

CHAPTER 2 – ECONOMIC CONDITIONS AND OUTLOOK

- The global economic environment has continued to deteriorate. Global economic activity is forecast to decline in 2009, which would be the weakest outcome in the post-war period.
- In the face of the Global Financial Crisis, the economic outlook for Victoria has been revised down. Victoria's gross state product is expected to grow by 0.5 per cent in 2008-09 and 0.25 per cent in 2009-10, followed by a gradual recovery to trend rates of growth by the end of the estimates period.
- In 2009-10, the key area of weakness in Victoria will be private business investment, where the pipeline of work has diminished due to low confidence and tighter credit conditions. This will be partly offset by public investment, as the Victorian and Commonwealth Governments boost infrastructure investment.
- Consumption is expected to be subdued. Although household disposable incomes have been boosted by lower interest rates and petrol prices, households are increasing saving in response to reduced household wealth. Dwelling investment is forecast to grow, in part due to significant stimulus measures by government.
- Labour market conditions have also eased. Employment growth has stalled, and the unemployment rate has steadily risen from its previously historical lows. Victorian employment is forecast to decline by 1.0 per cent, and the unemployment rate is expected to average 7.0 per cent in 2009-10.
- Wage growth and underlying consumer price inflation are forecast to ease, in response to lower commodity prices and easing demand pressures.
- Population growth has been revised up, reflecting the recent unexpected strength in both births and net overseas migration.
- The economic outlook is sensitive to a number of risks. The key downside risks include a further deterioration in the global outlook, ongoing financial market volatility, entrenched low confidence, and higher-than-envisaged unemployment. The key upside risk to growth relates to the impact of stimulus on the economy.
- While the near-term economic outlook is weak and there are still a number of downside risks to growth, the longer-term prospects for the Australian and Victorian economies remain positive.

VICTORIAN ECONOMIC PROJECTIONS

The economic outlook has deteriorated further since the *2008-09 Budget Update*. Driven by a severe financial crisis and a wide-spread loss of confidence, the world economy is experiencing a synchronised recession. The Australian and Victorian economies are not immune to these developments. Economic activity has slowed in response to lower external demand, falling asset prices, tighter credit conditions and lower business and consumer confidence.

The Victorian economic projections have been revised to reflect this weaker economic environment. Victorian gross state product (GSP) is expected to grow by 0.5 per cent in 2008-09 and by 0.25 per cent in 2009-10. The weakest growth is expected to occur in the first half of 2009. Growth is then forecast to recover gradually, rising to 2.25 per cent in 2010-11, and returning towards trend rates of growth by the end of the forward estimates period. The recovery is forecast to be relatively gradual, as households, firms, governments and financial institutions recover from large declines in asset prices. The slower GSP growth is accompanied by lower forecasts for employment growth, and a higher projected unemployment rate. Reflecting the weaker economic activity, wage growth and inflation are expected to moderate faster than previously envisaged. Near-term population projections have been revised up, due to the recent unexpected strength of population growth, from both births and net overseas migration.

The main contributor to Victoria's weaker economic growth in 2009-10 will be private business investment, where the impacts of low confidence and credit constraints are most pervasive, and where the private sector pipeline of activity is diminishing quickly. This will be partly offset by a stronger contribution from public investment, as the Victorian and Commonwealth Governments boost infrastructure investment in response to the downturn. Household consumption is expected to be subdued, as households increase their saving in response to reduced household wealth. On the other hand, dwelling investment is forecast to post solid growth, driven by low interest rates, the *First Home Owner Boost* and pent-up demand.

The overall outlook is marked by considerable uncertainty, and the Victorian economic projections are sensitive to a number of risks. The key downside risks include a further deterioration in the global outlook, ongoing global financial market volatility, entrenched low confidence, and higher-than-envisaged unemployment. The key upside risk to growth relates to the impact of stimulus – fiscal and monetary – on the economy.

The economic projections used in the *2009-10 Budget* are set out in Table 2.1. These assume constant exchange rates, and that oil prices follow the path implied by oil futures contracts. The remainder of this chapter contains an overview of the international, national and Victorian economic conditions and outlook, and a discussion of key issues and risks to the Victorian economic outlook.

Table 2.1 Victorian economic projections^(a)

	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
	Actual	Forecast	Forecast	Forecast	Forecast	Forecast
Real gross state product	3.2	0.50	0.25	2.25	3.00	3.00
Employment	2.7	0.25	-1.00	0.50	1.50	1.50
Unemployment rate ^(b)	4.5	5.00	7.00	7.75	7.75	7.75
Consumer price index	3.6	3.25	2.00	2.25	2.50	2.50
Wage price index ^(c)	3.8	4.25	3.75	3.25	3.50	3.50
Population ^(d)	1.8	1.80	1.60	1.50	1.40	1.40

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

Notes:

- (a) Year-average per cent change on previous year unless otherwise indicated. 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.

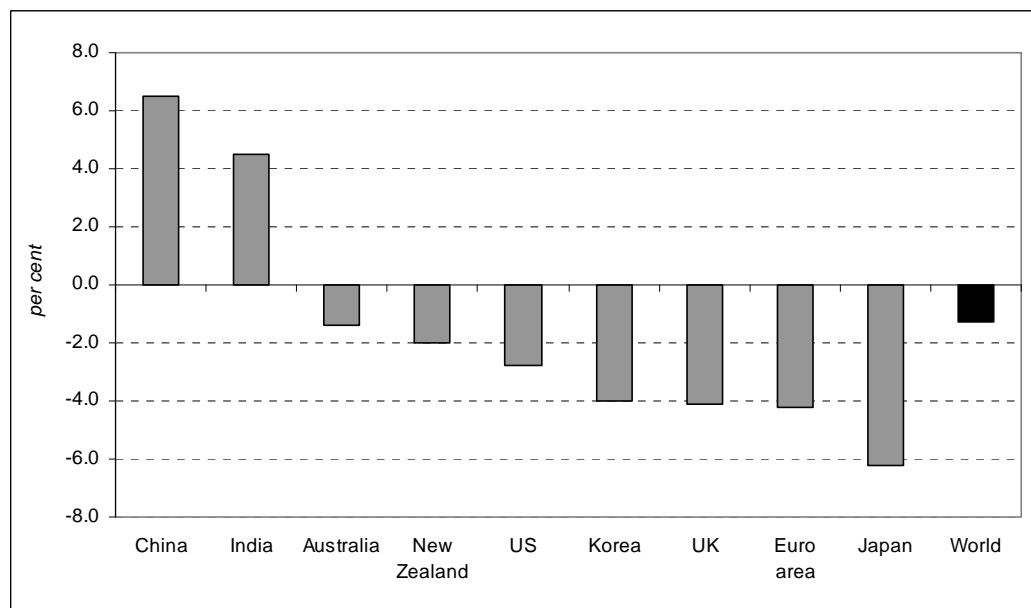
ECONOMIC OVERVIEW

International economic conditions and outlook

The weakening of international economic conditions has been considerably worse than expected at the time of the *2008-09 Budget Update*. Global production and trade contracted very sharply in the last quarter of 2008, and there have been large downward revisions to forecast world economic growth. The International Monetary Fund's (IMF) April *World Economic Outlook* has forecast that the world economy will contract by 1.3 per cent in 2009 (Chart 2.1). This would be the weakest outcome in over sixty years. The advanced economies are expected to contract by 3.8 per cent in 2009. Emerging and developing economies are also being significantly impacted, and are expected to expand by 1.6 per cent in 2009. The decline in global economic activity is reflected in the outlook for world trade volumes, which are forecast by the IMF to decline by 11.0 per cent in 2009. The IMF projects a gradual recovery over the course of 2010, with growth of 1.9 per cent.

The global financial system remains under significant stress. There is a high level of investor uncertainty about bank solvency, lending standards have been tightened, credit spreads remain elevated and markets for securitised assets mostly remain frozen in the absence of government support. The problems in the financial sector persist despite extensive public sector support, including liquidity provisions, capital injections, asset purchases, bank deposit insurance and wholesale funding guarantees. Difficulties in the financial sector are having a negative impact on the real economy, which in turn is worsening the problems in the financial sector. A sustained recovery in the global economy will depend on the stabilisation of financial conditions.

Chart 2.1: Economic growth forecasts for major trading partners in 2009^(a)



Source: International Monetary Fund

Note:

(a) Real GDP, annual per cent change. World GDP calculated using purchasing power parity weights.

In the United States, the problems in the financial sector and weakness in the housing market continue to weigh on the economy. The drop in asset prices has significantly reduced household wealth, leading to sharp reductions in consumer spending. Business investment has been reduced and is being impacted by the adverse financial conditions. Exports are no longer a driver of economic growth as the economies of major trading partners weaken. As a result, the labour market is deteriorating rapidly with the loss of around five million jobs since December 2007, and the unemployment rate rising to 8.5 per cent in March. However, there are signs that the pace of decline in economic activity is beginning to slow, and significant monetary and fiscal stimulus should support economic growth in the months ahead. Following a forecast fall of 2.8 per cent in 2009, US gross domestic product (GDP) is forecast to be flat in 2010.

The major European economies are also experiencing a severe downturn. This reflects a sharp decline in export demand, which has led to low business confidence and investment. Adverse financial conditions are also weighing on a number of European economies, with the United Kingdom particularly affected by the strains in its large financial sector. In some European countries, such as Spain, Ireland and the United Kingdom, the economies have been severely impacted by housing market corrections. The Eurozone economy is expected to experience a more severe slowdown than the United States due to its larger export sector, and the more moderate response of monetary and fiscal policy. GDP is forecast to decline by 4.2 per cent in the Eurozone and by 4.1 per cent in the United Kingdom in 2009.

The Japanese economy has been one of the hardest hit by the global downturn. A decline in export demand, partly due to the marked appreciation of the yen, has had flow-on effects to business investment and consumer spending, and has led to a slump in the Japanese economy. Industrial production has declined by over 30 per cent in the past six months, to be at its lowest level since the early 1980s. The outlook for the Japanese economy is very weak, with poor prospects for a near-term pick-up in export growth, which has been a significant driver of economic growth in Japan in recent years. Japanese GDP is expected to decline by 6.2 per cent in 2009 and then rise by 0.5 per cent in 2010.

China's economic growth is decelerating but is holding up better than in most other countries. Economic growth has slowed due to a decline in exports, as well as weakening export-related investment and real estate investment. Consumer spending growth is decelerating but remains at a relatively high level. China's financial sector has not been significantly affected by the broader financial crisis, and the Chinese economy is not significantly reliant on external financing. In addition, the Chinese Government's 4 trillion yuan fiscal stimulus is expected to provide significant support to economic growth in the coming months, and there are early indications that the package is already having a positive effect, especially in terms of infrastructure investment. The IMF forecasts the Chinese economy to grow by 6.5 per cent in 2009, which is a sharp fall from its 13 per cent growth in 2007, and slightly below the government's target of 8 per cent growth.

Elsewhere in Asia, the newly industrialised Asian economies – Hong Kong, South Korea, Singapore and Taiwan – have been hit hard by the Global Financial Crisis, with trade and production contracting. For these economies, GDP is expected to decline by 5.6 per cent in 2009. The New Zealand economy is also slowing, with weakness evident in household consumption, business investment and exports, and the economy weighed down by a weak housing market. The IMF forecasts New Zealand's economy to contract by 2.0 per cent in 2009.

The Global Financial Crisis has resulted in commodity prices declining significantly across all commodity sectors, marking the end of the commodity price boom that began in 2003. Weakening demand has seen crude oil prices falling by around 65 per cent from the peak in July 2008, to be around US\$50 per barrel. Lower commodity prices and increasing spare capacity are placing significant downward pressure on consumer price inflation in many countries. The IMF considers deflation to be a significant risk to the outlook, particularly for advanced economies including the United States and Japan.

The outlook for the global economy is highly uncertain. The projection of a modest recovery in 2010 is conditional on effective policy responses to stabilise financial conditions and improve confidence. Global equity markets have shown signs of recovery since early March suggesting that investors have become less bearish about the outlook.

Australian economic conditions and outlook

The Australian economy has been significantly affected by the global financial and economic turmoil. This has led to tighter credit conditions, large declines in Australian equity prices, lower global commodity prices, weaker economic growth of major trading partners, and negative impacts on the confidence of Australian households, businesses, and investors. These adverse effects are now being seen in the Australian real economy. Australia's GDP contracted by 0.5 per cent in the December quarter, the first such quarterly decline since December 2000. Over the course of 2008, GDP expanded by only 0.3 per cent, with all states experiencing a slowing in growth.

While Australia's financial system has felt the effects of the Global Financial Crisis, it is better placed to withstand these effects than the financial systems of many other countries. Australia's banks remain profitable and are soundly capitalised, supported by a strong regulatory and prudential system, and with low exposure to the high-risk securities that have led to large losses for many overseas financial institutions. The Commonwealth Government has also taken steps to support the Australian financial system by providing guarantees of deposits and wholesale funding of authorised deposit taking institutions in Australia.

One of the key drivers of Australia's growth in the recent past has been the terms of trade boom, which was the outcome of strong global demand for commodity resources. This boom significantly boosted domestic incomes and activity in resource-rich states. The outlook for Australia's key exports and the terms of trade has changed significantly with the onset of the Global Financial Crisis. Contract prices of thermal and coking coal have fallen by around 44 per cent and 59 per cent respectively, and iron ore contract prices are likely to fall by around 30 to 40 per cent. Such falls in the terms of trade will reduce gross domestic income, and possibly lead to a narrowing of some of the growth differentials that had emerged between the resource and non-resource states. It has also weakened the Australian dollar, which depreciated significantly over the second half of 2008, although it has appreciated in more recent weeks.

The national labour market performed strongly throughout the first half of 2008, and the unemployment rate reached a generational low of 3.9 per cent in February 2008. However, the labour market has weakened since mid 2008. Employment has been broadly unchanged, as a fall in full-time employment has been offset by higher part-time employment. The participation rate remains near record highs, but the national unemployment rate has increased sharply, to 5.7 per cent in March. Despite the easing in labour market conditions, national wage growth remains robust, at 4.3 per cent over the year to December.

Headline consumer price inflation was high throughout 2008, with pressure stemming from high petrol prices, rents, food and finance and insurance costs. Falling petrol prices and lower finance and insurance costs eased the pressure on inflation in the December and March quarters. Despite this, underlying price pressures remain high, with national underlying inflation at 4.2 per cent over the year to March.

While inflationary pressures led to a more restrictive monetary policy setting throughout 2007-08, the speed and severity of the global economic slowdown in 2008-09 led to the Reserve Bank of Australia (RBA) embarking on an aggressive easing of monetary policy. The official cash rate has been reduced by 4.25 percentage points since September 2008, to 3 per cent.

The Commonwealth Government has also acted to support economic growth by announcing two discretionary fiscal stimulus packages. The \$10.4 billion *Economic Security Strategy*, announced in October 2008, consisted of \$8.7 billion in payments to pensioners, carers, and low and middle income families, \$1.5 billion to help first home buyers purchase a home, as well as \$0.2 billion for new training places. The \$42 billion *Nation Building – Economic Stimulus Plan*, announced in February 2009, includes \$28.8 billion in direct public investment in schools, housing, energy efficiency, community infrastructure, roads and support to small businesses, mainly delivered in 2009-10 and 2010-11. It is also delivering \$12.2 billion in payments to low and middle income Australians, mainly in late 2008-09.

Overall, the Australian economy is relatively well placed, given strong population growth, greater policy flexibility, a strong regulatory and prudential system, and a sound banking system. The IMF expects Australia to fare better than most other advanced economies in the current global downturn. The IMF forecasts Australian GDP to contract by 1.4 per cent in 2009 and to rise by 0.6 per cent in 2010. The IMF forecasts are at the lower end of the range of Consensus forecasts for Australia.

Victorian economic conditions and outlook

Like Australia, the Victorian economy faces a much more challenging economic environment than it has for many years, and economic conditions in Victoria are likely to mirror national trends. While there have been a number of stimulatory policy measures aimed at tempering the impacts of the Global Financial Crisis, the economic outlook has deteriorated and the economic projections have been revised down significantly since the *2008-09 Budget Update*.

Victoria's GSP is expected to grow by 0.5 per cent in 2008-09 and 0.25 per cent in 2009-10, reflecting significant falls in business investment and weak household consumption, offset by growth in dwelling investment and public investment. Growth is forecast to recover gradually, rising to 2.25 per cent in 2010-11 and to trend rates of growth by the end of the forecast period, as improving global economic conditions drive a recovery in business investment and consumption.

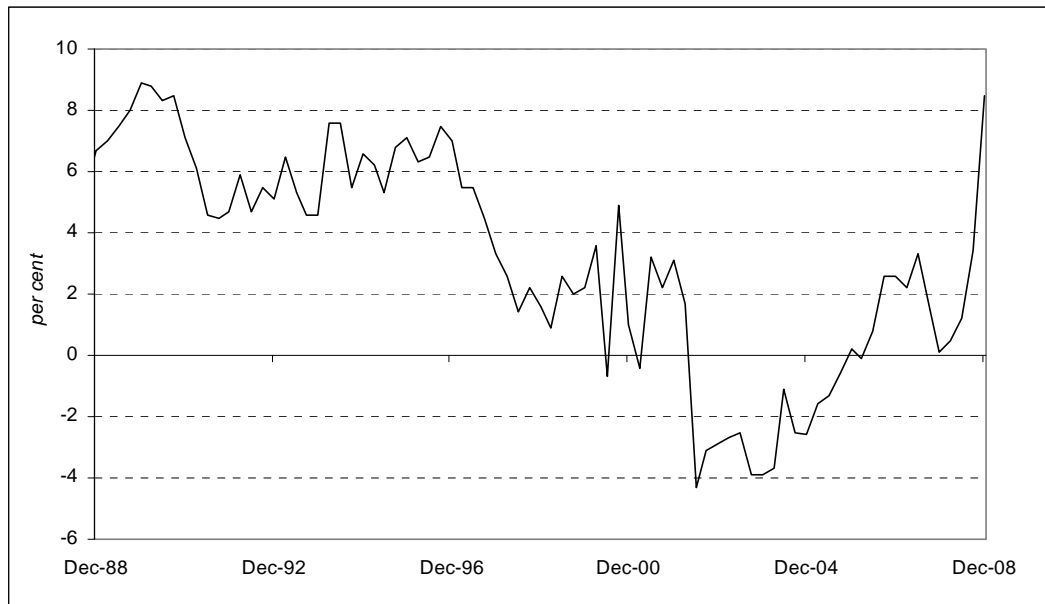
While the near-term economic outlook is weak, the longer-term prospects for the Victorian economy remain positive. Victoria has a diversified economy with sound fundamentals and a competitive business environment. It is benefiting from strong population growth and the Government's investment in infrastructure and human capital.

Consumer spending

Household consumption has weakened significantly, to be 0.5 per cent lower over the year to the December quarter 2008. Household wealth has fallen, reflecting a decline of around 50 per cent in the Australian sharemarket since its peak in late 2007 and a softening in Melbourne house prices over the past year. As a consequence, households have increased their saving to rebuild assets and reduce household debt (see Chart 2.2). More recent spending indicators, such as retail turnover, suggest that consumption continued to decline in the early part of 2009.

The slowing in consumption has come despite significant boosts to household disposable incomes from significantly lower interest rates, fiscal stimulus measures and lower petrol prices. The anticipated deterioration in the labour market is expected to further constrain consumer spending, due to the adverse effect on real income growth from weaker employment and wage growth. Consumer confidence is also at low levels, although it appears to have stabilised.

Chart 2.2: Australian household saving ratio

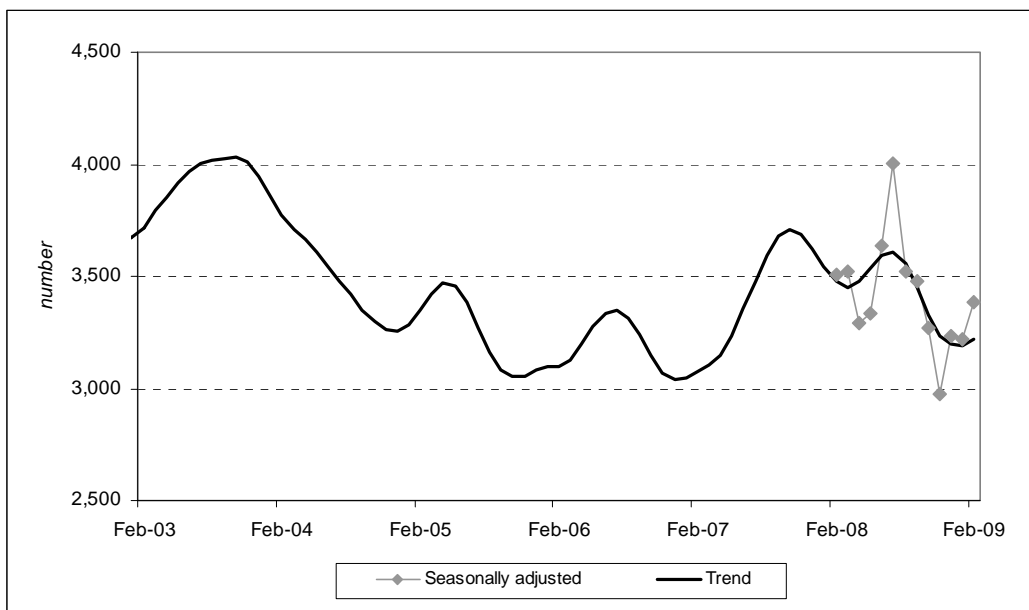


Source: Australian Bureau of Statistics

Dwelling investment

Victorian dwelling investment has exhibited solid growth in recent quarters, outpacing national growth. The near-term outlook for dwelling investment is weaker, reflecting the fall in dwelling approvals and housing finance in the second half of 2008 (Chart 2.3). However, a recovery is expected to occur by the second half of 2009 as a result of the effects of interest rate cuts and the stimulatory effect of the *First Home Owner Boost*. There are early signs of a rebound in the number of housing finance commitments and in first home buyer demand. Dwelling finance obtained by first home buyers as a percentage of total dwelling finance (excluding re-financing) increased to a record of almost 40 per cent in January. Dwelling approvals have also increased, to be up 13.8 per cent over the three months to February. Victoria has accounted for more than 30 per cent of national dwelling approvals in recent months and there is anecdotal evidence of cautious optimism in the Victorian housing industry.

Chart 2.3: Victorian dwelling approvals



Source: Australian Bureau of Statistics

Business investment

Private business investment in Victoria is easing, following particularly strong growth in recent years. Business conditions have been severely affected by the deterioration in the world economy. Similar to national trends, business confidence in Victoria has fallen to near 20 year lows, while a lack of available credit as well as more stringent lending criteria has led to several project delays and cancellations. The pass-through of recent cuts in official interest rates to business lending has also been much less than for household mortgages. In the face of low confidence and tighter credit conditions, the private sector pipeline of work yet to be done has diminished, with the value of Victorian non-residential building approvals declining by around 30 per cent over the past six months. These factors point to significantly lower capital expenditure over the next 12 months, across both machinery and equipment investment and non-residential construction.

International trade

Victorian services exports performed strongly in 2007-08, rising by over 11 per cent in volume terms, the second fastest growth of any state. The value of Victoria's education-related services exports has grown particularly strongly, more than doubling over the past five years. Victoria's services imports also grew strongly in 2007-08, supported by a strong Australian dollar and the strength of domestic demand.

Victorian merchandise exports increased moderately in 2008, largely driven by non-farm exports. Exports have been hampered by weaker trading partner growth, while agricultural exports continue to be held back by poor seasonal conditions. Victorian merchandise imports have declined recently as a result of weakening domestic demand.

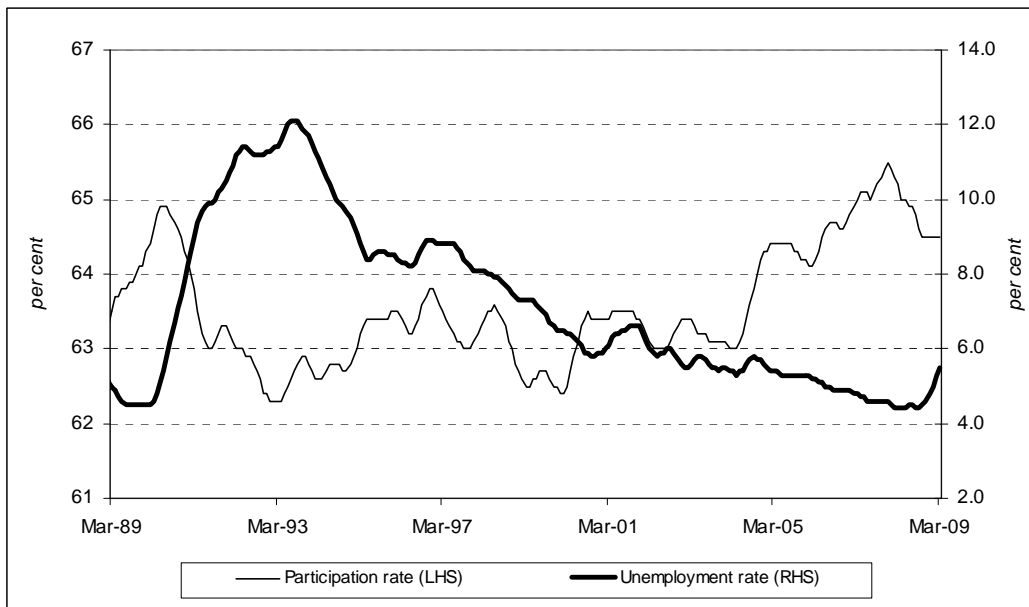
Looking ahead, near-term export growth in Victoria is expected to be adversely affected by the rapid slowdown in the economies of key trading partners such as Japan and Korea. It is expected that significantly weaker global demand will more than offset gains in the competitiveness of Victorian exporters from the lower Australian dollar. Victorian imports are likely to continue to moderate as a result of weakened business confidence and weakness in the manufacturing sector which has been the main driver of the imports of machinery and equipment. Overall, net trade is expected to make a small but positive contribution to Victoria's GSP growth in 2008-09 and 2009-10.

Labour market

The Victorian labour market has softened over the past year. Employment is broadly unchanged over the year to March. This reflects a fall in full-time employment offset by a rise in part-time employment. The participation rate has declined over the past year but remains at a relatively high level. Victoria's unemployment rate has increased by 1.5 percentage points to 5.7 per cent, to be in line with the Australian average (see Chart 2.4).

Employment growth is expected to deteriorate further in the year ahead. Employment conditions reported in recent business surveys suggest a further rise in the unemployment rate as businesses respond to weaker economic activity. Other leading indicators are similarly weak; the ANZ measure of job advertisements has fallen by more than 50 per cent in the past year. Looking ahead, employment is forecast to decline by 1.0 per cent and the unemployment rate is forecast to average 7.0 per cent in 2009-10, rising to 7.75 per cent in 2010-11.

Chart 2.4: Victorian participation and unemployment rates^(a)



Source: Australian Bureau of Statistics

Note:

(a) Trend data.

Wages

Victorian wage growth in recent years has been relatively robust. The latest data from the December quarter show the Victorian wage price index recorded growth of 4.3 per cent over the year, above the average rate over the 11-year history of the series. Wage growth has been high across both the public and private sectors. The ongoing strength over the past few years reflected the tightness of the labour market, characterised by a historically low unemployment rate, higher inflationary expectations and skill shortages.

However, consistent with slowing economic activity, wage growth is set to ease, to 3.75 per cent in 2009-10 and 3.25 per cent in 2010-11. While this is yet to show in official statistics, current business surveys signal an initial easing in expected labour costs and less difficulty in finding labour. Consultation with business suggests this trend will continue into 2009. There is also evidence of employers and workers adopting wage moderation, in order to limit job losses arising from the downturn. This is consistent with the Victorian Government's new wages policy.

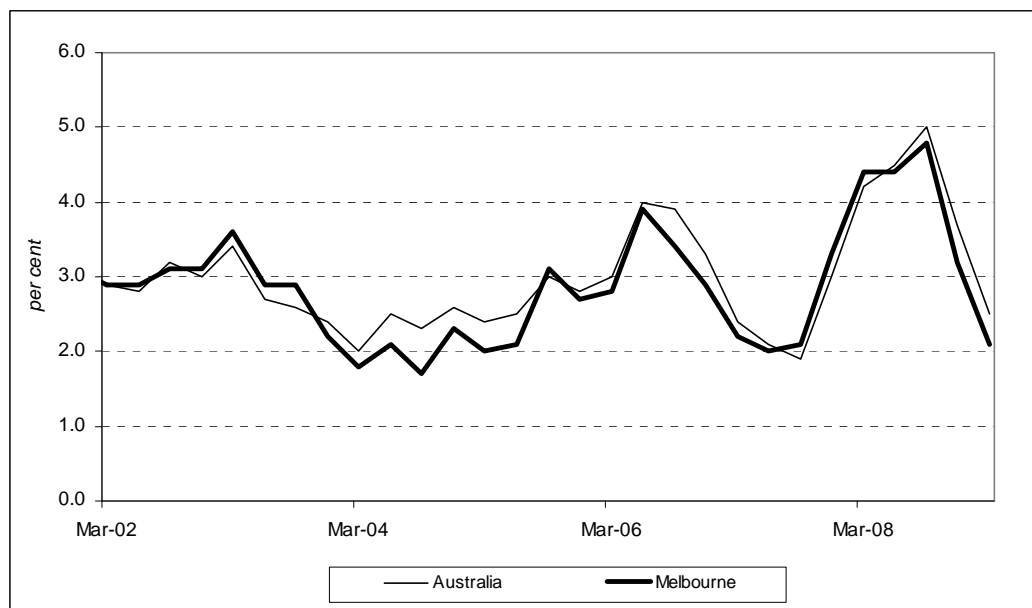
Inflation

Headline inflationary pressures have moderated significantly since the *2008-09 Budget Update*. Annual inflation was 2.5 per cent nationally and 2.1 per cent in Melbourne over the year to March (see Chart 2.5). Inflation has eased mainly due to sharply lower fuel costs as well as lower costs of financial and insurance services. However, underlying inflation is still relatively high.

Price rises were relatively broad-based during 2008, with particularly strong increases in the costs of food, housing, financial and insurance services, and transportation. More broadly, this occurred during a period of rising world commodity prices, strong domestic demand and high rates of capacity utilisation. These forces have now reversed, and it is expected that this will result in weaker price growth. The weakness in domestic demand is expected to reduce the pricing power of producers and retailers, and also lead to more moderate increases in labour costs. This may be partially offset by upward pressure from housing and non-market prices.

Melbourne consumer price inflation is expected to ease from a relatively high rate of 3.25 per cent in 2008-09, to 2.0 per cent in 2009-10, before returning to trend at 2.50 per cent from 2011-12. Indicators of inflation expectations have eased significantly.

Chart 2.5: Consumer price inflation^(a)



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

Note:

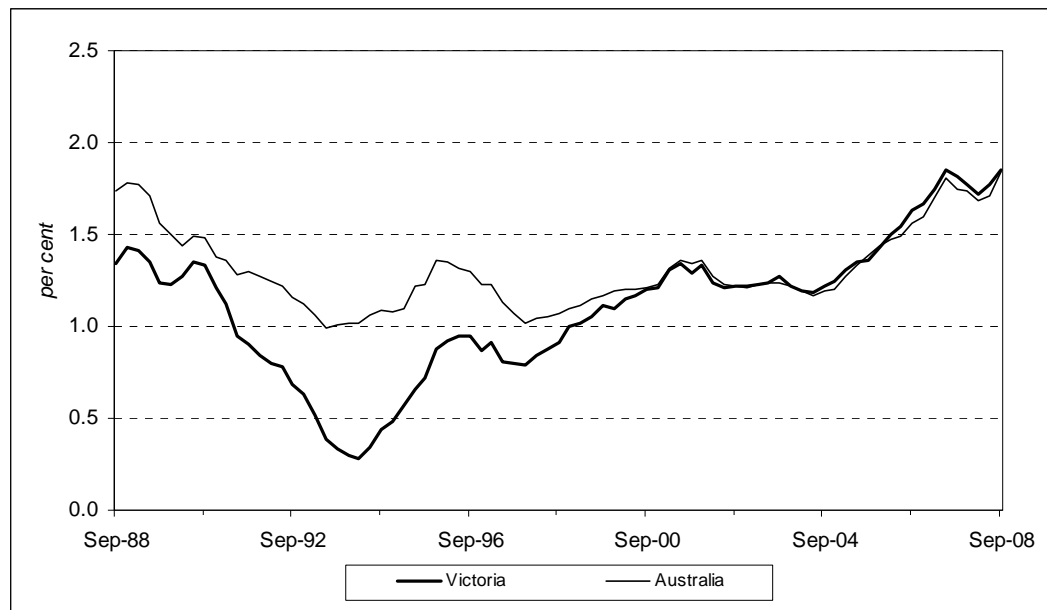
(a) Four-quarter ended percentage change.

Population

Victoria's population has grown by a very strong 1.8 per cent over the past year (see Chart 2.6). The increase has continued to be driven by net overseas migration, which is at a record high and accounted for more than 60 per cent of growth in the year to September 2008. Notably, several upwards revisions to net overseas migration numbers were applied following finalisation of migration statistics using matched passenger cards. The revisions amounted to 15 330 persons in 2006-07, an upward movement of over 30 per cent. There has also been an increase in the birth rate.

Near-term population growth has been revised up, and population growth is then forecast to ease gradually over the forecast period. This is based largely on expected declines in net overseas migration, which could moderate in response to less favourable labour market conditions and decreases in the Commonwealth Government's migration targets.

Chart 2.6: Growth of estimated resident population



Source: Australian Bureau of Statistics

Regional Victoria

The economy of regional Victoria is dealing with the challenges posed by the Global Financial Crisis, prolonged drought conditions and the recent devastating bushfires. While activity may be weak in the near-term, the medium and longer term prospects are positive.

In response to the weaker economic environment, employment in regional Victoria has eased, to be 1.9 per cent lower over the year to the March quarter. The unemployment rate in regional Victoria has risen to 6.0 per cent. According to Building Commission data, the value of regional building approvals remained at a high level of around \$4.1 billion in 2008. This level of activity has been underpinned by strong population growth in regional Victoria of 1.3 per cent in 2007-08 and a revised 1.4 per cent in 2006-07, the highest growth rate since 1990.

Poor weather conditions have resulted in the output of the Victorian agricultural sector being subdued in 2008-09. The latest Australian Bureau of Agricultural and Resource Economics estimate for Victorian winter crop production is 3.1 million tonnes in 2008-09, down 21 per cent on 2007-08, and below the five-year average. In the dairy sector, milk production has shown a modest increase of 1.8 per cent in the first eight months of 2008-09. Assuming a return to more normal seasonal conditions, an increase in the output of the agricultural sector is expected in 2009-10. A potential recovery may be constrained, however, by reduced irrigation water allocations. While rural commodity prices have declined in recent months, farmers remain cautiously optimistic

about the medium-term outlook for agricultural demand and prices, especially from the growing Asian region.

In February 2009, Victoria experienced its most devastating bushfires on record. There was significant loss of life and extensive loss of private property, including the partial or almost complete destruction of townships like Marysville. These bushfires have caused disruptions to economic activity in these regions, particularly primary production, forestry and tourism. However, economic activity is expected to recover. This will be supported by construction activity to rebuild and repair public infrastructure, buildings and dwellings, and additional tourism promotional activity.

RISKS TO THE OUTLOOK

The economic landscape has been very volatile in the past six-to-nine months, and as a result the economic projections are marked by a greater-than-usual degree of uncertainty. The key downside risks include continued deterioration in the global outlook, ongoing financial market volatility, entrenched low confidence, and higher-than-envisaged unemployment. The key upside risk to growth relates to the impact of stimulus, fiscal and monetary, on the economy.

The global economic outlook has deteriorated markedly in a very short space of time. The IMF's forecast of 2009 world GDP growth has been revised down from 3.0 per cent to -1.3 per cent in the past seven months. While there are some signs of stabilisation in the United States and China, most economic indicators remain weak. Hence there is the risk that there will be further downward revisions to forecast global growth, which would have negative implications for Victoria's growth outlook.

A key feature of the global economy has been weakness and volatility in financial markets. Equity markets fell by around 50 per cent from their late 2007 peaks, and credit spreads increased to historically high levels. These movements adversely affected wealth and confidence. Over the forecast period, the projections assume an improvement in credit conditions and gradual recovery in equity prices. While there have been some encouraging signs, there is a risk that financial markets remain very volatile, which could temper any economic recovery.

It could also prolong the weakness in consumer and business confidence, which has been at significantly below-average levels. An improvement in confidence is important to facilitate the economic recovery, whereas continued weakness in confidence could lead to further reductions in spending, investment and employment.

To date, the Australian household sector's financial position has been in relatively good shape. Disposable incomes have increased significantly due to lower interest rates and petrol prices, and stimulus payments from the Commonwealth Government, and a large part of this income gain has been devoted to households reducing their debt levels. However, with unemployment now rising, it is possible that there will be an increased prevalence of household financial stress. If the unemployment rate rises significantly more than expected, this would have negative implications for household spending, asset prices and the economic outlook generally.

There is a risk that the recovery in economic activity, domestically and abroad, could be much faster than expected. The cut-backs in global production towards the end of 2008 were severe, and there are few signs of excess inventory stocks. There are signs that some countries have started to rebuild inventories in some key commodities. There is also the risk that monetary and fiscal policy, which has been loosened significantly, could stimulate demand and activity by more than is anticipated.

While the near-term economic outlook is weak and there are still a number of downside risks to growth, the longer term prospects for the Australian and Victorian economies remain positive. Policy flexibility and a stable banking sector will mitigate the negative consequences of the Global Financial Crisis. Population growth is at an historically high level, which will continue to underpin spending and investment in the Victorian economy. The Victorian Government is investing heavily in infrastructure and human capital to meet the demands of a growing population and to support the productive capacity of the economy. This will leave the Victorian economy in a good position to take advantage of the eventual upturn in economic prospects.