to its weight in global GDP. Reflecting a reliance on export-led growth, Japan's economy contracted by a record 3.8% in March quarter 2009, or by 8.4% over the year, while the Korean economy has shrunk by 5.0% since September quarter 2008. The US economy contracted by 3.1% over the two quarters to March quarter 2009, its largest six-month fall since 1958, while Eurozone GDP declined by a record 2.5% last quarter.

Table 2.1
Queensland major trading partner GDP outlook
(annual % change)

	Actual	Forecasts				
	2008	2009	2010	2011	2012	2013
World[1]	3.2	-1.3	1.9	4.3	4.8	4.9
Major trading partners[2]	2	-3	1½	3¾	4½	4½
Non-Japan Asia[3]	4¼	-¾	3	5¾	6¼	6¼
Japan	-¾	-6¼	½	2¼	3¼	2¾
Europe[4]	1	-4¼	-½	1½	2¼	2¼
US	1	-2¾	0	3½	3¾	3¼

Notes:
1. Sourced from the April 2009 IMF *World Economic Outlook* database. World GDP comprises 173 countries, weighted by purchasing-power-parity (PPP) GDP.
2. Queensland's major trading partner output comprises 31 countries, weighted by their share of merchandise exports in the three years to 2007-08. Forecasts are sourced from IMF.
3. Includes New Zealand.
4. Includes United Kingdom.

Sources: International Monetary Fund and Queensland Treasury.

A distinguishing characteristic of the current global recession compared with previous downturns has been the scale of wealth destruction caused by the financial crisis. This has seen a broad-based shift in consumer and business priorities toward repairing balance sheets. This de-leveraging process remains incomplete and is likely to prolong the current downturn, despite numerous monetary and fiscal policy efforts to stimulate activity and relieve credit market stresses.

Given a prerequisite for a sustainable economic recovery is the restoration of stability in the global financial system, substantial efforts have been made to increase liquidity, reduce borrowing costs and recapitalise the banking sector. Easing global inflation, as a result of lower commodity prices and excess capacity, has enabled central banks to loosen monetary policy considerably. Official interest rates are now at or near record lows in the US, Japan, UK and Eurozone. More unconventional efforts to promote financial stability have been adopted, including quantitative or credit easing by the US and UK central banks, as well as the US Treasury's *Troubled Asset Relief Program*. Moreover, numerous governments have provided guarantees on private sector borrowing and purchased 'toxic' assets from the banking sector. Such efforts should help normalise financial markets, restore sentiment and stabilise economic activity by late 2009. As a result, global economic growth is forecast to re-emerge in the first half of 2010.

However, growth is forecast to be relatively more subdued compared with previous recoveries. Recoveries from recessions caused by financial crises tend to be weaker, given the protracted nature of the private sector de-leveraging process. The highly synchronised nature of the current global recession also reduces prospects for an export-led recovery. The cost of credit is likely to remain higher, and availability more restricted, than in the years preceding the crisis, reflecting a more rational pricing of risk. Further, current private sector de-leveraging will eventually transfer to the public sector. With governments globally becoming more indebted from necessary fiscal expansion and a deteriorating revenue base, public sector spending is unlikely to contribute as significantly to economic growth after the recession ends. Consequently, Queensland's major trading partner economies are expected to expand at a below trend rate of 1½% in 2010, with the peak in their combined economic output achieved in June quarter 2008 not expected to be reached again before the second half of 2011.

Australian economy

Reflecting the impact of the global recession on business confidence and export demand, the Australian Government forecasts GDP to be unchanged in 2008-09 and fall ½% in 2009-10. This would result in a recession of similar magnitude to that of the early 1990s (see Chart 2.2). The contraction in GDP in 2009-10 is expected to be driven by a sharp fall in business investment and exports, while a one-third decline in household net financial wealth in 2008 is forecast to drive a ¼% fall in household consumption.

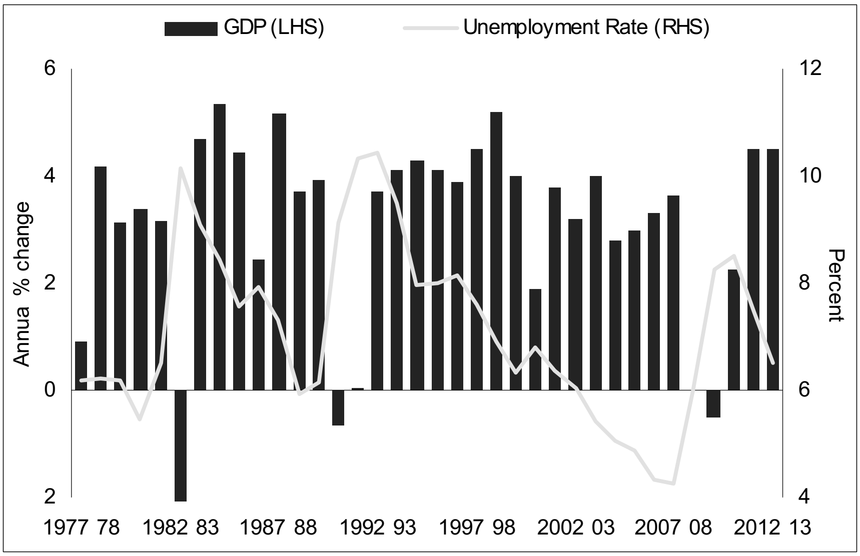
With the world economy expected to gradually recover during 2010, a turnaround in exports and strong growth in dwelling investment are anticipated to support a return to GDP growth of 2¼% in 2010-11. Households are forecast to continue to rebuild their balance sheets, resulting in below average consumption growth, while a modest recovery in business investment is based on an expectation that a number of high value resource projects scheduled to commence in 2010-11 will proceed.

Employment is forecast to contract 1½% over the year to June quarter 2010, causing the unemployment rate to rise to 8¼% in the quarter. With modest jobs growth in 2010-11 insufficient to absorb growth in the labour supply, the unemployment rate is forecast to peak at 8½% in June quarter 2011, before declining over the following two years.

In an effort to reduce the depth of the recession, the Australian Government has initiated significant fiscal stimulus measures. In particular, public investment is forecast to rise by its sharpest rate on record in 2009-10, partly reflecting the February 2009 *Nation Building and Jobs Plan* and the December 2008 *Nation Building* package. The Australian Government has estimated that in the absence of policy actions to stimulate the economy, the level of GDP would be 2¾% lower in 2009-10 and 1½% lower in 2010-11, with the unemployment rate peaking at 10%, rather than 8½%.

Looking further ahead, the Australian Government projects GDP to grow at 4½% in each of the two projection years, 2011-12 and 2012-13, above the medium term trend rate of 3%. When combined with the forecast for 2010-11, this represents only a marginally weaker three-year recovery path compared with the early 1990s recession.

Chart 2.2
Gross domestic product[1, 2] and unemployment rate[2, 3], Australia



Notes:
1. Chain Volume Measure (CVM), 2006 07 reference year.
2. 2008 09 is an estimated actual, 2009 10 and 2010 11 are forecasts, 2011 12 and 2012 13 are projections.
3. Unemployment rate is for the June quarter of each financial year.

Sources: ABS 5206.0, 6202.0 and Australian Government 2009 10 Budget.

THE QUEENSLAND ECONOMY

External forecast assumptions

Forecasts for economic growth in Queensland are based on the following assumptions about the national economy, trading partners and financial markets:

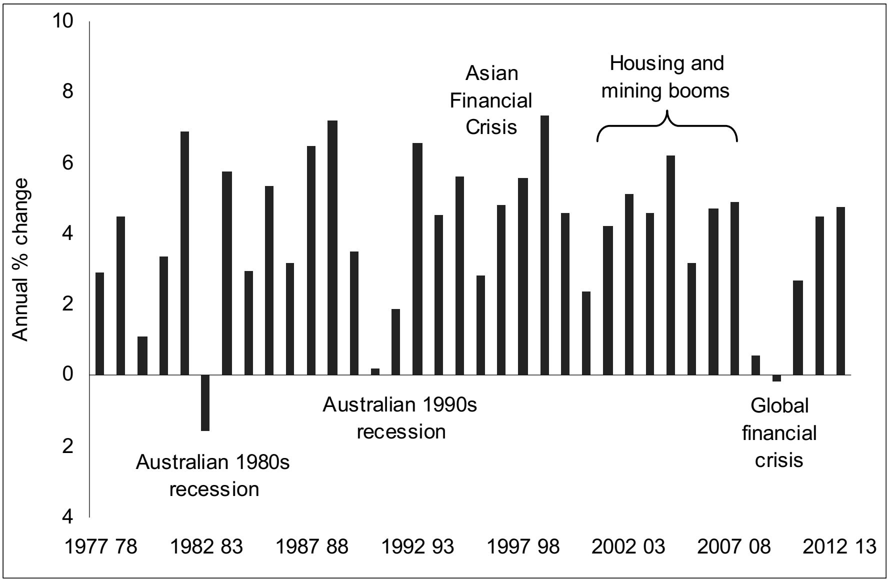
- as a whole, the economies of Queensland's major trading partners are forecast to contract by 3% in 2009, before recovering to mild growth of 1½% in 2010. Assuming some normalisation in financial markets, growth is projected to return to its long-term average of around 3¾% in 2011.
- in line with expectations in the futures market, the Australian official cash rate is assumed to fall slightly in September quarter 2009 from its current level of 3.0%, before gradually rising to 3.5% by the end of 2010-11.
- the A$ plunged between mid-July and late November 2008, with sudden risk aversion triggering an unwinding of A$/Yen carry trades. With some return of risk appetite, the A$ began to partly recover from early March 2009. Given the milder downturn and less aggressive monetary easing expected in Australia relative to other economies, the A$ is forecast to appreciate mildly over the forecast period.
- production cuts by OPEC and an assumed depreciation of the US$ are expected to maintain oil prices close to US$65 per barrel by June quarter 2010, before increasing to around US$70 per barrel by June quarter 2011.
- floods and other adverse weather events in early 2009 have been factored into estimates of agricultural and tourism exports in 2008-09. Seasonal conditions are assumed to return towards normal from 2009-10 onwards.
- as outlined in the Australian Government Budget delivered on 12 May 2009, the national economic forecasts and projections, as well as stimulus measures, have been adopted as the basis for national economic performance.

A discussion of the risks and opportunities associated with some of these assumptions is contained later in this chapter.

Summary of economic outlook

Largely reflecting the impact of the financial crisis on household wealth, investment and exports, growth in Queensland's gross state product (GSP) is estimated to slow sharply in 2008-09, after which the economy is forecast to contract marginally in 2009-10. However, a recovery in housing investment and confidence is forecast to see economic growth recover to 2¾% in 2010-11, which would represent the fifteenth successive year that the State economy outperforms the national average. Driven by a rebound in business investment and an acceleration in exports, State economic growth is projected to strengthen to 4¾% by 2012-13, as the global recovery gathers pace (see Chart 2.3).

Chart 2.3
Growth in Queensland's gross state product[1]



Note:
1. CVM, 2006 07 reference year. 2008 09 is an estimated actual, 2009 10 and 2010 11 are forecasts and 2011 12 and 2012 13 are projections.

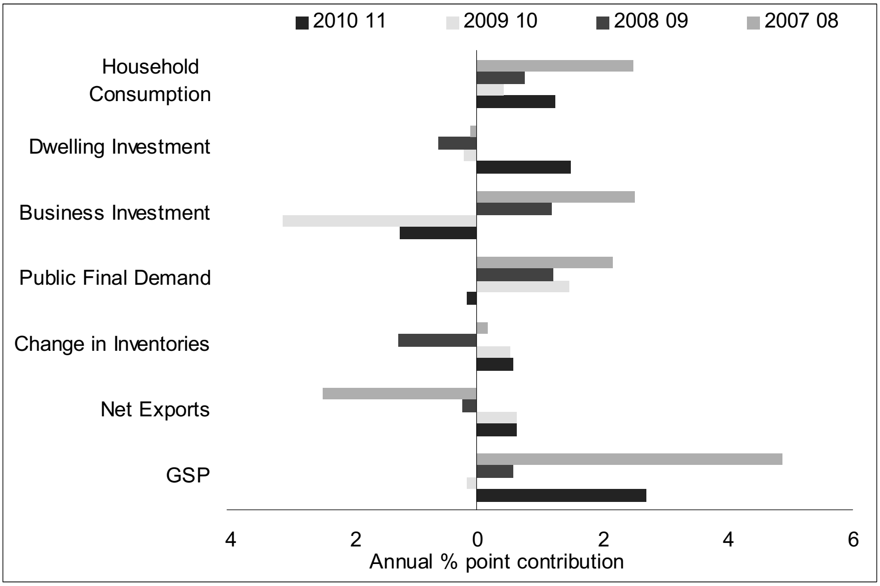
Sources: Queensland Treasury and Queensland State Accounts historical data.

Economic growth is estimated to slow to ½% in 2008-09. While interest rate cuts from late 2008 and stimulus payments have boosted disposable incomes, a fall in wealth due to lower equity and domestic house prices has seen household saving rates rise. As a result, growth in private consumption is estimated to ease to 1¼% in 2008-09. The lagged effect of high interest rates in much of 2008, combined with weak investor confidence, is also estimated to drive a 7¾% fall in dwelling investment.

Economic growth in 2008-09 is also expected to be more modest than forecast in the February 2009 Economic and Fiscal Update (EFU), with exports now expected to fall for the first time since 1989-90. Sharp cuts in global steel and industrial production have lowered mineral exports, while tourism exports have been affected by adverse weather events, swine influenza and recessions in source countries for overseas arrivals. The weakening in the economic outlook and tighter credit conditions have also caused a sharper run-down in stocks than anticipated at EFU, with this inventory adjustment now estimated to detract 1¼ percentage points from growth in 2008-09 (see Chart 2.4).

While inventories have been run down, construction activity by businesses and the public sector continued to contribute to economic growth and productive capacity in 2008-09. In particular, a large amount of commercial and resource projects still to be completed is estimated to see business investment rise a further 7% in 2008-09, to exceed $38 billion in real terms, a level three times that recorded in 2000-01.

Chart 2.4
Contribution to growth in Queensland's gross state product[1]



Note:
1. CVM, 2006 07 reference year. 2008 09 is an estimated actual, 2009 10 and 2010 11 are forecasts.

Source: Queensland Treasury.

However, largely reflecting a peaking in the investment cycle, the Queensland economy is forecast to contract in 2009-10. Business investment is forecast to fall 17%, as rising vacancy rates and limited access to funding weigh on commercial property, and the global recession causes a scaling back in mining construction. While lower interest rates and the First Home Owners Boost should see a recovery in new house construction in 2009-10, tight lending conditions are forecast to weigh on medium-to-high density construction. An ongoing adjustment to lower wealth, along with a decline in employment, is also forecast to further moderate growth in consumption. Exports are anticipated to fall again in 2009-10. A forecast 3% contraction in Queensland's major trading partner economies in 2009 is forecast to lower mineral and service exports. However, improved rainfall and water storages will boost rural exports in 2009-10.

Offsetting a fall in private investment and exports, public investment in Queensland is forecast to rise sharply in 2009-10. This reflects the State Government's own significant capital works program, in addition to spending from Australian Government infrastructure initiatives, including the *Building Australia* package and the *Nation Building and Jobs Plan*.

Economic growth in Queensland is forecast to improve in 2010-11, albeit modestly to 2¾%, representing the third successive year of below average growth. With the global recovery from the financial crisis expected to take longer than after previous downturns, this will act to initially temper growth in Queensland's exports of commodities and services. The improvement in State economic growth in 2010-11 is forecast to be driven primarily by stronger growth in consumption, after household balance sheets are strengthened and confidence recovers, as well as a 20¾% rise in dwelling investment, in response to fast population growth and a decline in housing construction in prior years.

Economic growth is projected to accelerate to 4½% in 2011-12 and strengthen further to 4¾% in 2012-13, matching its long-run rate over the decade prior to the forecast period (see Table 2.2). Benefiting from significant investment in capacity during the recent resources boom, exports growth is projected to improve considerably, as the recovery in the global economy gathers pace. In line with this, business investment is projected to resume an upward trend, as excess capacity in the economy is absorbed and stronger domestic demand improves investment returns.

With economic output forecast to decline in 2009-10 and stage a mild upturn in 2010-11, employment is forecast to fall ¾% and recover 1¼% in these respective years. As a result, population growth is forecast to exceed jobs growth, causing the year-average unemployment rate to rise to 6½% in 2009-10 and peak at 7¼% in 2010-11, the highest year-average rate since 2001-02. However, with jobs growth projected to strengthen to 2½% and 2¾% over 2011-12 and 2012-13 and to exceed population growth, the unemployment rate is expected to fall over this period.

Table 2.2 Economic forecasts/projections[1] (annual % change)						
	Outcome	Est. Act.	Forecasts		Projections	
	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
Queensland						
Gross state product[2]	4.9	½	-¼	2¾	4½	4¾
Employment	2.4	2¼	-¾	1¼	2½	2¾
Unemployment rate	3.7	4¼	6½	7¼	6¾	6½
Inflation	4.1	3¾	2½	2½	2½	2¾
Wage Price Index	4.2	4¼	3½	3¼	3½	3¾
Population	2.4	2½	2¼	2	2	2
Australia						
Gross domestic product[2]	3.6	0	-½	2¼	4½	4½
Employment[3]	2.4	-¼	-1½	½	2½	2½
Unemployment rate[4]	4.2	6	8¼	8½	7½	6½
Inflation[3]	4.5	1¾	1¾	1½	2	2½
Wage Price Index[3]	4.1	4¼	3¼	3¼	na	na
Population	1.7	na	na	na	na	na

Notes:
1. Decimal point figures indicate an actual outcome. na indicates not available.
2. CVM, 2006 07 reference year.
3. Through the year growth to the June quarter.
4. Estimate for the June quarter.

Sources: Queensland Treasury and Australian Government 2009 10 Budget.

Sectors of the Queensland economy

Household consumption

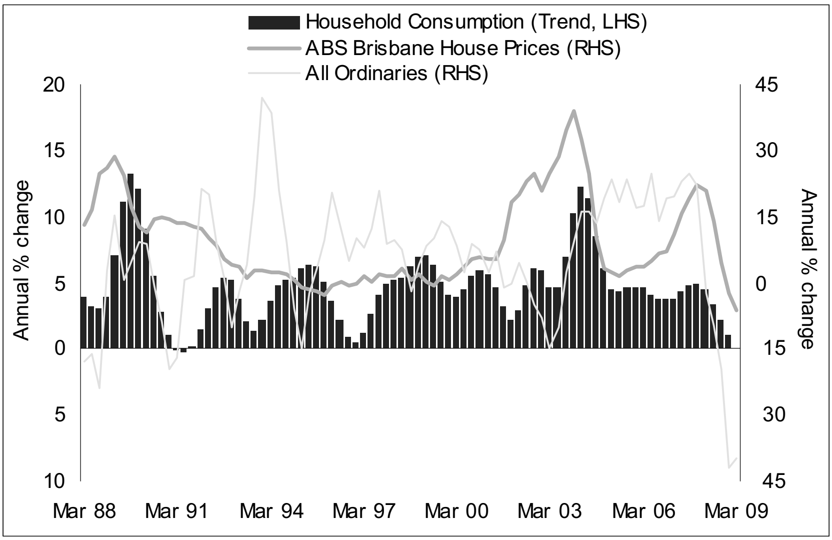
Household consumption growth is estimated to ease to 1¼% in 2008-09, following long run average growth of 4.6% in 2007-08. Discretionary spending has been restrained by significantly lower household wealth, with equity prices halving between late 2007 and March 2009 and house prices falling since June quarter 2008 (see Chart 2.5). Spending on cars, household furnishings, hospitality, clothing and footwear (totalling one fifth of consumption) fell 5.3% in annual terms in the first three quarters of 2008-09.

The deterioration in both the domestic and international outlook has weighed heavily on consumer confidence in 2008-09. This limited the effect of the substantial boost to household disposable incomes from lower interest rates and the Federal Government's initial fiscal stimulus, with households more inclined than usual to use additional income to save or reduce debt, rather than for consumption, particularly in late 2008.

Consumption growth is forecast to ease further in 2009-10, to ¾%, its lowest rate in more than two decades. This partly reflects a continued adjustment to lower wealth, as well as the lagged impact of a decline in dwelling investment in recent years on housing related expenditure. Further, a forecast decline in employment will restrain spending over the year, through its impact on both growth in incomes and consumer confidence.

An improvement in household finances and expected recovery in confidence are forecast to strengthen spending in 2010-11. However, at 2¼%, growth is forecast to remain below trend, partly due to the lagged impact of ongoing dwelling sector weakness in 2009-10.

Chart 2.5
Household consumption[1] and wealth, Queensland



Note:
1. Trend, CVM, 2006 07 reference year.
Sources: ABS 6416.0, Datastream and Queensland Treasury.

Table 2.3
State and National economic forecasts[1]

	Outcome	Est. Actual	Forecasts	
	2007-08	2008-09	2009-10	2010-11
	%	%	%	%
Queensland forecasts				
Domestic production[2]				
Household consumption	4.6	1¼	¾	2¼
Private investment[3,4]	9.1	¼	-11½	1¾
Dwellings	-1.3	-7¾	-3	20¾
Business investment[4,5]	16.3	7	-17	-8¼
Other buildings and structures[4]	10.6	14¼	-17¾	-11
Machinery and equipment[4]	21.0	1¼	-16½	-6
Private final demand[4]	6.1	1	-3¼	2
Public final demand[4]	9.4	5	5¾	-½
Change in inventories[6]	0.2	-1¼	½	½
Gross state expenditure[7]	7.0	¾	-¾	2
Exports of goods and services	3.1	-2	-2¼	3
Imports of goods and services	8.8	-1	-3¼	1
Net exports[6]	-2.5	-¼	¾	¾
Gross state product	4.9	½	-¼	2¾
Other state economic measures				
Inflation	4.1	3¾	2½	2½
Wage Price Index	4.2	4¼	3½	3¼
Employment	2.4	2¼	-¾	1¼
Unemployment rate (%, year-average)	3.7	4¼	6½	7¼
Labour force	2.1	3	1¾	1¾
Participation rate (%, year-average)	67.2	67½	67¼	67
National forecasts				
Domestic production[2]				
Household consumption	3.7	1	-¼	1¾
Private investment	na	na	na	na
Dwellings	1.6	-2½	0	11½
Business investment[4,5]	14.2	2½	-18½	3½
Other buildings and structures[4]	11.4	½	-26	3
Machinery and equipment[4]	16.0	3	-16½	4
Private final demand[4]	5.5	½	-4	2¾
Public final demand[4]	4.6	5	7¾	-½
Change in inventories[6]	0.2	-1½	¼	¾
Gross national expenditure[7]	5.5	¼	-1¼	2½
Exports of goods and services	4.3	-½	-4	4½
Imports of goods and services	12.9	-1½	-6½	6½
Net exports[6]	-1.9	¼	¾	-½
Gross domestic product	3.6	0	-½	2¼
Other national economic measures				
Inflation[8]	4.5	1¾	1¾	1½
Wage Price Index[8]	4.1	4¼	3¼	3¼
Employment[8]	2.4	-¼	-1½	½
Unemployment rate[9]	4.2	6	8¼	8½
Labour force	2.3	na	na	na
Participation rate[9]	65.5	65¼	64¾	64¼

Notes:
1. Unless otherwise stated, all figures are annual % changes. Decimal point figures indicate an actual outcome.
   na - Indicates not available.
2. CVM, 2006-07 reference year.
3. Private investment includes livestock, intangible fixed assets and ownership transfer costs.
4. Adjusted for second-hand asset sales between the public and private sectors.
5. National calculations of business investment include investment in livestock and intangible fixed assets, which are not included in the Queensland calculations.
6. Percentage point contribution to growth in gross state or domestic product.
7. Includes statistical discrepancy and change in inventories.
8. Through-the-year growth rate to the June quarter.
9. Estimate for the June quarter.

Sources: ABS 3101.0; 6401.0; 6345.0; 6202.0, Queensland Treasury and Australian Treasury.

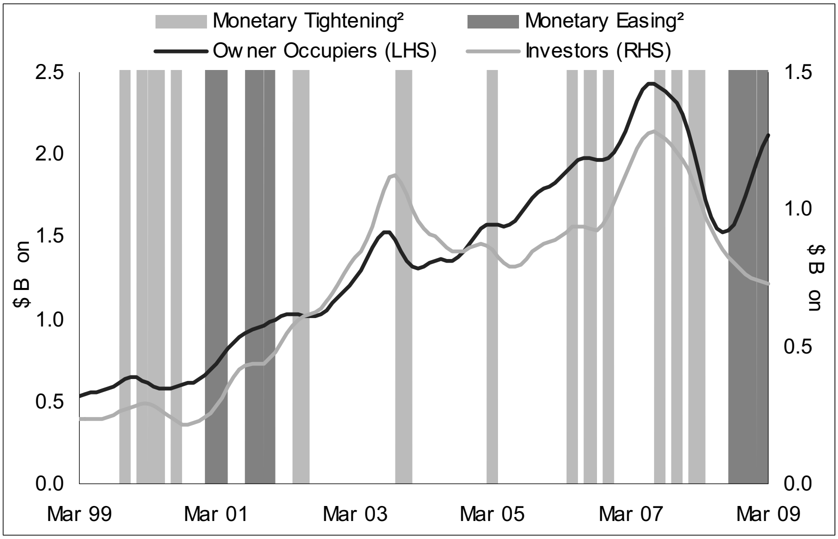
Dwelling investment

Dwelling investment is forecast to decline 7¾% in 2008-09, driven mainly by a fall in new house construction. Approvals for the construction of new houses fell at an annual rate of 36.1% in the first ten months of 2008-09, reflecting the lagged impact of restrictive interest rates in much of 2008 and weak consumer and investor confidence following the worsening in the credit crisis since September 2008. This has also coincided with a reduction in renovation activity in 2008-09. Other dwelling construction (high-rises, townhouses and duplexes) is expected to have reached a cyclical peak in early 2008-09, with a tightening in lending standards weighing on investors in particular.

While investor activity continued to decline in early 2009, Australian and State Government initiatives have strengthened first-home buyer and owner occupier activity since late 2008 (see Chart 2.6). This reflects cuts to stamp duty in September, the First Home Owners Boost in October and a fall in variable mortgage rates from an average of 9.6% in August 2008 to 5.8% in April 2009, their lowest rate since 1968.

Increased housing activity from these policy stimuli is forecast to translate into a recovery in new home construction in 2009-10. However, limited access to funding, lower expected capital gains due to a lacklustre outlook for house prices, together with significant lags associated with larger developments, suggests investment in other dwellings, particularly high-rise complexes, will fall in 2009-10. As a result, total dwelling investment is forecast to decline by a further 3% in year-average terms.

Chart 2.6
Monthly value of finance approvals[1] for new and existing dwellings



Notes:
1. Seasonally adjusted and trended by Queensland Treasury.
2. Month in which the official cash rate increased (monetary tightening) or decreased (monetary easing).

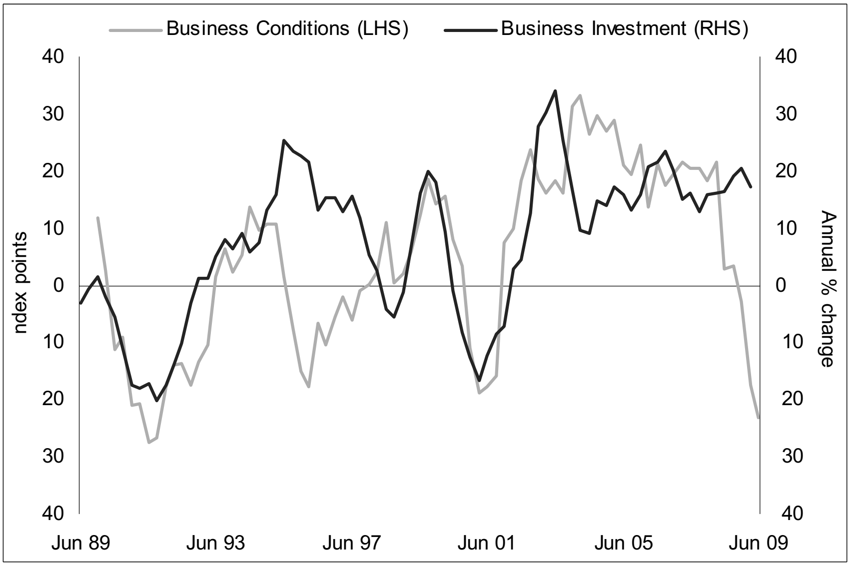
Sources: ABS 5609.0, 5671.0, RBA and Queensland Treasury.

However, dwelling investment is forecast to rebound strongly in 2010-11, rising 20¾%. Solid population growth, low interest rates and fast growth in rents, combined with the fall in construction in previous years, are expected to boost demand for new dwellings.

Business investment

Business investment continued to be a key driver of economic growth in 2008-09. Despite a deterioration in the outlook over the year, a large number of projects still to be completed in the commercial, resource and infrastructure sectors is expected to support estimated growth of 14¼% in other buildings and structures investment in 2008-09. Machinery and equipment investment is expected to rise 1¼%, supported by work under construction and the Federal Government's tax incentives, but tempered by a depreciation in the A$ between mid-July and late November 2008 (which made imported equipment more expensive). Overall, the volume of business investment is estimated to rise 7% in 2008-09 to exceed $38 billion, a level three times that recorded in 2000-01.

Chart 2.7
Business conditions[1] and investment[2], Queensland



Notes:
1. National Australia Bank *Business Conditions Index*, seasonally adjusted by Queensland Treasury, advanced one quarter.
2. CVM, 2006 07 reference year, four quarter rolling sum. Excludes private sector net purchases of second hand public sector assets.

Sources: National Australia Bank and Queensland Treasury.

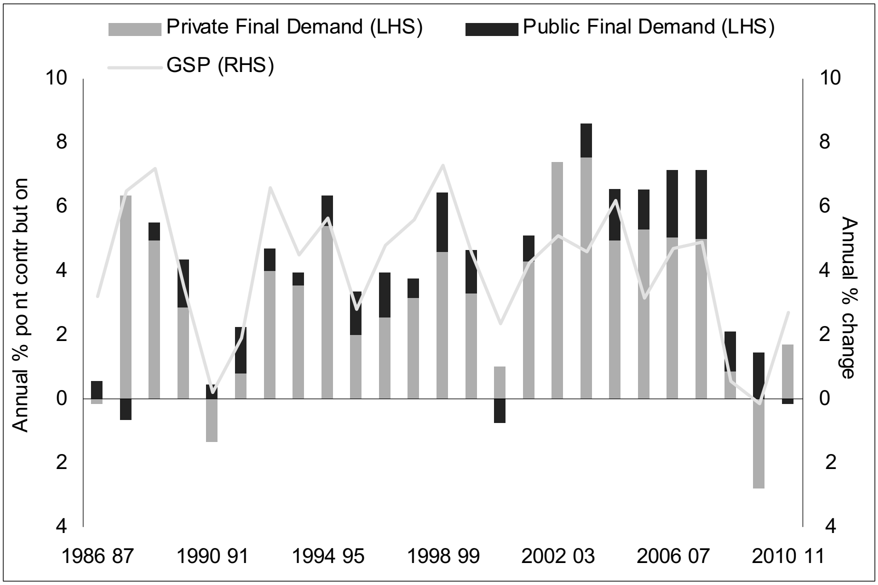
Investment is expected to peak in 2008-09, with a number of factors forecast to see businesses rein in expansion plans in 2009-10. A dramatic rise in risk aversion by both Australian and overseas lenders has limited access to funding for new projects, particularly in commercial property, while rising vacancy rates have also reduced the need for new office space. The global economic recession and decline in commodity prices has also led to the postponement or cancellation of a number of resource projects. As a result, business investment is forecast to decline 17% in 2009-10, with machinery and equipment investment anticipated to fall 16½% and other buildings and structures investment to decline 17¾%.

In line with previous recessions, business investment is forecast to continue to unwind in 2010-11, declining a further 8¼%. It is expected that the additional productive capacity created during the sustained investment boom since 2001 will take time to be absorbed, given the modest economic recovery expected globally and domestically in 2010-11.

Public final demand

Playing a crucial role in supporting economic activity, public final demand is estimated to grow 5% in 2008-09 and forecast to rise 5¾% in 2009-10, helping to offset the decline in private demand anticipated in 2009-10. As a result, growth in public investment is forecast to contribute one percentage point to economic growth in 2009-10. This reflects the State's own significant capital program as well as infrastructure initiatives in partnership with the Australian Government.

Chart 2.8
Public and Private Demand Growth, Queensland[1,2]



Note:
1. Public final demand comprises public investment plus public consumption.
2. CVM, 2006 07 reference year. Adjusted for second hand asset sales between the public and private sectors. 2008 09 is an estimated actual, 2009 10 and 2010 11 are forecasts.

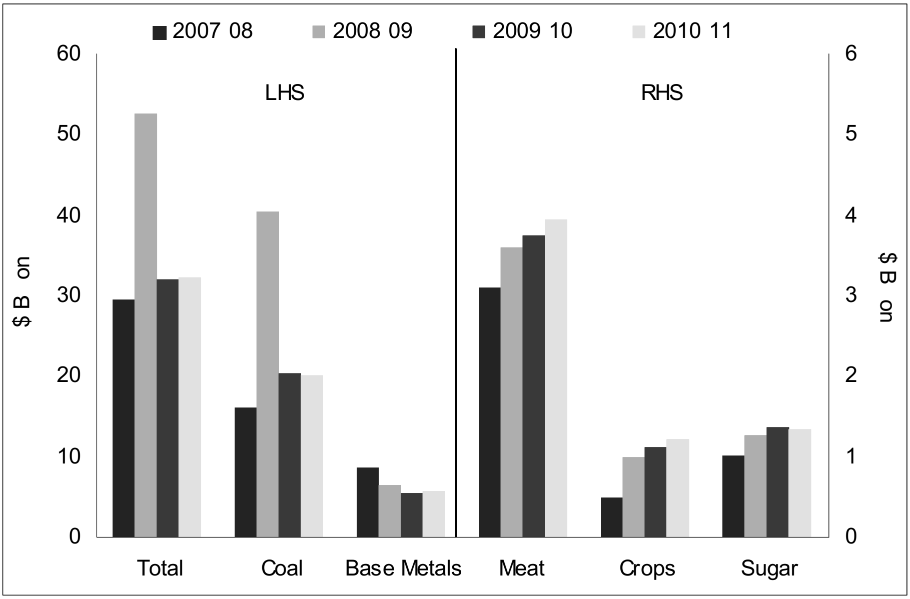
Source: Queensland Treasury.

Net exports

Despite significant improvements to production and transport capacity in recent years, the volume of exports is forecast to contract by 2% in 2008-09 and 2¼% in 2009-10, largely reflecting recessions across Queensland's major trading partners. In particular, sharp reductions in steel production in Japan, Korea, Taiwan and India have lowered hard coking coal exports since late 2008, while a scaling back in global industrial production has caused base metal exports to fall in the second half of 2008-09. These trends are forecast to continue in 2009-10.

Export incomes are also expected to unwind next financial year. Commodity earnings in A$ terms are expected to rise by more than $20 billion in 2008-09, reflecting a tripling and doubling in US$ hard coking and thermal coal export prices for Japanese Financial Year 2008-09 (JFY, April 2008 - March 2009), as well as a depreciation of the A$ between July and November 2008. However, coal contract prices for JFY 2009-10 have partly unwound last year's gains, having been negotiated 57% and 44% lower for hard coking and thermal coal respectively. Base metals are also trading at prices well below peak levels, which, along with funding difficulties associated with the global financial crisis, has exacerbated production cuts by some of Queensland's base metal producers. As a result, commodity export earnings are expected to decline in 2009-10, but remain higher than their level in 2007-08 (see Chart 2.9).

Chart 2.9
Overseas commodity exports, Queensland



Note:
1. 2008 09 is an estimated actual, 2009 10 and 2010 11 are forecasts.
Source: ABS unpublished trade data and Queensland Treasury.

Partly offsetting lower mining exports, improved growing conditions will support a recovery in the rural sector. Despite the impact of substantial flooding in the north of the State in early 2009, beef exports are forecast to rise, reflecting above-average rainfall in non-flood affected beef producing regions, as well as strong demand from the US for lower-grade manufacturing beef. Improved water storages are forecast to boost exports of cotton and other crops over the period to 2009-10.

Services exports will also be affected by conditions overseas. International enrolments for education have remained strong in 2008-09, reflecting some depreciation of the A$ and continuing strong demand from emerging markets (such as India and China). However, the economic downturn in other major student-source countries is expected to weigh on overseas education in 2009-10. Tourism exports are expected to fall in 2008-09, reflecting significant recessions in major overseas markets, such as Japan, the US, UK and South Korea, as well as concerns about swine influenza. Interstate tourism exports are also likely to be adversely affected by the economic slowdown in Australia, as well as adverse events experienced in Queensland, including floods, cyclones and an oil spill. However, some recovery in interstate tourism from these transitory factors is expected in 2009-10, supported by a lower A$ relative to its recent peak and cheaper fuel prices, which have made interstate holidays more cost effective relative to overseas travel for Australians.

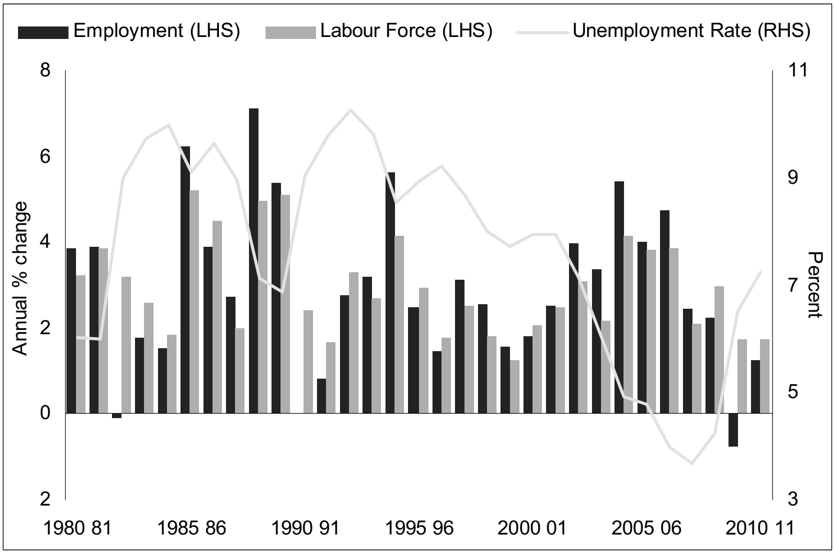
Queensland's total imports are expected to fall by 1% and 3¼% in 2008-09 and 2009-10 respectively. Goods imports are expected to fall, as slower growth in consumer spending and a sharp decline in business investment in 2009-10 lowers demand for imported consumer and capital goods. Overseas tourism imports are also expected to fall, as Queenslanders substitute international with domestic tourism or postpone holiday plans.

Overall, net exports are expected to detract ¼ percentage point from growth in 2008-09, with exports forecast to fall by a greater amount than imports. In 2009-10, imports are expected to decline at a faster rate than exports, resulting in net exports contributing ¾ percentage point to growth, the first contribution since 2000-01. With the global economy expected to gradually recover over the course of 2010-11, Queensland's exports are forecast to rise by 3% and exceed imports growth of 1% that year. As a result, net exports are forecast to contribute a further ¾ percentage point to growth in 2010-11.

Labour Market

A weakening in domestic economic growth, combined with a sharp reduction in business confidence, has seen demand for labour weaken in 2008-09. However, previous difficulties in finding and retaining skilled workers had seen many employers reluctant to reduce staff levels in the first half of the financial year, and instead reduce hours worked. As a result, year-average employment growth is estimated to only moderate slightly, to 2¼% in 2008-09, representing an increase in employment of almost 50,000 persons. The labour force participation rate in Queensland is estimated to increase marginally in 2008-09, to an historic high of 67½%, driven in particular by greater mature age workforce participation.

Chart 2.10
Employment growth, labour force growth and unemployment rate, Queensland[1]



Note:
1. Year average, 2008 09 is an estimated actual, 2009 10 and 2010 11 are forecasts.
Sources: ABS 6202.0 and Queensland Treasury.

Rising participation and ongoing strong growth in the civilian population has seen labour force growth exceed jobs growth in 2008-09. Consequently, the unemployment rate is estimated to rise to 4¼% in 2008-09, the first year-average increase in eight years.

Due to a contraction in economic activity, the level of employment is expected to fall by ¾%, or 16,000 persons, in 2009-10. Employment is expected to be most affected in the retail and construction sectors, in line with a more cautious household sector and a fall in business and dwelling investment next year. Mining is also expected to experience a decline in employment, after doubling over the previous five years due to the resources boom.

The labour force participation rate is forecast to fall to 67¼% in 2009-10, as poor job prospects see some unemployed persons leave the labour force and potential entrants remain outside of it. However, this fall in participation is likely to be less marked than in previous downturns, reflecting some postponement of retirement by mature aged workers, who have both a structurally higher participation rate than preceding generations and an incentive to rebuild savings following recent falls in asset prices. Ongoing civilian population growth will see a further rise in the labour force, despite a lower participation rate. This, combined with a fall in employment, is forecast to increase the unemployment rate to 6½% in 2009-10.

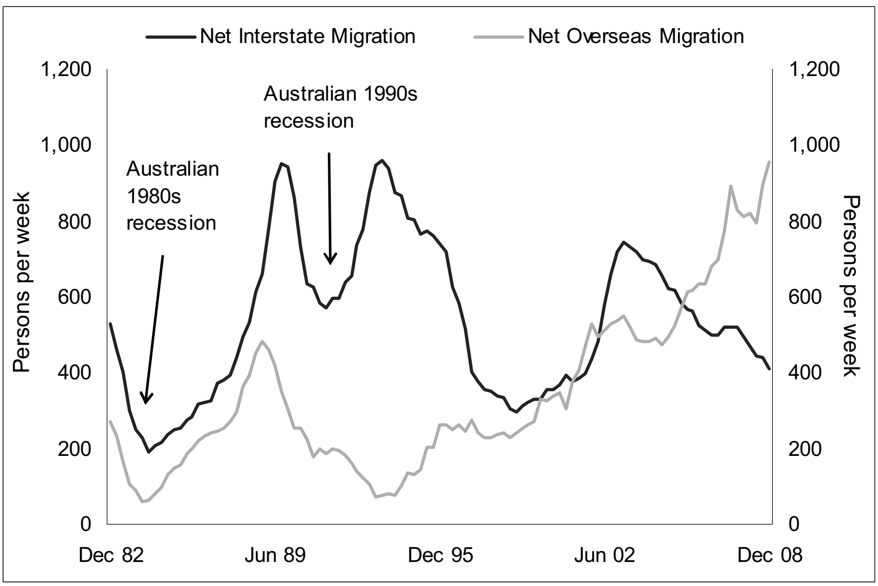
Employment is forecast to recover in 2010-11, albeit to a below-average rate of 1¼%, or 26,000 persons, reflecting the lagged impact of the subdued economic activity in 2009-10 and only a modest recovery in 2010-11. With labour force growth forecast to again exceed jobs growth, the year-average unemployment rate is anticipated to peak at 7¼% in that year, the highest year-average rate since 2001-02.

Population

Following growth of 2.4% to 2.5% in each of the last six years, Queensland's population growth is expected to remain at 2½% in 2008-09, before easing to 2¼% in 2009-10 and 2% in 2010-11. However, this still translates into an increase of more than one quarter of a million persons, or over 1,800 persons per week, in these three years. Reflecting ongoing higher net interstate migration than any other State, Queensland's population growth is expected to remain above the national rate.

Some slowing in net interstate migration is expected, contributing to an expected easing in population growth. Net inflows have eased since 2003, as relatively stronger growth in Brisbane house prices narrowed the house price gap with southern states (see Chart 2.11). Following the pattern of previous periods of weak national growth, Australian interstate flows, including those to Queensland, are forecast to ease further in 2009-10. While low unemployment and expansions in the national quota have seen overseas migration become the main driver of Queensland population growth, a reversal in these factors should also moderate overseas inflows over the forecast period.

Chart 2.11
Net migration, Queensland



Source: ABS 3101.0.

Wages

Growth in the Wage Price Index in Queensland is estimated ease from 4¼% in 2008-09 to 3½% and 3¼% in 2009-10 and 2010-11 respectively, in line with a softening in labour market conditions. However, fiscal stimulus payments, as well as cuts in both interest rates and income taxes, will boost average real disposable incomes over 2008-09 and 2009-10.

Inflation

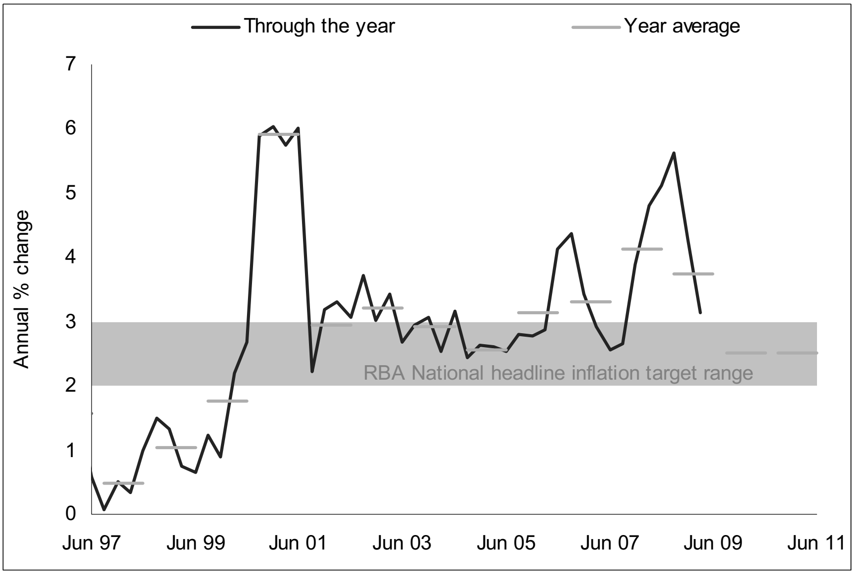
Inflation (as measured by Brisbane's Consumer Price Index (CPI)) peaked at 5.6% in through-the-year terms in September quarter 2008, reflecting the lagged effects of rising oil prices, buoyant global and domestic economic growth and domestic capacity constraints throughout 2007-08. However, with all of these factors unwinding in 2008-09, year-average inflation is estimated to ease to 3¾% in 2008-09, and forecast to moderate further to 2½% in 2009-10 (see Chart 2.12).

The housing sector remained a key contributor to inflation in 2008-09. Weak construction activity combined with fast population growth has lowered rental vacancy rates and underpinned strong rental price growth. Adverse weather conditions across the country in late 2008, including flooding, cyclones and bushfires, also drove substantial, albeit transitory, increases in food prices during the year.

With a further fall in dwelling investment expected in 2009-10, rental prices are forecast to continue to grow and contribute further to inflation next year. However, several factors are expected to ease inflation in 2009-10, including discounting of clothing and footwear as well as tourism services, and a modest improvement in wholesale credit markets. Price growth for imported goods is also expected to be subdued, reflecting a sharp deceleration in global price inflation and some appreciation of the A$.

The lagged impact of subdued economic activity and softer labour market conditions are forecast to see inflation remain modest, at 2½%, in 2010-11, below its average rate of 3.1% over the decade prior to the forecast period.

Chart 2.12
Headline inflation[1], Brisbane



Note:
1. Brisbane All Groups CPI. 2008 09 is an estimated actual, 2009 10 and 2010 11 are forecasts.
Sources: ABS 6401.0 and Queensland Treasury.

Risks and opportunities

Future developments in the global financial crisis and the worldwide economic recession are crucial to the outlook for the Queensland and national economies:

- A key risk is the development of a vicious cycle, whereby widespread corporate failures resulting from the global economic downturn further disrupt the wellbeing of the financial system. This would result in an additional tightening in credit conditions, again impacting the real economy and prolonging the global downturn.
- The extent of the geographical contagion may also not yet be fully revealed, with the impact of the downturn in industrialised economies on Asia possibly larger than currently anticipated. Based on IMF forecasts, GDP growth in 2009 for Queensland's trading partners in non-Japan Asia has been downgraded from 5% in October 2008 to -¾% in April 2009. Although newly industrialised and emerging Asian economies did not heavily engage in the financial activities that led to the crisis, they have been severely affected through extensive trade and financial linkages with the US, Japan and Europe. Developing economies heavily reliant on external financing are particularly vulnerable to a reversal in foreign capital flows. Indeed, the *United Nations Conference on Trade and Development* revealed foreign direct investment flows into this region declined in March quarter 2009.

- The extent of the downturn in emerging Asia will also influence commodity prices. While world prices of copper, lead and zinc have experienced a sizeable recovery so far in 2009, coal prices remain depressed as demand wanes. Nevertheless, China significantly increased metallurgical coal imports from Queensland in the first four months of 2009, cushioning a fall in imports from traditional buyers such as Japan, India, South Korea, Taiwan and the UK. Current economic forecasts are based on the expectation that some of this surge in Chinese demand proves short lived. However, if this trend were to continue for all of 2009, China could replace India as Queensland's second largest destination for metallurgical coal, and help support contract prices for JFY 2010-11.
- In an attempt to re-capitalise the financial system, governments have injected unprecedented amounts of liquidity into failing financial institutions, and have taken on a large amount of 'toxic' assets. While these efforts have so far tempered the financial crisis, the sustainability of these rescue programs and their long term consequences have been questioned. The sharp rise in government debt issuance may heighten sovereign risk, driving global interest rates higher in the long term.
- Aggressive monetary easing has seen policy interest rates fall to almost zero in major industrialised economies as a whole. In this near-zero interest rate environment, central banks have devised unconventional strategies aimed at further easing monetary policy. However, the effectiveness of these methods has yet to be tested, while possible unintended consequences need to be considered. Some commentators fear that this extremely loose monetary stance may lead to a surge in inflation as the global economy recovers, while others are concerned that increased liquidity may instigate asset price bubbles elsewhere in the financial system.

Economic growth prospects could also be further jeopardised by the spread of swine influenza to the Asian region in particular, which was particularly scarred by the SARS outbreak in 2003. This could in turn affect Queensland's overseas tourism exports in 2009-10.

Reflecting the relatively less aggressive monetary easing in Australia assumed over the forecast period, some appreciation in the A$ has been factored into economic forecasts for 2009-10 and 2010-11. However, the current trend suggests that the A$ may rise faster than assumed. Indeed, the value of the A$ averaged 76.25USc in May 2009, compared with 66.40USc in March. A larger than expected A$ appreciation will further erode export earnings and domestic incomes in 2009-10.

Domestically, a key element of the outlook for the national and Queensland economy is the proposed infrastructure initiatives announced in the 2009-10 State and Australian Budgets, with their timely implementation crucial to supporting economic activity.