PART 2: ECONOMIC OUTLOOK

OVERVIEW

International growth prospects have weakened since Budget and the risks to global financial stability from the European sovereign debt crisis have intensified, undermining confidence in the global recovery. These developments are being transmitted globally through financial markets, confidence and trade channels.

The deterioration in global conditions has contributed to a weaker outlook for the Australian economy, with forecast growth in real GDP and employment revised down since Budget. Still, the Australian economy is expected to grow at around its trend rate over the forecast horizon, underpinned by a record pipeline of resources investment and strong growth in commodity exports. However, conditions are expected to remain uneven, with the global weakness and uncertainty, the high Australian dollar and cautious household spending behaviour weighing heavily on some sectors.

Australia's real GDP growth is forecast to increase to 3¼ per cent in both 2011-12 and 2012-13, employment growth is forecast to be solid, the terms of trade are expected to remain at a high level, and inflation is expected to remain well contained. The unemployment rate is forecast to remain low, but to drift up a little over the next year, easing some of the capacity pressures foreshadowed in the 2011-12 Budget.

The weak and fragile economic position of the major advanced economies presents considerable risks to the domestic economic outlook. There remains substantial uncertainty about how the European crisis will unfold over coming months, posing considerable risks for global growth. However, barring a more severe slowing in the major advanced economies, the large emerging market economies are expected to continue growing at solid rates, with our linkages to the fast-growing Asian region continuing to support Australia's economic growth prospects.

DOMESTIC ECONOMIC OUTLOOK

The weaker international environment is weighing on Australia's economic outlook, exacerbating existing pressures on some sectors of the economy and driving downward revisions to forecast growth in real GDP and employment since Budget.

The marked deterioration in global economic and financial conditions over recent months has been transmitted to the Australian economy through a number of channels, with considerable volatility in the exchange rate, falls in Australian equity prices, lower prices for some of Australia's key export commodities — particularly iron ore and coal — and weaker business and consumer confidence. This has contributed to a reduction in momentum in some parts of the economy and a slowdown in employment growth.

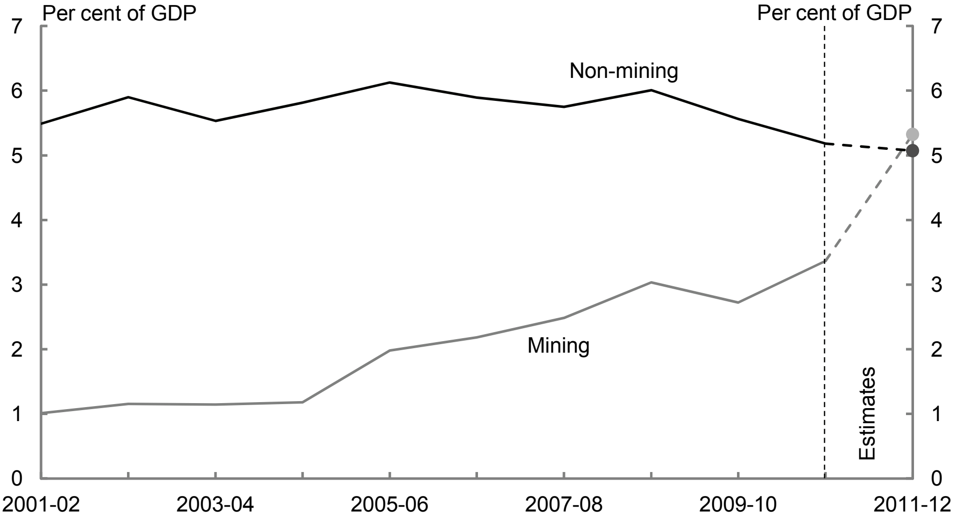
Notwithstanding these pressures, Australia's real GDP growth is still expected to strengthen over the forecast period, rising from 2.1 per cent in 2010-11 to 3¼ per cent in both 2011-12 and 2012-13. Employment is forecast to grow 1 per cent through the year to the June quarter of 2012 and 1½ per cent through the year to the June quarter of 2013, still solid but weaker than forecast at Budget. The unemployment rate is forecast to drift up to 5½ per cent by the June quarter of 2012, remaining broadly unchanged through to the June quarter of 2013.

Australia's economic growth outlook is underpinned by the strong prospects for the resources sector, notwithstanding recent declines in commodity prices. Global prices for Australia's key non-rural commodity exports have declined since early September, coinciding with falls in broader commodities markets, strong growth in supply and a recent easing of global steel production. However, by the end of October, prices appeared to have fallen more than fundamentals would suggest. Iron ore prices have since increased and it is anticipated they will regain further ground over coming months. Notwithstanding recent volatility, coal and iron ore prices remain at high levels and production remains highly profitable for mining companies operating in Australia.

The pipeline of resources investment has continued to build over recent months, reflecting final investment decisions on a number of existing projects and several new project announcements. While cyclical fluctuations in global growth will have implications for commodity prices, mining investment decisions are taken over longer time horizons and are underpinned by projections of the growing resource needs of the large emerging market economies over a period of decades. In value terms, around two-thirds of the large mining projects included in the economic forecasts have received final investment approval, with the majority of these already under construction. In 2011-12, the mining sector intends to invest around $82 billion, which, based on the long-run realisation of investment plans, would see mining investment increase to a record 5.3 per cent of GDP (Chart 2.1).

With continued solid demand from emerging Asia and significant production capacity anticipated to come on line, the volume of non-rural commodity exports is forecast to grow by around 20 per cent over the next two years.

Chart 2.1: Mining versus non-mining investment



Note: Estimates for 2011-12 are from the ABS CAPEX survey and are based on long-run average realisation ratios.
Source: ABS cat. no. 5204.0, 5625.0 and Treasury.

While the Australian economy is forecast to grow at around its trend rate in aggregate, conditions are expected to remain uneven, with the deterioration in international conditions adding to existing pressures on some sectors of the economy (Box 2.1).

Many Australian businesses are well-equipped to deal with short-term volatility in the exchange rate; however, the sustained strength of the Australian dollar is placing significant strain on trade-exposed sectors of the economy. The exchange rate has been above its post-float average for most of the past decade, prompting a growing number of firms in trade-exposed industries to re-evaluate their business models. Even before the recent international turmoil, it was increasingly evident that the elevated exchange rate was having a greater impact on economic activity than previously anticipated.

Compounding these pressures are a number of legacy effects from the global financial crisis, including the difficulty some businesses still confront in accessing credit and cautious household spending behaviour. Household spending is likely to be further affected in the near term by falls in equity markets and easing employment growth. Looking ahead, household spending is forecast to grow broadly in line with income growth, with the household saving ratio expected to remain elevated over the forecast period.

These forces are expected to weigh heavily, if unevenly, on some parts of the economy that are not directly benefitting from the resources boom. Business surveys suggest that the prospects for profitability, investment, and employment outside the resources sector have softened since the start of 2011, notwithstanding the partial recovery in the past couple of months.

With the Australian economy expected to grow at around its trend rate and the unemployment rate forecast to drift up a little, capacity pressures are expected to remain well contained, with forecast wages growth and inflation revised down since Budget. The Wage Price Index is forecast to increase 3¾ per cent in both 2011-12 and 2012-13, with continued strong wages growth in resources-related industries expected to be tempered by more modest increases in other parts of the economy.

Headline inflation is forecast to rise from 2¼ per cent through the year to the June quarter of 2012 to 3¼ per cent through the year to the June quarter of 2013, including a one-off ¾ of a percentage point increase due to the introduction of the carbon price. Underlying inflation is expected to remain well contained at 2¾ per cent through the year to the June quarter of 2013, including a one-off ¼ of a percentage point addition due to the carbon price.

The introduction of the carbon price is fully accounted for in the MYEFO forecasts and is not expected to have a material impact on the economic outlook. In addition to the one-off increase in headline and underlying inflation, the carbon price is expected to reduce real GDP and employment growth by less than ¼ of a percentage point in 2012-13, with no discernible impact on the forecast unemployment rate.

Forecast growth in the terms of trade has been revised up in year-average terms for 2011-12, notwithstanding the falls in iron ore and coal prices in September and October. This reflects unanticipated strength in bulk commodity prices through to the September quarter, in part due to a more protracted return to normal operations at Queensland coal mines and underpinned by continued robust demand from China. However, a sharper decline is now expected in 2012-13, consistent with recent declines in coal and iron ore prices and the expected growth in global supply of Australia's key non-rural commodity exports. The terms of trade are now expected to increase 1¾ per cent in 2011-12, before declining 5¼ per cent in 2012-13. Notwithstanding the near-term changes in the forecast terms of trade profile, the level of the terms of trade in 2012-13 is close to that forecast at Budget.

The risks to the outlook remain firmly on the downside. In the context of an already fragile global economy, rapidly evolving events in Europe have shaken confidence and financial markets, and pose a significant risk that the global economic outlook could deteriorate quickly. In this environment, Australia's terms of trade could also decline more sharply than currently forecast.

Table 2.1: Domestic economy forecasts[(a)]

	Outcomes(b)	Forecasts			
		2011-12		2012-13	
	2010-11	Budget	MYEFO	Budget	MYEFO(c)
Panel A - Demand and output(d)					
Household consumption	3.4	3 1/2	3	3 1/2	3
Private investment					
Dwellings	2.8	1 1/2	1 1/2	3	1 1/2
Total business investment(e)	5.7	16	14	14 1/2	14 1/2
Non-dwelling construction(e)	9.3	18 1/2	17 1/2	17 1/2	17
Machinery and equipment(e)	2.6	17 1/2	14	14	14 1/2
Private final demand(e)	3.6	6	5 1/4	6	5 3/4
Public final demand(e)	2.8	1 1/4	1 1/4	-1 1/4	-1 1/4
Total final demand	3.4	4 3/4	4 1/4	4 1/2	4
Change in inventories(f)	0.7	0	0	0	0
Gross national expenditure	4.2	4 3/4	4 1/4	4 1/4	4
Exports of goods and services	0.4	6 1/2	6	5 1/2	6
Imports of goods and services	10.4	10 1/2	10	8 1/2	9 1/2
Net exports(f)	-2.0	-1	-1 1/4	- 3/4	-1
Real gross domestic product	2.1	4	3 1/4	3 3/4	3 1/4
Non-farm product	1.9	4	3 1/4	3 3/4	3 1/2
Farm product	9.2	1	1	-3	-10
Nominal gross domestic product	8.3	6 1/4	6 1/4	5 3/4	5
Panel B - Other selected economic measures					
External accounts					
Terms of trade	20.4	- 1/4	1 3/4	-3	-5 1/4
Current account balance (per cent of GDP)	-2.4	-4	-4	-5 1/4	-5 3/4
Labour market					
Employment(g)	2.2	1 3/4	1	1 3/4	1 1/2
Unemployment rate (per cent)(h)	4.9	4 3/4	5 1/2	4 1/2	5 1/2
Participation rate (per cent)(h)	65.5	66	65 1/2	66	65 1/2
Prices and wages					
Consumer price index(i)	3.6	2 3/4	2 1/4	3	3 1/4
Gross non-farm product deflator	5.9	2 1/4	3	2	2
Wage price index(g)	3.8	4	3 3/4	4 1/4	3 3/4

(a) Percentage change on preceding year unless otherwise indicated.
(b) Calculated using original data unless otherwise indicated.
(c) MYEFO forecasts incorporate the introduction of a carbon price on 1 July 2012.
(d) Chain volume measures except for nominal gross domestic product which is in current prices.
(e) Excluding second-hand asset sales from the public sector to the private sector.
(f) Percentage point contribution to growth in GDP.
(g) Seasonally adjusted, through-the-year growth rate to the June quarter.
(h) Seasonally adjusted rate for the June quarter.
(i) Through-the-year growth rate to the June quarter.
Source: ABS cat. no. 5204.0, 5206.0, 5302.0, 6202.0, 6345.0, 6401.0, unpublished ABS data and Treasury.
Note: The forecasts are based on several technical assumptions. The exchange rate is assumed to remain around its recent average level — a trade-weighted index of around 74 and a United States dollar exchange rate of around 101 US cents. Interest rates are assumed to fall in line with market expectations. World oil prices (Malaysian Tapis) are assumed to remain around US$120 per barrel. The farm sector forecasts are based on an assumption of average seasonal conditions.

Box 2.1: The patchwork economy

The past few years have seen an increasing divergence in the performance of different sectors of the Australian economy. While the resources-related parts of the economy are doing very well, some other parts are struggling under the weight of the high Australian dollar, legacy effects from the global financial crisis and the recent global instability.

The rapid urbanisation and industrialisation in Asia is driving strong growth in demand and high prices for Australia's key non-rural commodity exports. This has lifted Australia's terms of trade to record highs and contributed to a substantial appreciation of the Australian dollar.

The resources sector has been the key beneficiary. Production is down over the past year, but this largely reflects the effects of the severe flooding earlier in the year, with growth expected to ramp up sharply in 2011-12. Mining capital investment grew by 34 per cent to a record $48 billion in 2010-11, with mining employment increasing by 14 per cent over the year to August 2011.

Agriculture is also performing well, buoyed by good weather conditions and relatively high prices, with growth exceeding 9 per cent over the past year.

Elsewhere in the economy, conditions are uneven, with some parts of the economy very weak, while other parts are performing solidly. The weakness is particularly pronounced in the 'goods' parts of the economy — manufacturing, retail and wholesale trade, and road transport. There is also weakness in construction outside of the resources sector.

Manufacturing output rose by 0.1 per cent over the past year, and manufacturing employment declined 5.4 per cent over the year to August 2011. The high exchange rate appears to have accelerated the structural changes that have been underway in the sector for some time. Not all manufacturing has been weaker, however, with mining-related manufacturing performing strongly. In particular, metal products manufacturing grew almost 8 per cent over the past year.

Domestic retailers have faced subdued conditions in recent years, with retail sales growing well below trend. The weakness reflects a broader pattern of heightened household caution since the global financial crisis, with consumers saving more and borrowing less, notwithstanding solid growth in household incomes. It also reflects the effects of the strong Australian dollar, with Australians taking advantage of cheaper overseas travel. In other parts of the 'goods' chain activity has also been subdued.

The performance of the 'services' sector, which accounts for a large part of the economy, continues to be uneven, with some parts performing poorly, and other parts, including those linked to the resources sector, performing well. Rental, hiring and real estate services output has fallen over the past year and other sectors, such as information media and telecommunications, have also been relatively weak.

Box 2.1: The patchwork economy (continued)

On the other hand, education and training, and health care and social assistance have grown solidly, while administrative and support services and professional, scientific and technical services have grown strongly over the same period.

Overall, this part of the economy appears to be doing reasonably well.

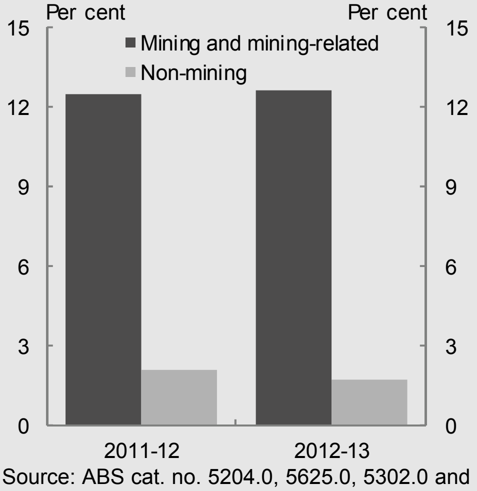
The strength of these service sectors helps explain why the unemployment rate has remained low in the face of pronounced weakness in some other parts of the economy. Although mining (and mining construction) employment is growing strongly, the sector only employs a small part of the labour force and even strong growth in employment in this sector would not be enough to offset the weakness in the larger employing sectors such as manufacturing and retail.

It is the large employing service sectors that are helping to bolster employment growth in the patchwork economy: for example, over the past year the health care and social assistance sector has added nearly 45,000 jobs; public administration and safety has added nearly 34,000 jobs; administrative and support services have added over 23,000 jobs; and professional, technical and scientific services have added around 22,000 jobs. Together, the service sectors have added 195,000 jobs over the past year, more than 3 times the number of jobs created by the mining and construction sectors combined.

These divergent trends are set to continue through at least the next two years, and probably longer.

Growth in the resources and resources-related parts of the economy — about 15 per cent of total GDP — is expected to exceed 10 per cent in both 2011-12 and 2012-13. In contrast, average growth in the remainder of the economy (outside of agriculture) is expected to remain very modest, with significant divergences in growth rates across sectors (Chart 2.2).

Chart 2.2: Growth in mining and non-mining sectors



Source: ABS cat. no. 5204.0, 5625.0, 5302.0 and Treasury.

International economic outlook

The Budget papers highlighted very considerable risks to the global economy. Unfortunately almost all of those risks have subsequently eventuated, with the world growth outlook deteriorating significantly since Budget. In particular, this reflects a dramatic intensification of the European sovereign debt crisis and a weaker-than-expected United States economy. Risks continue to be tilted strongly to the downside with considerable potential for damaging contagion from a downward spiral of events in Europe.

Emerging economies' growth is holding up relatively well on the back of strong domestic demand. However, the global uncertainty arising from Europe exposes these economies to the risks of sharp outflows of capital, a reduction in US dollar liquidity and a deterioration of trade finance. They would also inevitably be affected by a more severe slowing in European or US growth through trade and confidence effects.

Commodity prices have also been buffeted by weaker global growth prospects and uncertainties about the strength of demand from emerging markets.

The deterioration in the global economic outlook means that world GDP is now expected to grow 4 per cent in 2011 and 3½ per cent in 2012, compared with Budget forecasts of 4¼ per cent in 2011 and 4½ per cent in 2012. The global recovery remains vulnerable to shocks, most notably emanating from Europe. Growth in emerging economies, led by China, while slowing, is holding up and is forecast to continue to drive global growth. However, a further sharp deterioration in the situation in Europe or the US would be expected to have spill-over effects on the growth performance of emerging market economies.

Table 2.2: International GDP growth forecasts[a]

	Actuals	Forecasts		
	2010	2011	2012	2013
United States	3.0	1 3/4	2	2 1/4
Euro area	1.8	1 1/2	- 1/4	1
Japan	4.1	- 1/4	2 1/4	1 1/4
China(b)	10.4	9 1/4	8 1/4	8 1/2
India(b)	10.0	7 1/2	6 1/2	8
Other East Asia(c)	7.7	4 1/2	3 3/4	4 3/4
Major trading partners	6.7	4	4 1/4	4 1/2
World	5.1	4	3 1/2	4

(a) World, euro area and other East Asia growth rates are calculated using GDP weights based on purchasing power parity (PPP), while growth rates for major trading partners are calculated using export trade weights.
(b) Production-based measure of GDP.
(c) Other East Asia comprises the newly industrialised economies (NIEs) of Hong Kong, South Korea, Singapore and Taiwan and the Association of Southeast Asian Nations group of five (ASEAN-5), which comprises Indonesia, Malaysia, the Philippines, Thailand and Vietnam.
Source: National statistical agencies, IMF *World Economic Outlook* September 2011, Thomson Reuters and Treasury.

Growth of Australia's major trading partners (MTPs) is forecast to remain solid, albeit lower than at Budget, reflecting the uncertainty arising from developments in Europe. Following strong MTP growth of 6.7 per cent in 2010, growth is forecast to ease to 4 per cent in 2011, before picking up to 4¼ per cent in 2012 and 4½ per cent in 2013. The more robust prospects for growth in Australia's MTPs compared with growth in world GDP reflects the composition of our MTPs, which is increasingly weighted towards the fast growing emerging Asian economies.

The 26 October 2011 euro area leaders' summit made some welcome decisions to address the European sovereign debt crisis. Those measures included a plan to write-down more Greek debt, recapitalise European banks and increase the fire-power of the euro area bailout fund. However, many details remain unresolved and concerns linger that the measures may not be enough to combat the crisis. There are also clear implementation risks as political instability in Greece casts doubt on Greece's ability to stave off default. Indeed, questions about the extent of political commitment to tackle the crisis remain the single largest source of uncertainty. For Europe, the task at hand is enormous, with most countries pursuing contractionary fiscal policies, yields on Italian and Spanish debt at unsustainable levels and the prospect of deleveraging by European banks in the face of requirements to recapitalise. Italy, as the third largest economy in the euro area, is of particular concern given its large level of sovereign debt, weak growth prospects, poor economic reform record, political instability and rising risk premia being priced into its bonds.

The bank recapitalisation plan is vexed by the symbiotic links between the banking system and sovereign debt. If banks recapitalise by deleveraging rather than raising capital in markets, lending growth will be further constrained, hampering already weak economic activity in the region. In addition, the underlying problems facing the euro area, such as the need to enhance competitiveness and growth, and increase economic and fiscal integration, will be extremely difficult to address in circumstances of financial sector fragility. The confluence of these factors is expected to result in much of Europe returning to recession in 2012.

Given the poor outlook for Europe, sustaining the global recovery in the period ahead will rely primarily on the United States and China, the two largest economies in the world.

A confluence of temporary factors weighed on US GDP growth in the first half of 2011, including the disruption to motor vehicle supply chains caused by the Japanese earthquake, tsunami and nuclear accident, and high world oil prices. Data released in late July then saw downward revisions to US GDP which revealed that the recovery was much weaker, and the 2007-09 recession much deeper, than previously estimated. The latest data show a modest pick-up in growth as the impacts of the temporary factors continue to unwind. However, with US housing and labour markets remaining depressed, the US recovery will be weak and vulnerable to external shocks. In addition, given the ongoing political debate in the US concerning fiscal policy, we face the situation whereby failure to commit to a medium-term fiscal consolidation program creates uncertainty, while any premature fiscal consolidation would risk further exacerbating current weakness. This risk has been exacerbated by the failure of the Congressional 'Super Committee' to agree on a comprehensive package of budget cuts. What is required is a clear, moderate but staged approach to improving the US' fiscal position.

Economic growth in China is expected to remain strong over the forecast horizon. However, the rate of expansion is likely to moderate relative to the robust investment-driven growth in 2010 and 2011. Activity in the industrial and housing sectors has slowed as Government stimulus spending has declined and authorities have tightened monetary and credit policy settings in response to inflationary concerns. Recent financial market stress and continued sluggish growth in Europe and the US have reinforced downside risks from external conditions, which overlay existing pockets of domestic vulnerability flowing from the investment-driven post-GFC boom and the way in which sub-national governments have financed growth. However, authorities remain well placed to respond to external shocks, or a faster-than-expected moderation in domestic activity, with targeted policy easing.

Elsewhere in the region, the outlook remains broadly positive, barring a further substantial deterioration in the global economy. Japan's recovery from the March disasters has been slower than expected at Budget, primarily reflecting delays in reconstruction efforts, although growth is expected to strengthen in 2012. In Indonesia, domestic demand continues to drive solid growth and this is forecast to continue. India's economic growth is forecast to slow in 2012 as past monetary policy tightening takes effect, before returning to trend in 2013. Growth in Asia's other trade exposed economies is holding up relatively well, although these economies remain vulnerable to a further substantial deterioration in global growth and financing conditions.

DETAILED DOMESTIC FORECASTS

Australia's real GDP is forecast to grow 3¼ per cent in both 2011-12 and 2012-13. Compared with Budget, the forecasts have been downgraded by ¾ of a percentage point in 2011-12 and ½ of a percentage point in 2012-13, largely reflecting the deterioration in global economic and financial conditions. Economic growth is expected to be underpinned by business investment and commodity exports.

Household consumption is forecast to grow below trend, increasing 3 per cent in both 2011-12 and 2012-13. This is weaker than expected at Budget, reflecting a slower anticipated pace of employment and wages growth over the forecast horizon. House price falls and the recent global volatility, which have led to falls in household net worth and consumer confidence, are expected to weigh on consumption growth in the near term. Household consumption is forecast to grow broadly in line with household disposable income, with the household saving ratio expected to remain elevated.

Dwelling investment is forecast to grow 1½ per cent in both 2011-12 and 2012-13. New dwelling investment grew 5.2 per cent in 2010-11, the strongest performance since 2002-03, underpinned by a high level of construction activity in the Victorian market. However, with few signs of growth in other states, the further weakening in building approvals is expected to see growth ease over the forecast period, in line with broader softness in the housing market.

New business investment is expected to grow 14 per cent in 2011-12 and 14½ per cent in 2012-13, reflecting strong forecast growth in resources investment but a weaker outlook for investment in other parts of the economy. Sustained strong demand for Australia's key non-rural commodity exports continues to drive record investment intentions in the mining sector. **New engineering construction** is expected to grow 29½ per cent in 2011-12 and 23 per cent in 2012-13, underpinned by liquefied natural gas, iron ore and coal projects. The resources sector is also expected to drive higher levels of investment in **new machinery and equipment**, with growth forecast to be 14 per cent in 2011-12 and 14½ per cent in 2012-13. The weakness in non-mining investment is most evident in **new non-residential building** activity, which is forecast to decline 5 per cent in 2011-12 before recovering by 2 per cent in 2012-13.

Public final demand is forecast to grow 1¼ per cent in 2011-12, before falling 1¼ per cent in 2012-13. The public final demand forecasts reflect the withdrawal of fiscal stimulus and the fiscal consolidation plans of the Commonwealth and State governments. The withdrawal of fiscal stimulus is expected to detract around ½ of a percentage point from real GDP growth in 2011-12 and have no impact on real GDP growth in 2012-13, as the withdrawal of fiscal stimulus will be complete.

Export growth forecasts have been downgraded since Budget for 2011-12, but remain solid. The downgrade largely reflects a slower-than-expected recovery in Queensland coal exports following the floods, ongoing delays nationally in commodity export capacity expansions coming on line and weaker forecast growth in Australia's major trading partners. Nevertheless, non-rural commodity exports are expected to grow strongly over the period. Services and manufacturing export growth is expected to remain weak, in line with the weaker outlook for Australia's major trading partners and the high exchange rate. Farm production and consequently rural exports surged in 2010-11 and are expected to remain elevated in 2011-12 owing to continuing favourable weather conditions. In 2012-13, rural output and exports are expected to decline to more normal levels, in line with an assumed return to average weather conditions. Total exports are forecast to increase by 6 per cent in both 2011-12 and 2012-13.

Import growth forecasts have been downgraded slightly for 2011-12, reflecting weaker domestic demand, and upgraded for 2012-13, reflecting stronger expected capital imports associated with expenditure on major mining projects. Import volumes are forecast to grow 10 per cent in 2011-12 and 9½ per cent in 2012-13. Net exports are expected to detract 1¼ percentage points from real GDP growth in 2011-12 and 1 percentage point in 2012-13.

Forecast growth in the **terms of trade** has been revised up in year-average terms in 2011-12, reflecting higher-than-anticipated bulk commodity prices through to the September quarter. The terms of trade are expected to decline, albeit to still-elevated levels, in 2012-13, consistent with recent declines in coal and iron ore prices and the strong projected increase in the global supply of non-rural commodities. The terms of trade are expected to increase 1¾ per cent in 2011-12, before declining 5¼ per cent in 2012-13.

The **current account deficit** is forecast to widen over the next two years. This reflects a widening net income deficit associated with rising mining profits generating increased equity income outflows and the movement of the trade balance from surplus to deficit. The current account deficit is expected to be 4 per cent of GDP in 2011-12 and 5¾ per cent of GDP in 2012-13.

The **unemployment rate,** currently around 5¼ per cent, is expected to rise slightly to around 5½ per cent by the June quarter of 2012 and to remain broadly stable through to the June quarter of 2013. The labour market outlook has weakened since Budget following slower employment growth during 2011 and a downgrade to the economic outlook, particularly in the non-mining sectors of the economy where the majority of workers are employed. Employment is forecast to grow 1 per cent through the year to the June quarter of 2012 and 1½ per cent through the year to the June quarter of 2013, weaker than forecast at Budget.

Wages growth is expected to slow, consistent with the softer labour market outlook. The Wage Price Index is expected to grow 3¾ per cent through the year to the June quarters of both 2012 and 2013, weaker than forecast at Budget.

After spiking in 2010-11 due to the impact of floods and cyclones on fruit and vegetable prices, headline **inflation** is expected to moderate in 2011-12 and remain contained in 2012-13, in line with the outlook for trend economic growth and relatively stable unemployment. Both underlying and headline measures of inflation are expected to be 2¼ per cent through the year to the June quarter of 2012. Underlying inflation is then expected to rise modestly to 2¾ per cent through the year to the June quarter of 2013, including a one-off ¼ of a percentage point addition due to the carbon price; headline inflation, including the one-off impact of the carbon price, is forecast to be 3¼ per cent through the year to the June quarter of 2013.

Nominal GDP is forecast to grow 6¼ per cent in 2011-12 and 5 per cent in 2012-13. Forecast growth in nominal GDP is unchanged in 2011-12, but ¾ of a percentage point weaker in 2012-13 than expected at Budget, reflecting the ½ of a percentage point downward revision to real GDP growth and a steeper forecast decline in the terms of trade.

Box 2.2: Iron ore prices

Most commodity prices have fallen significantly over recent months. While iron ore prices defied this broader trend initially, spot prices fell by more than US$50 (or over 30 per cent) in October to below US$120/tonne. This was the largest monthly fall in iron ore prices since the global financial crisis. Iron ore spot prices subsequently increased by around $US30 (or 25 per cent) in the first half of November, remaining below their early-September peak, but at levels that are still high by historical standards (Chart 2.3).

Chart 2.3: Iron ore spot prices

Note: Series is daily spot China import Iron Ore Fines 62 per cent Fe CFR. Data prior to December 2008 are spliced backwards using weekly spot China import Iron Ore Fines 63.5 per cent Fe CFR.
Source: Bloomberg and Treasury.

The substantial volatility in iron ore prices appears to have been driven by a reinforcing combination of demand and supply factors, some of which are expected to be temporary.

Activity in global steel markets traditionally softens in the latter part of the calendar year as production eases and significant maintenance work is undertaken. This seasonal softening appears to have been amplified this year by the announcement of large scale steel production cuts in Europe, tighter global credit conditions, and tighter financial conditions in China. While European demand is likely to remain lower than normal for some time, Chinese demand is expected to pick up in the near term as steel mills restock in the lead up to winter.

On the supply side, Australian iron ore producers have recently been exporting at record rates. Combined with redirected iron ore supplies from Europe and record Chinese domestic iron ore production, this additional supply has also weighed on prices in the face of temporarily weaker Chinese demand.

Prices rose in the first half of November and are expected to recover a little further in the near term as prices had fallen below the marginal cost of production for some producers. With a significant proportion of China's domestic iron ore production estimated to be high cost, some Chinese domestic supply could have been wound back or shut down if these lows had been sustained.

Over the longer term, the outlook for iron ore demand remains positive despite the recent financial market turbulence. Growth prospects for emerging Asia, particularly China, continue to be robust.

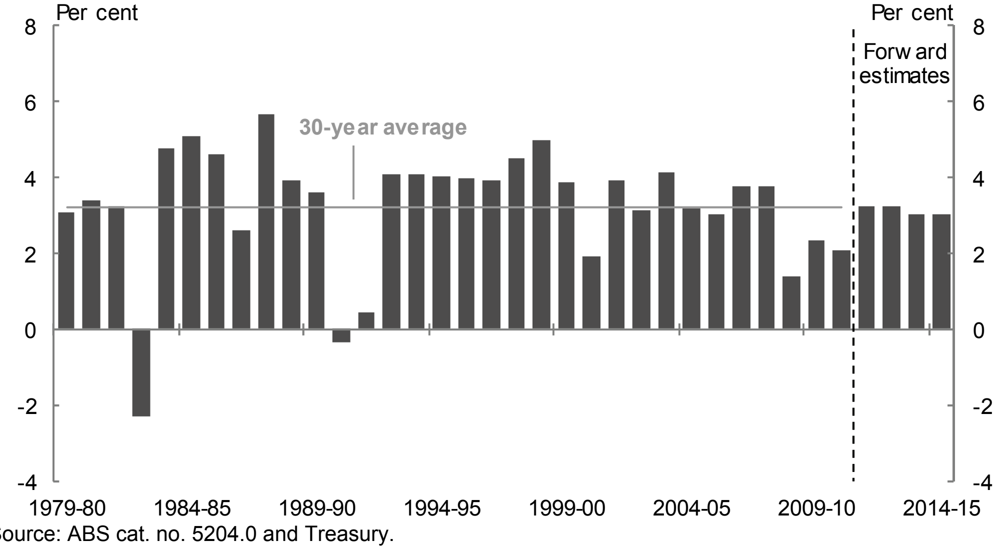
With iron ore accounting for 20 per cent of Australia's total exports in 2010-11 (valued at $58 billion) and over 4 per cent of GDP, developments in the market have significant implications for the Australian economy and Government revenues.

Medium-term economic projections

The fiscal aggregates in the MYEFO are underpinned by a set of forward estimates consisting of short-term economic forecasts for 2011-12 and 2012-13 and a further 2 years of projections based on medium-term assumptions.

Real GDP is projected to grow at around 3 per cent annually over the two projection years of the forward estimates (Chart 2.4). These projections are based on analysis of underlying trends in employment and productivity.

Chart 2.4: Real GDP growth over the forward estimates period



Source: ABS cat. no. 5204.0 and Treasury.

Beyond the forward estimates, real GDP is projected to grow at around 3 per cent until 2022-23, when growth is projected to slow as population ageing generates a gradually falling participation rate.

The unemployment rate is projected to be 5 per cent over the medium term, the assumption that has long been used for medium-term projections, and near the top of the band of current estimates of the NAIRU (4½ to 5 per cent). Inflation is projected to be 2½ per cent, consistent with the Reserve Bank of Australia's medium-term target band.

The terms of trade are projected to decline by a total of around 20 per cent over a 15-year period from 2012-13, settling just above their 2006-07 level. This reflects an expectation that current levels of commodity prices will not be sustained in the longer term, as supply increases gradually bring down prices over time.

The exchange rate is assumed to remain at recent levels during the forecast period. Over the projection period, the exchange rate is assumed to move in line with the long-term historical relationship between the terms of trade and the real effective exchange rate. The terms of trade projections imply a fall in the real exchange rate of 0.9 per cent per annum over the projection period.