STATEMENT 2: ECONOMIC OUTLOOK

This statement presents the economic forecasts that underlie the Budget estimates.

STATEMENT 2: ECONOMIC OUTLOOK

The Australian economy is forecast to grow around trend in 2012-13 and 2013-14, outperforming most of the developed world. While global financial market tensions eased in the early months of 2012 following the acute bout of instability in late 2011, global conditions remain weak, particularly in the major advanced economies, and financial markets are fragile.

Against this backdrop, the global economy is undergoing dramatic structural change as the weight of economic activity shifts towards Asia and this has significant implications for Australia. Strong demand from Asia is expected to continue to support historically high commodity prices, drive record levels of investment in resources and resources-related projects in Australia and underpin solid growth in export volumes.

Nonetheless, conditions in some parts of the economy are likely to remain challenging, with unsettled global conditions, the high Australian dollar, ongoing consumer caution and changes in expenditure patterns all expected to weigh heavily on some sectors.

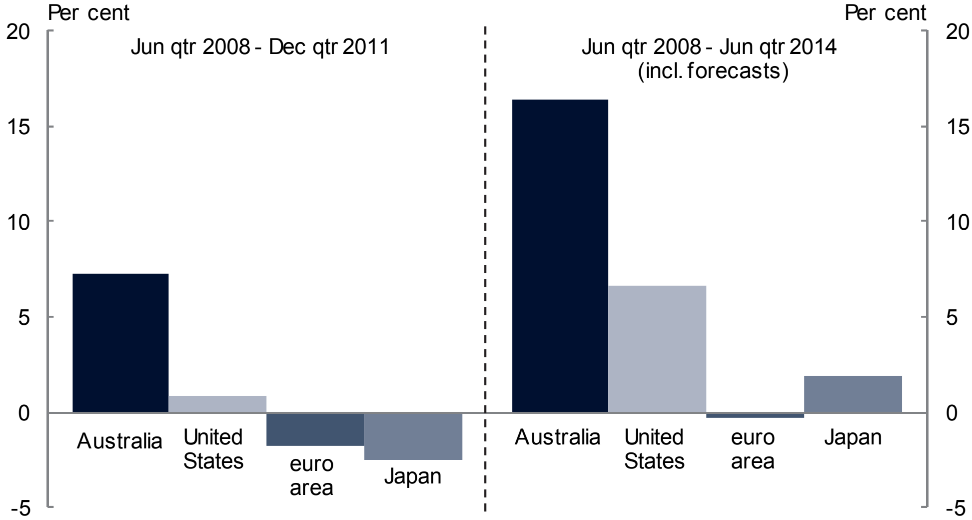
Despite this, Australia's economic outlook remains positive, with economic growth expected to be solid, the unemployment rate expected to remain low and inflation likely to be well contained.

OVERVIEW

The fundamentals of the Australian economy remain strong and the outlook is favourable, with solid growth, low unemployment and well-contained inflation.

The level of output is well above pre-global financial crisis levels and the economy is expected to grow around its trend rate over the next two years. GDP growth is forecast to be 3¼ per cent in 2012-13 and 3 per cent in 2013-14, with the economy expected to outperform every major advanced economy over this period (Chart 1).

Chart 1: Real GDP growth



Source: ABS cat. no. 5206.0, national statistical agencies, Thomson Reuters and Treasury.

Global financial stresses eased somewhat in the early months of 2012, after the period of acute instability in late 2011, but the global economy remains weak and the global outlook remains uncertain. Many advanced economies are yet to return to pre-global financial crisis output levels and face the substantial task of putting public finances on a sustainable footing while simultaneously supporting growth.

While there have been encouraging signs in the United States in recent months, the euro area appears to have, and the United Kingdom has, re-entered recession. There has also been some recent re-emergence of elevated risk aversion in global markets, particularly in relation to concerns about Spain's fiscal and financial stability.

Against this backdrop, there are dramatic structural changes underway in the global economy, with economic activity shifting towards Asia. This uneven pattern of global growth is expected to see emerging economies, particularly China and India, account for around three-quarters of global growth over the next two years. China is forecast to grow at an average annual rate of over 8 per cent over the next two years and India around 7 per cent.

With external demand from Asia expected to remain strong, particularly for non-rural commodities, Australia's exports are forecast to grow solidly and non-rural commodity prices are expected to remain high, notwithstanding some forecast decline as global supply expands.

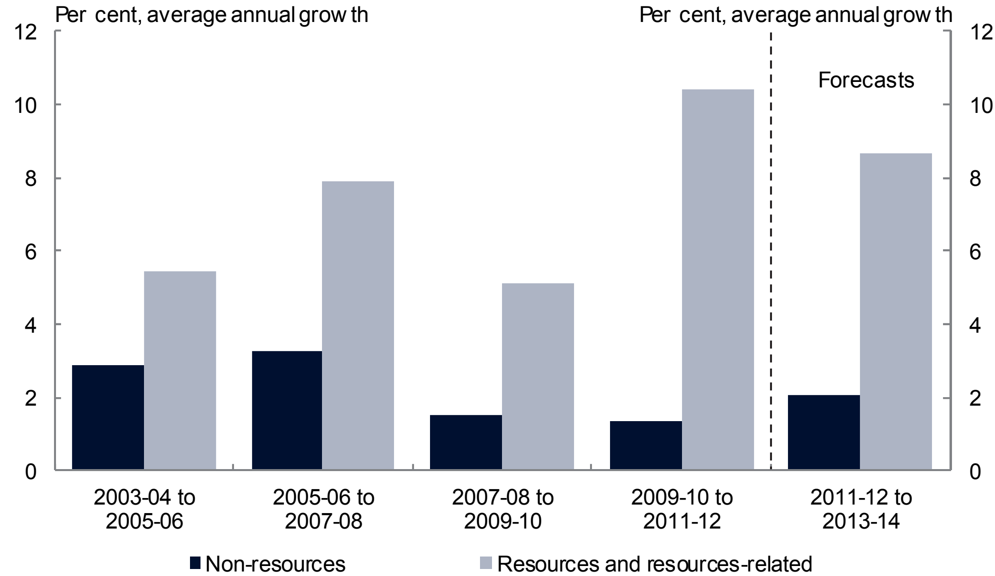
While the terms of trade are likely to have passed their peak, they remain close to historical highs, supported by sustained strength in commodity prices. The terms of trade are forecast to decline over the forecast period, with non-rural commodity prices expected to ease as global supply increases, including from Australia. The terms of trade are projected to decline gradually over the medium term. Notwithstanding this, high commodity prices and activity in the resources sector should continue to support incomes and activity in the broader economy.

Robust demand in Asia should continue to underpin the strong outlook for the resources sector, where investment has reached unprecedented levels. Businesses expect to invest a record $120 billion in the resources sector in 2012-13, around 150 per cent higher than its level just two years before, and 13 times the level of investment before the first phase of the boom. The resources investment pipeline is currently over $450 billion, with more than half of these projects already committed or under construction. Over the forecast period, new business investment as a proportion of GDP is expected to reach its highest level on record.

Strong growth in the resources sector is expected to continue to spill over into other sectors, including parts of the construction sector, parts of manufacturing and parts of the services sector. Together, the resources and the resources-related sectors of the economy are expected to account for 15 to 20 per cent of total GDP over the forecast horizon and grow by an average of nearly 9 per cent per year (Chart 2). However, conditions remain difficult for those sectors not benefiting directly or indirectly from the resources boom. Many sectors are facing challenging conditions from the high Australian dollar, ongoing global instability and uncertainty, and consumer caution.

The high Australian dollar is weighing particularly heavily on trade-exposed sectors of the economy such as manufacturing and tourism. Ongoing global uncertainty has also reinforced the cautious behaviour that consumers have shown since the global financial crisis and they remain reluctant to take on more debt. This is particularly challenging for the retail sector and other sectors linked to the retail sector such as wholesale trade and road transport. Weak demand and tight credit conditions are also making conditions challenging in parts of the construction sector. While some of the headwinds outside the resources sector are likely to be temporary, some are structural, reflecting the transition that is currently underway across the economy. Overall, the non-resources part of the economy is forecast to grow at a below-trend average annual rate of 2 per cent over the next two years.

Chart 2: Growth in resources/resources-related and non-resources activity



Note: Bars are the average annual growth rate over the two financial years. Growth in 2011-12 is an estimate.
Source: ABS cat. no. 5206.0, 5209.0 and Treasury.

Within the non-resources part of the economy, there is also considerable divergence between sectors and even within sectors. Indeed a complex transition is taking place in the economy, only part of which is driven by the resources boom and the high Australian dollar. Further dimensions of this transition are being driven by shifts in household spending patterns towards services, changed attitudes towards debt, broader competitive pressures and technological change, which are leading to shifts in the patterns of domestic and external demand.

These forces are being reflected in significant shifts in the sectoral composition of growth and employment which have more dimensions than suggested by the simple resources/non-resources divide. The patchwork economy is multifaceted. While growth in the resources part of the economy has been exceptional in recent years, there has also been strong growth in sectors such as health care and social assistance, professional scientific and technical services, and education and training. At the same time, conditions have been particularly challenging in retail trade, manufacturing and non-resources related construction. However, even within the slower growing sectors there have been pockets of strength. More generally there is ongoing product and process innovation right across the economy as businesses adjust their business models to take advantage of emerging opportunities.

The complexity of the transition is also reflected in the labour market. While employment growth has been weak in some non-resources sectors, there has been strong growth in others. Despite the geographic concentration of resources activity and employment, the aggregate unemployment rate has remained low and the dispersion of regional unemployment rates has continued to decline since the start of the mining boom. The continued fall in the regional dispersion of unemployment over this period shows that, despite the uneven pattern of growth in the economy and across regions, the benefits of the strong economy are being spread broadly across Australia.

Employment growth is expected to remain solid over the forecast period, but reflect the uneven growth pattern across the economy. While employment in the resources sector and parts of the services sector has grown solidly over the past year, aggregate employment growth has slowed after robust growth in 2010, as continued global weakness and instability, the high dollar, cautious consumer behaviour and shifting patterns of domestic spending have seen employers reluctant to take on new workers.

Notwithstanding the unevenness in the patchwork economy, the unemployment rate has remained low and been relatively stable. At close to 5 per cent, it is also lower than in most other advanced countries. The unemployment rate is around half that in the euro area and significantly below that in the United States. In aggregate, employment is expected to grow 1¼ per cent through the year to the June quarter of 2013 and 1½ per cent through the year to the June quarter of 2014. The unemployment rate is expected to drift up to 5½ per cent by the June quarter of 2013. With the economy growing around trend, inflation is expected to remain contained, notwithstanding a temporary increase associated with the introduction of a carbon price in 2012-13.

The outlook for trend growth in the economy over the next two years is consistent with the fiscal consolidation being undertaken by the Commonwealth and state governments. As is standard practice, the forecasts assume policy interest rates move broadly in line with market expectations at the time that the forecasts are finalised, with the market expectation at that time being that policy interest rates would be lower over the coming year. The planned fiscal consolidation should continue to provide scope for monetary policy to be eased, if appropriate, without generating price and wage pressures. The impact of the fiscal consolidation, particularly in 2012-13, should be more than offset by growth in private demand, particularly from the resources sector, with the aggregate economy growing around trend.

Although the outlook for the Australian economy is positive, substantial downside risks remain. The key international risk is the potential for a re-escalation of the euro area sovereign debt crisis. The capacity of many advanced economies to respond is limited and any further weakness could flow through to the emerging economies of Asia and to Australia. The prospect of a sharp rise in oil prices in the event of escalating tensions in the Middle East is also a risk to the global outlook.

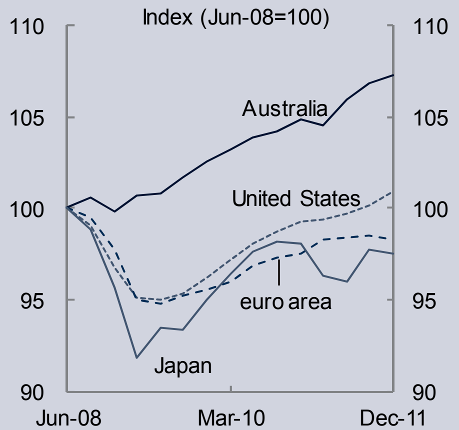
Domestically, the transition taking place in the economy poses a risk for the labour market as these transitional frictions could see a temporary rise in the unemployment rate while businesses adjust to the evolving patterns of demand.

Box 1: International comparisons

Australia's economy continues to outperform most other advanced economies. Australia has outperformed nearly all advanced economies since the global financial crisis with both economic growth and employment growth much stronger.

The Australian economy has grown by over 7 per cent on its pre-GFC levels. By contrast, the United States economy has grown by around 1½ per cent, and both the euro area and Japan have not made up lost ground (Chart A).

Chart A: GDP international comparison



Source: ABS cat. no. 5206.0, national statistical agencies, Thomson Reuters and Treasury.

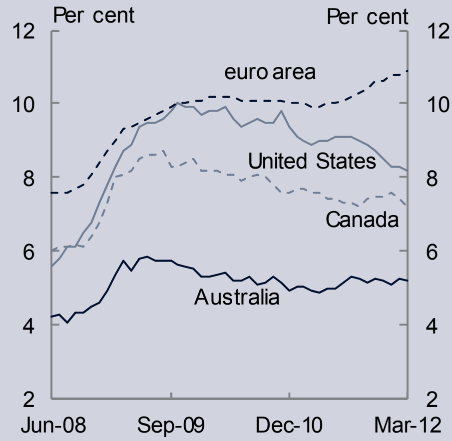
Australia's outperformance is expected to continue. By the end of the forecast period, cumulative growth of Australian GDP since the GFC is expected to have been around 16½ per cent. This is well above that expected from the United States (around 6½ per cent), Japan (around 2 per cent) and the euro area (which is expected to have not made up the lost ground by the end of the period).

This outperformance has also been reflected in much stronger labour market outcomes in Australia.

Australia's labour market has performed strongly since the onset of the global financial crisis in September 2008.

While many advanced economies experienced significant rises in their unemployment rates during the global financial crisis, the unemployment rate rose less than 2 percentage points in Australia — from 4.0 to 5.9 per cent (Chart B).

Chart B: Unemployment rates



Source: ABS cat. no. 6202.0, national statistical agencies, Thomson Reuters and Treasury.

Following the global financial crisis, strong employment growth saw the Australian unemployment rate fall to around 5 per cent.

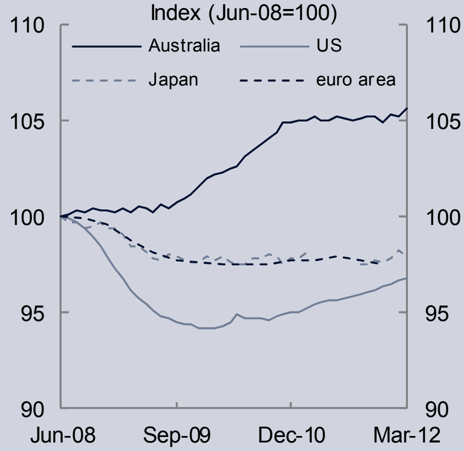
Box 1: International comparisons (continued)

More recently, in Australia, the high dollar and global weakness and instability have unsettled consumers and made businesses more hesitant in their hiring decisions, which has led to much slower employment growth over the past year. The slowdown follows particularly strong employment growth in 2010, reflecting pre-emptive hiring in some sectors.

In contrast, employment in the United States and euro area is yet to return to pre-crisis levels (Chart C).

While Australia has added more than 750,000 jobs since the end of 2007, more than 25 million jobs have been lost around the world, including more than 3 million in the euro area and around 5 million in the United States. There are now around 200 million unemployed people worldwide.

Chart C: Employment



Note: Data for the euro area are quarterly. Employment data for Japan from March 2011 to August 2011 are not available due to the impacts of the Japanese earthquake and tsunami.
Source: ABS cat. no. 6202.0, national statistical agencies, Thomson Reuters and Treasury.

However, despite a range of pressures, the Australian unemployment rate has remained low, and at 5.2 per cent is lower than in every major advanced economy except Japan.

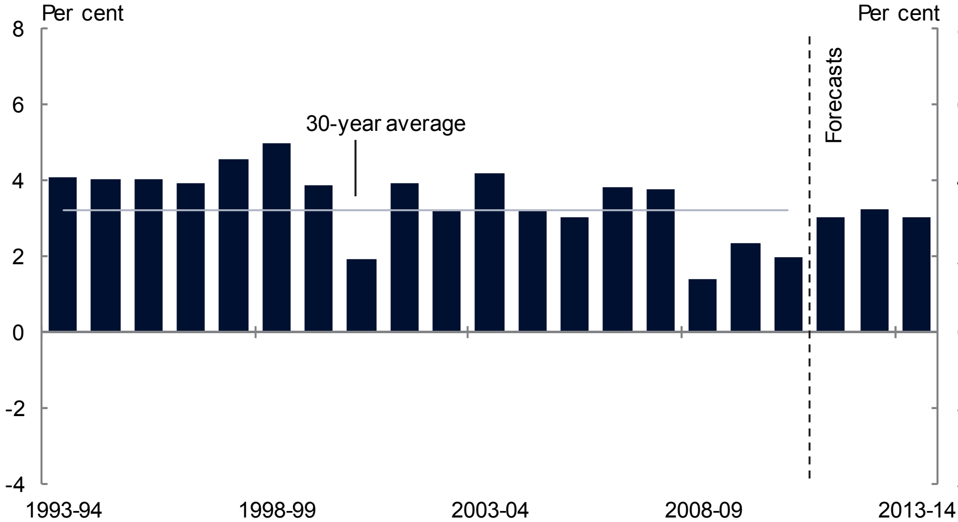
Summary of forecasts

World GDP growth is expected to pick up over the forecast period, albeit from a position of considerable weakness, as strong growth in emerging market economies moderates slightly and recoveries in the large advanced economies slowly gather momentum. The world economy is forecast to grow 3½ per cent in 2012, 4 per cent in 2013 and 4¼ per cent in 2014.

Australia's major trading partners (export weighted) as a group are expected to grow strongly over the forecast period, reflecting the rapid growth of emerging Asia, particularly China. Major trading partner growth is forecast to be 4¼ per cent in 2012 and 5 per cent in both 2013 and 2014.

Australia's real GDP is forecast to grow 3¼ per cent in 2012-13 and 3 per cent in 2013-14 (Chart 3). The main drivers of economic growth are expected to be business investment and exports.

Chart 3: Growth in real GDP



Source: ABS cat. no. 5206.0 and Treasury.

Household consumption is expected to grow moderately over the forecast period, broadly in line with household income growth. Nevertheless, consumers remain cautious and the household saving rate is expected to remain elevated. Household consumption is expected to grow 3 per cent in both 2012-13 and 2013-14.

Dwelling investment is expected to remain subdued over the forecast period, with households reluctant to take on more debt and some investors hesitant because of the prospect of continued subdued house price growth. Dwelling investment growth is expected to be flat in 2012-13 before rising to 2½ per cent in 2013-14.

New business investment is expected to continue growing strongly over the forecast period, reaching a record share of GDP in 2013-14. This reflects an expectation of unprecedented investment in the resources sector, with investment elsewhere in the economy expected to be more subdued. New business investment growth is expected to be a strong 12½ per cent in 2012-13 and 8 per cent in 2013-14.

Public final demand is expected to fall in 2012-13 and remain flat in 2013-14, with falling Commonwealth Government spending in 2012-13 partially offset by modest increases in state spending, consistent with recent state budget updates, notwithstanding the fiscal consolidation plans announced by most state governments.

Exports are expected to grow 4½ per cent in each of 2012-13 and 2013-14 as non-rural commodity export capacity continues to expand to meet global demand. However, the high Australian dollar is expected to weigh on growth of exports of manufactures and services, notwithstanding the positive outlook for major trading partner growth.

Imports are expected to grow 7½ per cent in 2012-13 and 5½ per cent in 2013-14, underpinned by record levels of investment in the resources sector and the high

Australian dollar. While import growth is expected to be broad-based, capital goods imports associated with the booming liquefied natural gas sector are expected to be a key driver of the increase.

The **terms of trade** are expected to decline 5¾ per cent in 2012-13 and 3¼ per cent in 2013-14, as increases in global supply, led by Australia, place downward pressure on non-rural commodity prices. Despite these forecast falls, the terms of trade are expected to remain close to their highest sustained levels in 140 years.

The **current account deficit** is expected to widen to 4¾ per cent of GDP in 2012-13 and 6 per cent of GDP in 2013-14. This largely reflects the forecast shift of the trade balance from surplus in 2011-12 to deficit in both 2012-13 and 2013-14 because of a strong rise in resources investment-related imports and the expected decline in the terms of trade.

Employment growth is expected to be 1¼ per cent through the year to the June quarter of 2013 and 1½ per cent through the year to the June quarter of 2014, reflecting solid overall economic growth, notwithstanding the challenging conditions in some sectors of the economy. The **unemployment rate** is expected to drift up to 5½ per cent by the end of 2012-13 and remain there through 2013-14. The participation rate is forecast to remain close to historical highs at around 65¼ per cent.

Wages growth is expected to remain around trend over the forecast period, in line with expected subdued labour market conditions and the moderate inflation outlook. The **Wage Price Index** is expected to grow 3¾ per cent through the year to the June quarters of both 2013 and 2014.

Underlying inflation is expected to be 2¾ per cent through the year to the June quarter of 2013, including a ¼ of a percentage point increase from the introduction of the carbon price in 2012-13. Underlying inflation is expected to ease to 2½ per cent through the year to the June quarter of 2014.

Headline inflation is expected to be 3¼ per cent through the year to the June quarter of 2013, including a ¾ of a percentage point increase from the introduction of the carbon price. Headline inflation is expected to ease to 2½ per cent through the year to the June quarter of 2014.

Nominal GDP is expected to grow 5 per cent in 2012-13 and 5¼ per cent in 2013-14, reflecting forecast close-to-trend growth in the real economy and the expected decline in the terms of trade.

Table 1: Domestic economy forecasts[(a)]

	Outcomes(b)	Forecasts		
	2010-11	2011-12	2012-13	2013-14
Panel A - Demand and output(c)				
Household consumption	3.1	3 1/4	3	3
Private investment				
Dwellings	3.0	-1	0	2 1/2
Total business investment(d)	5.6	18	12 1/2	8
Non-dwelling construction(d)	8.8	25	14	7 1/2
Machinery and equipment(d)	3.0	16 1/2	12 1/2	8 1/2
Private final demand(d)	3.3	6	5	4 1/4
Public final demand(d)	3.4	1 1/2	- 1/2	0
Total final demand	3.3	5	3 3/4	3 1/4
Change in inventories(e)	0.5	0	0	0
Gross national expenditure	3.8	5	4	3 1/2
Exports of goods and services	0.2	4	4 1/2	4 1/2
Imports of goods and services	10.4	12 1/2	7 1/2	5 1/2
Net exports(e)	-2.0	-2	- 3/4	- 1/2
Real gross domestic product	**2.0**	**3**	**3 1/4**	**3**
Non-farm product	1.9	3 1/4	3 1/4	3
Farm product	7.1	-6	2	1
Nominal gross domestic product	8.3	5 1/2	5	5 1/4
Panel B - Other selected economic measures				
External accounts				
Terms of trade	20.6	3 1/4	-5 3/4	-3 1/4
Current account balance (per cent of GDP)	-2.4	-3	-4 3/4	-6
Labour market				
Employment (labour force survey basis)(f)	2.2	1/2	1 1/4	1 1/2
Unemployment rate (per cent)(g)	4.9	5 1/4	5 1/2	5 1/2
Participation rate (per cent)(g)	65.5	65 1/4	65 1/4	65 1/4
Prices and wages				
Consumer price index(h)	3.6	1 1/4	3 1/4	2 1/2
Gross non-farm product deflator	6.0	2 1/2	1 3/4	2 1/4
Wage price index(f)	3.8	3 1/2	3 3/4	3 3/4

(a) Percentage change on preceding year unless otherwise indicated.
(b) Calculated using original data unless otherwise indicated.
(c) Chain volume measures except for nominal gross domestic product which is in current prices.
(d) Excluding second-hand asset sales from the public sector to the private sector.
(e) Percentage point contribution to growth in GDP.
(f) Seasonally adjusted, through-the-year growth rate to the June quarter.
(g) Seasonally adjusted rate in the June quarter.
(h) Through-the-year growth rate to the June quarter.
Note: The forecasts for the domestic economy are based on several technical assumptions. The exchange rate is assumed to remain around its recent average level — a trade-weighted index of around 77 and a US$ exchange rate of around 103 US cents. Interest rates are assumed to move broadly in line with market expectations at the time the forecasts were finalised. World oil prices (Malaysian Tapis) are assumed to remain around US$126 per barrel. The farm sector forecasts are based on a return to average seasonal conditions over 2012-13 and 2013-14.
Source: ABS cat. no. 5206.0, 5302.0, 6202.0, 6345.0, 6401.0, unpublished ABS data and Treasury.

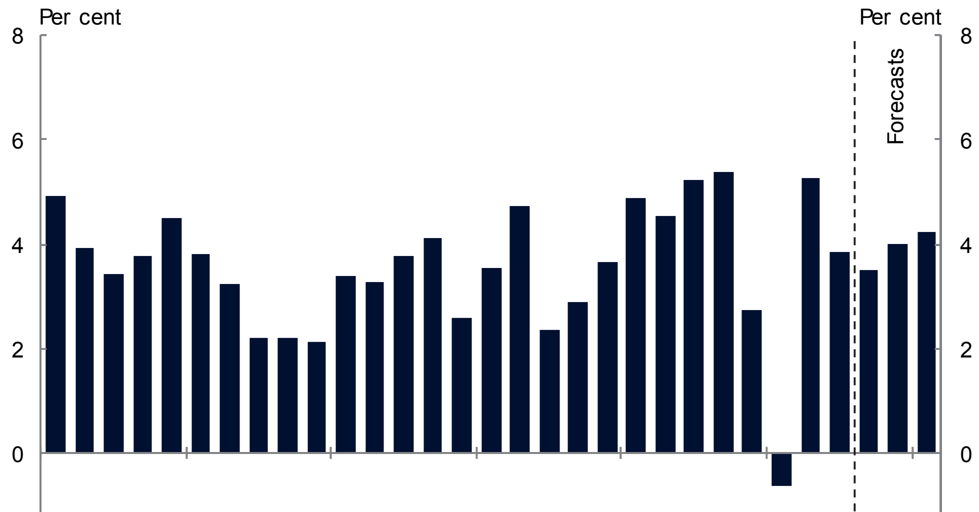
THE OUTLOOK FOR THE INTERNATIONAL ECONOMY

Global financial stresses eased somewhat in the early months of 2012, after the period of acute instability in late 2011, but the global outlook remains weak and uncertain, and substantial downside risks remain. It is likely that the uncertainty and associated volatility in financial markets will continue for some time. Economic conditions in the United States are looking more promising, but many advanced countries, including the euro area and the United States, face the significant task of rebuilding after the global financial crisis, while the euro area is also managing the effects of the sovereign debt crisis.

Output is well below potential in many advanced economies and these countries face a significant task of setting public finances on a sustainable footing, while supporting growth. The euro area appears to have, and the United Kingdom has, re-entered recession, and while the downturn is expected to be moderate in the absence of a re-intensification of the sovereign debt crisis, the recovery is also expected to be moderate at best.

Growth in the emerging economies as a whole remains relatively robust. While growth in China has moderated to a more sustainable pace in line with policy makers' intentions, the Chinese economy is expected to continue to grow solidly. This should provide some support for other emerging Asian economies which have been affected by weakness in the euro area and the subdued recovery in the United States.

Chart 4: World GDP growth



Source: IMF World Economic Outlook April 2012, Thomson Reuters and Treasury.

Global economic growth is expected to improve over the forecast horizon, driven by the United States and emerging Asia, particularly China. Global GDP growth is forecast to be 3½ per cent in 2012, 4 per cent in 2013 and 4¼ per cent in 2014 (Chart 4).

Australia's major trading partners (export weighted) as a group are expected to grow strongly over the forecast period, reflecting the rapid growth in emerging Asia, particularly China. Australia's major trading partners are forecast to grow 4¼ per cent in 2012 and 5 per cent in both 2013 and 2014 (Table 2).

Table 2: International GDP growth forecasts (a)

	Actuals	Forecasts		
	2011	2012	2013	2014
United States	1.7	2	2 1/4	2 1/2
Euro area	1.5	- 3/4	3/4	1 1/4
Japan	-0.7	2 1/4	1 3/4	1 1/4
China(b)	9.2	8 1/4	8 1/2	8 1/4
India(b)	7.3	6 1/4	7 3/4	7 1/2
Other East Asia(c)	4.2	3 3/4	5	5
Major trading partners	4.2	4 1/4	5	5
World	3.9	3 1/2	4	4 1/4

(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 weights.
(b) Production-based measure of GDP.
(c) Other East Asia comprises the 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 publications, IMF, Thomson Reuters and Treasury.

Europe's poor growth outlook makes it unlikely that it will make a significant contribution to global growth over the forecast horizon. Encouragingly, there have been a number of policy measures which have helped to temporarily stabilise euro area financial conditions, including the provision of liquidity by the European Central Bank, strong fiscal adjustment programs implemented by euro area governments, and ambitious planned product and labour market reforms. These policy responses temporarily eased pressure on banks and on some sovereigns, although the positive impact is starting to wane. Fresh concerns continue to emerge, most recently around Spain. The euro area also faces a prolonged period of fiscal consolidation and a challenging reform agenda. Economic activity in many euro area economies is already well below potential and any recovery is likely to be tepid and drawn out. There is still a risk of a sharp, deep financial crisis if markets judge that there is insufficient progress in implementing the measures that have been agreed.

The pace of recovery in the United States is picking up a little, with the economy forecast to grow 2 per cent in 2012, 2¼ per cent in 2013 and 2½ per cent in 2014. The temporary factors that impinged on growth in the first half of 2011 (particularly the impact on automobile and electronics industry supply chains of Japan's earthquake and tsunami) have fully abated. Nevertheless, the recovery remains subject to risks arising from the deep underlying weaknesses in the labour and housing markets.

Two years after the end of the recession there have been some encouraging signs that the long-awaited recovery in the United States' labour market may be underway. Employment growth is strengthening and the unemployment rate has been falling since the end of 2011. However, unemployment is still historically high, and includes a large number of long-term unemployed. An historically low participation rate (around a 30-year low) suggests that the labour market still has a long way to go before it returns to pre-global financial crisis conditions. In addition, the depressed housing market remains a constraint on growth, with a recovery still some way off due to the need to absorb the large housing inventory.

A key risk for the United States' outlook beyond 2012 is the ability to strike the appropriate balance between short-term fiscal support and medium-term fiscal consolidation. While Congress delayed a fiscal contraction earlier this year by extending the payroll tax cut and unemployment benefits that were originally legislated to expire at the end of 2011, it will face some difficult fiscal policy decisions in late 2012 that will have a large bearing on subsequent years. Markets continue to be sanguine about the ability of the United States to meet its sovereign debt obligations, with the yield on 10-year United States' Treasuries around a 60-year low. However, there is a risk that market concerns will emerge in the absence of a credible and substantive medium-term fiscal consolidation plan.

Economic conditions in China are expected to remain solid, despite some slowing in domestic activity and the deterioration in external demand, especially from the euro area. China is forecast to grow a little over 8 per cent in each of 2012, 2013 and 2014. Activity is generally moderating in line with the Chinese Government's intentions, with inflation having eased noticeably since mid-2011. With inflationary pressure likely to continue easing, policy makers are turning their attention to supporting sustainable growth.

Should external or domestic conditions deteriorate, China has the capacity to use macroeconomic policy to stimulate growth. However, the Chinese Government is likely to be more cautious in funding stimulus through the banking system than at the time of the GFC. Monetary policy has already tentatively shifted towards supporting growth. Selective monetary easing and an increase in credit to relieve stress amongst small and medium-sized enterprises are already underway. Furthermore, the extension of new loans is likely to be somewhat higher than last year, supported by government regulation to increase the funds available for banks to make loans.

Elsewhere in Asia, the outlook remains positive, with the region showing signs of recovery after being affected by weakness in the euro area last year. Japan's post-disaster recovery stalled in the December quarter, due largely to external factors, but is expected to get back on track as 2012 progresses. India's economy experienced a policy-induced slowing in 2011, but growth is expected to remain solid. Thailand's unprecedented floods led to sharply lower production in late 2011, but the economy, and affected regional production chains, are expected to recover strongly in 2012.

Global growth forecasts are for sustained, albeit below-trend, growth this year. However, risks to the outlook remain firmly to the downside. A re-escalation of the euro area sovereign debt crisis remains the key risk to the global recovery. Actions by the European Central Bank to inject liquidity into the European financial system in December 2011 and February 2012 have lessened the risk of a near-term European banking crisis, providing some necessary breathing space for reforms. The recent agreement of the IMF membership to boost the institution's lending capacity by more than US$430 billion is also a positive development, helping to bolster the global firewall to better guard against contagion. Nevertheless, with uncertainty over the sustainability of agreed austerity and structural reform measures in a number of euro area countries, the threat of further contagion from the euro area sovereign debt crisis persists.

Conditions in Europe, and in global financial markets, are fragile. Indeed, the actions of the European Central Bank have wedded many financial institutions even more closely to the euro area's sovereign debt. Substantial fiscal and structural reforms are needed to resolve the euro area sovereign debt crisis and boost growth and employment. There is still the potential for events to derail the progress achieved to date and for this to happen quickly.

Global oil prices have been drifting upwards since mid-February 2012, although it is difficult to disentangle how much of this reflects political tensions surrounding the Middle East, and how much stems from other factors. For example, improving sentiment over the economic prospects for the United States and the global economy, and oil supply disruptions in Syria, Yemen and Sudan have all played a role in pushing oil prices higher since the start of 2012. If tensions in the Middle East escalate, a sharp rise in oil prices could occur. A significant and sustained oil price shock would pose a major risk to global economic growth prospects.

THE OUTLOOK FOR THE DOMESTIC ECONOMY

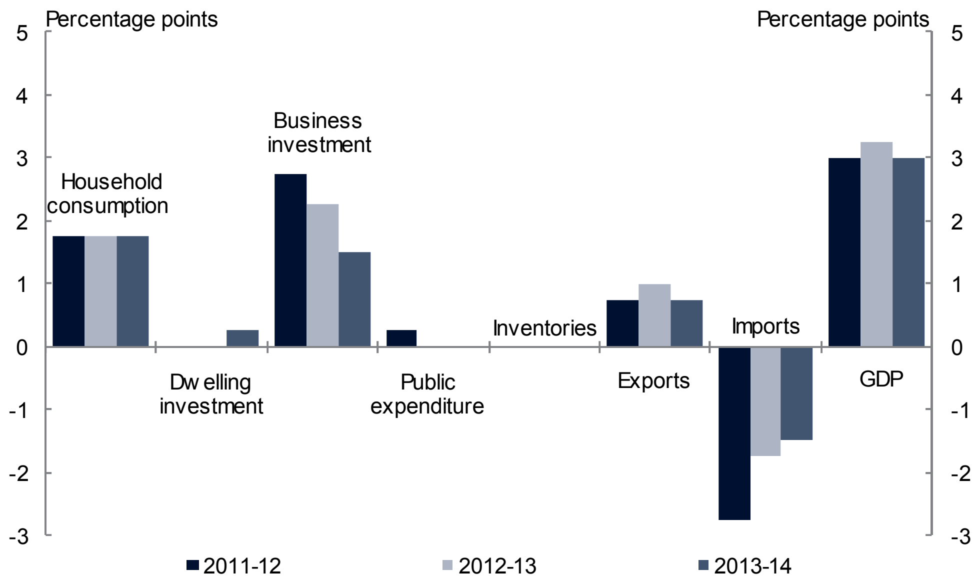
Demand and output

The Australian economy is expected to grow at around trend over the next two years, with real GDP growth forecast to be 3¼ per cent in 2012-13 and 3 per cent in 2013-14.

Growth is expected to be driven by surging resources sector investment and growth in non-rural commodity exports. Growth is also expected to be supported by moderate growth in household consumption. However, there is expected to be little contribution from either dwelling investment or public spending (Chart 5).

Economic conditions are expected to remain uneven across sectors over the forecast period. The resources and resources-related parts of the economy are expected to grow strongly, but activity in other parts of the economy is likely to be uneven. While some parts of the services sector are expected to continue performing solidly, pressures from the ongoing global uncertainty, the high Australian dollar, consumer caution and changes in expenditure patterns (Box 4) are all expected to continue to weigh heavily on other sectors, particularly retailing, manufacturing and tourism.

Chart 5: Contributions to real GDP growth



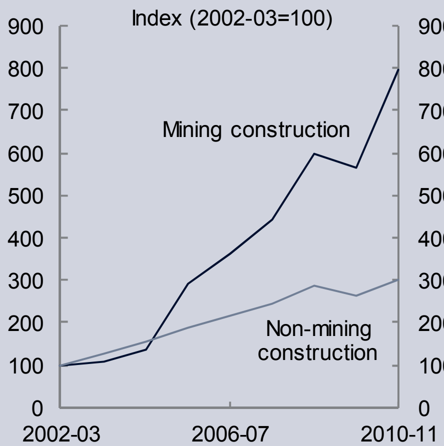
Note: Business investment and public expenditure are adjusted for second-hand asset sales from the public sector to the private sector.
Source: ABS cat. no. 5206.0 and Treasury.

Box 2: Direct spillovers from the resources boom

The mining sector (which includes liquefied natural gas) directly produces over 9 per cent of the economy's output and employs around 2 per cent of the workforce. While the mining sector is still relatively small, it is contributing both directly and indirectly to higher activity across a range of other sectors in the economy.

A substantial part of resources-related activity is occurring in the construction sector. The construction sector supports the mining sector through the construction of mines and plants, road and rail infrastructure, and through dwelling construction. With other areas of construction weak, mining sector demand is providing timely support for the sector. Around 60 per cent of capital expenditure on buildings and other structures over the past year has been mining related, up from 29 per cent at the start of the mining boom in 2003-04 (Chart A).

Chart A: Buildings and other structures (capital expenditure)



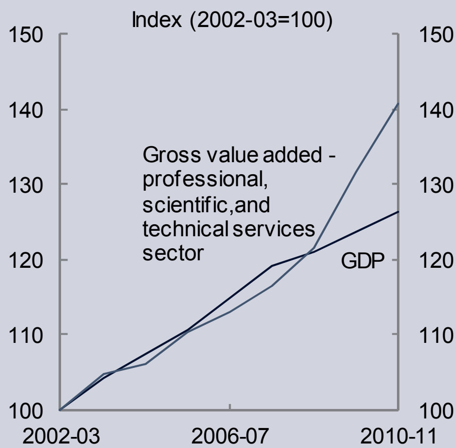
Source: ABS cat. no. 5625.0 and Treasury.

There is also resources-related activity occurring in the manufacturing sector, especially in that part which makes specialised machinery for mining. The mining sector also generates investment in research and development and mineral and petroleum exploration, which have grown strongly in recent years.

The resources sector supports activity in the transport sector as a significant user of road and rail networks, port facilities and shipping.

The resources sector also has direct spillovers to the services sector, including, for example, the financial and insurance services sector, and the professional, scientific and technical services sector, which has grown strongly in recent years (Chart B).

Chart B: Professional, scientific and technical services



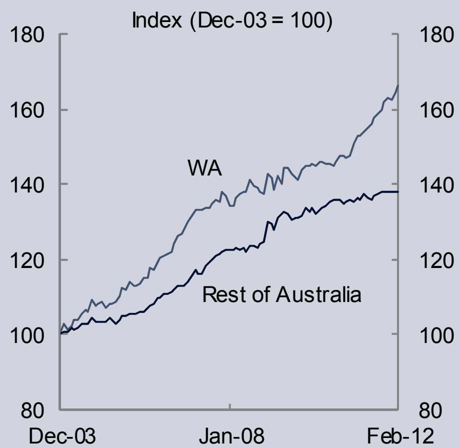
Source: ABS cat. no. 5206.0 and Treasury.

The Government is also helping spread the benefits of the boom, for example, through the Minerals Resource Rent Tax and other targeted policy initiatives.

Box 3: Indirect spillovers from the resources boom

The mining sector has substantial indirect effects on many parts of the economy. For example, the strong growth in incomes in the mining sector is supporting retail activity, particularly in the resources states, helping to offset some of the broader weakness in the sector. Retail sales in Western Australia (WA) have grown 6.4 per cent per year since the start of the mining boom compared with 4.0 per cent for the rest of Australia (Chart A).

Chart A: Retail sales



Source: ABS cat. no. 8501.0 and Treasury.

The effects of the boom are also being felt outside of the resources states, with consumption growing around trend nationally during 2011. One channel is through the fly-in fly-out (FIFO) workforce, which has been expanding rapidly in recent years. The Chamber of Minerals and Energy of Western Australia estimates that in 2011 over 50 per cent of the WA mineral and energy sector's workforce was employed on FIFO rosters and this is expected to continue to rise.

Over the year to July 2011, the fastest growing domestic airline routes were predominantly those involving key mining centres (such as Newman and Port Hedland) and Perth. Growth in aircraft movements to mining centres such as Port Hedland, Karratha, Newman and Gladstone has averaged around 10 to 20 per cent from 2008 to 2011, compared with a national average of around 2 per cent. While there are concerns about FIFO in some host communities, it is helping to spread the income and spending associated with the resources boom to many other parts of the country.

The benefits of the boom are also being shared in ways that are less obvious. For example, the sharp increase in commodity prices since the start of the mining boom has also been accompanied by a substantial rise in the Australian dollar. While this has made conditions more challenging for many businesses, it has helped hold down the prices of imported goods, including consumption imports and capital goods imports.

Indeed, the prices of goods, including manufactured goods and food, have only grown, on average, by about 0.6 per cent per year since the start of the boom, while household incomes have grown, on average, by 7.2 per cent per year. This has left households with more income to spend on services, where activity has increased strongly over recent years, generating large increases in employment and declines in many regional unemployment rates, not just in the resources states.

Household consumption

Household consumption growth is expected to be moderate over the next two years in line with slower, albeit still-solid growth in household income.

Global instability and ongoing global uncertainty have dampened consumer confidence and reinforced the cautious consumer attitudes to borrowing and spending that have persisted since the global financial crisis. Borrowing is unlikely to provide much support for consumption. With consumers reluctant to take on new loans and having a greater propensity to pay down existing debt, credit growth is likely to be much lower than it has been over recent decades.

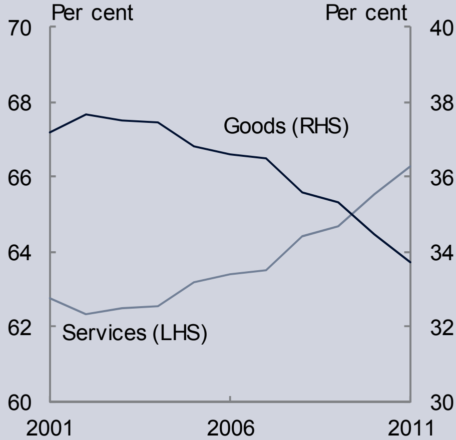
Difficult global conditions have reduced real household net worth, which is considerably lower than a year ago and well below pre-GFC levels, despite the cautious recovery in share prices and stabilisation in house prices in recent months. Households are expected to continue to save at elevated rates, rebuilding wealth and strengthening their balance sheets.

In this environment, consumption growth is likely to be more closely tied to income growth. Consumption growth is forecast to be 3¼ per cent in 2011-12, before easing to 3 per cent in both 2012-13 and 2013-14.

Box 4: Changing patterns of consumer spending

The past decade has seen ongoing changes in the pattern of consumer spending, with the services share of nominal household consumption continuing to rise and the goods share continuing to decline (Chart A).

Chart A: Services and goods shares of nominal household consumption



Source: ABS cat. no. 5206.0 and Treasury.

The solid growth in the share of consumption of services reflects a range of factors, particularly the strong growth in real household income, which grew by an average of around 4 per cent per year over the past decade.

This has seen increased demand, particularly for some services such as overseas travel and recreation, the consumption of which has grown relatively rapidly as households have become wealthier.

Trends in consumer tastes and the rise of new products in areas such as cultural and entertainment services, have also supported services demand.

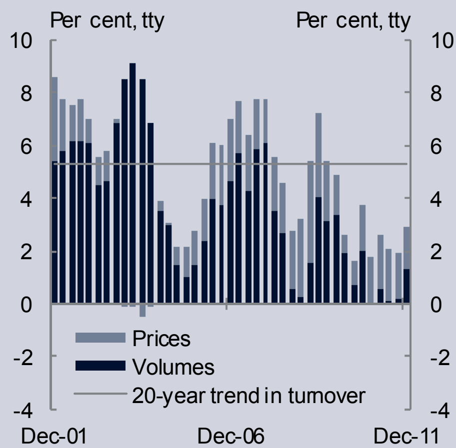
Services demand has also been supported by household preferences to maintain similar levels of consumption of 'essentials', like housing and utilities, even in the face of substantial price rises over the past decade.

The declining share of household spending on goods has contributed to particularly challenging conditions for Australian retailers in recent years.

Retailers have also been affected by higher rates of household saving and a reluctance of households and businesses to take on more debt. The high dollar has also seen Australian consumers spend more on overseas travel.

These factors have seen subdued growth in domestic retail volumes and prices, with aggregate turnover growing well below trend over recent years (Chart B).

Chart B: Retail trade turnover



Source: ABS cat. no. 8501.0.

Box 4: Changing patterns of consumer spending (continued)

Within retail, the pattern of demand has been uneven. While sales growth has been especially subdued for clothing and book retailing and department stores, other retail segments such as food and beverages, and pharmaceuticals retailing have fared considerably better.

While the internet has opened up new opportunities for businesses to expand their customer base, it has also contributed to easier price discovery and a compression of some retailers' margins. However, it does not appear to be responsible for the recent slowdown in retail sales.

The Productivity Commission estimates that, despite strong growth, total internet sales account for only 6 per cent of total retail sales in Australia, and that only around 2 per cent of total retail sales (or $4.2 billion) are sourced from overseas internet retailers.

As in the rest of the economy, patterns of demand are changing, even within the retail sector, challenging some businesses and providing opportunities for others.

Dwelling investment

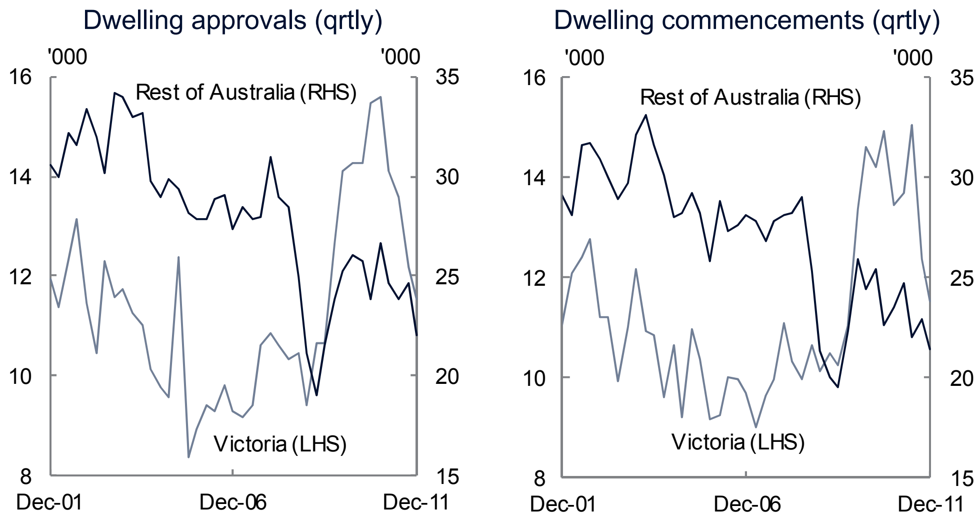
The outlook for dwelling investment is subdued, reflecting weak demand (due in part to households' cautious attitude towards taking on new debt, notwithstanding the prospect of lower mortgage interest rates) and ongoing supply constraints in some areas.

Over the past three years dwelling investment has been supported by particularly strong growth in Victoria's new housing market, but that market is now returning to more normal levels of activity, while demand in other markets is expected to remain weak. Outside Victoria, ongoing supply constraints associated with state and local planning and approval processes, as well as high costs of development and land release restrictions are also expected to continue to restrain dwelling investment growth.

Dwelling investment is expected to contract by 1 per cent in 2011-12. This reflects very weak recent outcomes and the ongoing deterioration in near-term forward indicators, with dwelling approvals and commencements both declining in 2011, also led by Victoria. (Chart 6).

Dwelling investment is forecast to be flat in 2012-13 before recovering a little in 2013-14.

Chart 6: Forward indicators of dwelling investment



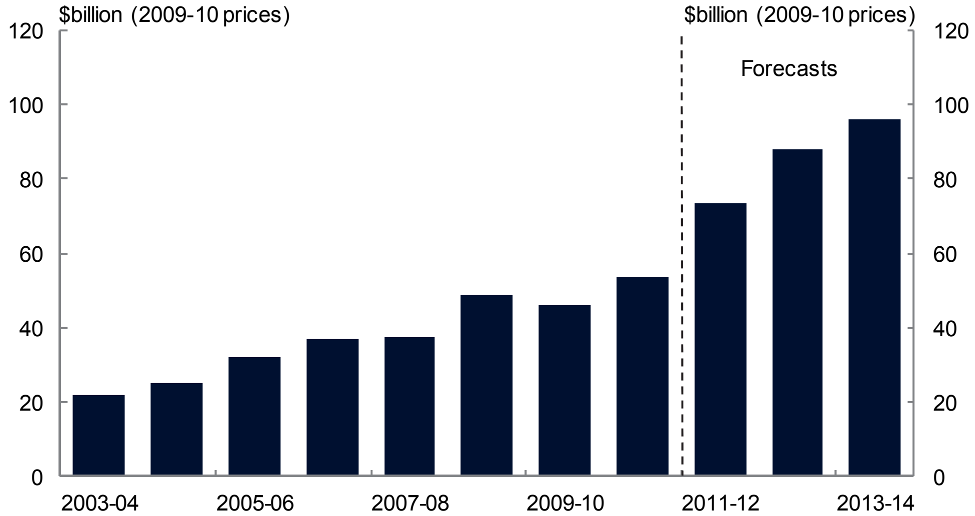
Source: ABS cat. no. 8731.0 and 8750.0.

Business investment

An expectation of strong ongoing demand for Australia's non-rural commodity exports over the next decade, particularly from Asia, continues to underpin robust growth in new business investment in the resources sector and record investment intentions. Growth in resources investment has rapidly gathered momentum over the past year and this is expected to continue in 2012-13 and 2013-14. Total resources investment, including exploration and research and development, is expected to reach around 9 per cent of GDP in 2013-14. However, elsewhere in the economy, the investment outlook is more subdued, with investment in non-resources-related machinery and equipment and non-residential building expected to record only modest growth. New business investment is expected to grow a robust 12½ per cent in 2012-13 and 8 per cent in 2013-14, taking it to record levels as a share of GDP.

Investment in the resources sector continues to be strong despite global uncertainty. The most recent ABS *Private New Capital Expenditure and Expected Expenditure* survey reported record highs in both actual and expected expenditure levels in the resources sector, with investment intentions jumping to a record $120 billion in 2012-13 from an expected $95 billion in 2011-12. Despite ongoing global uncertainty, the resources sector has committed to, or commenced construction on, over half of the estimated $456 billion resources investment pipeline. The strength of investment in the resources sector is expected to continue to be largely related to new engineering construction investment. Engineering construction investment has surged over the past year, up nearly 50 per cent in through-the-year terms, and is expected to continue to grow rapidly over the next two years. New engineering construction is forecast to grow 20½ per cent in 2012-13 and 9 per cent in 2013-14 (Chart 7).

Chart 7: New engineering construction (volumes)



Source: ABS cat. no. 5206.0 and Treasury.

The surge is underpinned by large-scale investment in the liquefied natural gas sector, although the iron ore and coal sectors will also make significant contributions. Over $80 billion of liquefied natural gas investment has received final investment approval in the past year, despite challenging global conditions.

New machinery and equipment investment is also expected to grow solidly over the next two years, driven by investment in the resources and resources-related sectors. Investment is also expected to be supported by taxation reforms commencing in the 2012-13 income year that will allow small businesses to immediately write off assets costing less than $6,500 and claim up to $5,000 as an immediate deduction on the purchase of any new or used motor vehicle costing $6,500 or more. Investment in new machinery and equipment is forecast to grow 12½ per cent in 2012-13 and 8½ per cent in 2013-14.

Investment in new non-residential building is expected to remain subdued over the next two years, despite some recent improvement. Underlying demand in the sector, particularly for new office and retail floor space, continues to be weighed down by the moderate employment outlook and weakness in some non-resources related sectors of the economy. Investment in new non-residential buildings is expected to fall ½ of a percentage point in 2012-13 before growing a modest 3½ per cent in 2013-14.

Box 5: Manufacturing

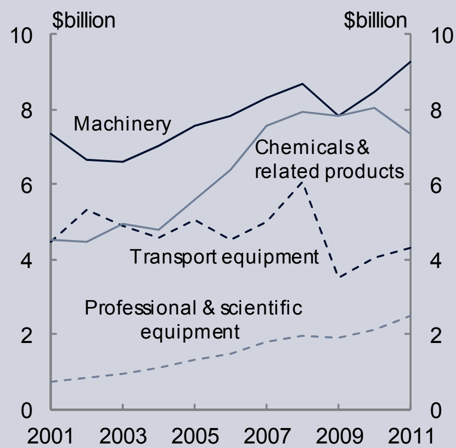
Manufacturing output has grown over the long term, but as a share of total output it has been trending down for many years, consistent with the experience of most advanced economies. Recently, the sustained high Australian dollar has placed additional pressure on the sector, accelerating the transition.

Over the past decade, manufacturing's share of output has fallen from over 12 per cent to around 8½ per cent, while its share of employment has fallen from over 11 per cent to around 8½ per cent.

However, these high-level trends mask important differences, with some parts of manufacturing struggling while other parts are doing well.

Those industries that are linked to Australia's resources sector, or are higher up the value chain and more reliant on human capital, are generally performing better than others.

Chart A: Manufacturing export volumes



Source: ABS cat. no. 5302.0.

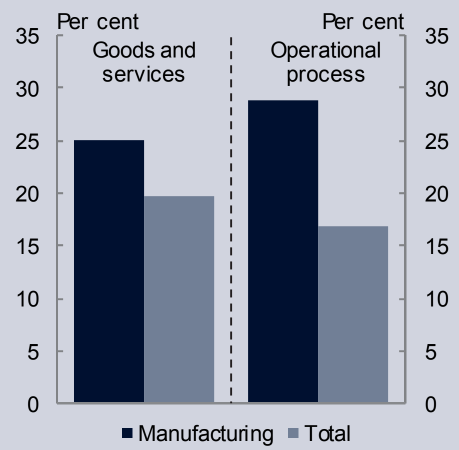
Over the past decade, professional and scientific equipment exports have tripled, while chemicals and related-products exports have increased by around 60 per cent. Exports of machinery have also grown solidly (Chart A).

Despite a difficult backdrop, there is evidence that manufacturing firms continue to look to become more competitive, both by bringing new products to market, as well as by driving productivity gains through improved processes and systems.

Around 25 per cent of manufacturing firms reported introducing new or significantly improved goods in 2009-10, with manufacturing exceeding the economy-wide average, as it has done for many years.

Manufacturing firms have also been more likely to innovate in the way they do business. In 2009-10, almost 30 per cent of manufacturers reported making process innovations such as in methods of manufacturing, logistics and distribution and back-office functions — almost twice the proportion for the economy as a whole (Chart B).

Chart B: Manufacturing innovation (2009-10)



Source: ABS cat. no. 8167.0.

Public final demand

Public final demand is expected to fall in 2012-13 and remain flat in 2013-14. Falling Commonwealth Government spending in 2012-13 is expected to be partially offset by weak, albeit positive growth in state spending, consistent with recent state budget updates, notwithstanding the planned fiscal consolidations announced by most states.

Exports and imports

Export volumes are forecast to increase solidly in 2012-13 and 2013-14, as the current resources investment boom translates into significant new production and export capacity in the resources sector. Exports are expected to continue to be supported by the strong outlook for Australia's major trading partners (Box 6), which is offsetting some of the drag caused by the high Australian dollar. Exports are forecast to increase by 4½ per cent in each of 2012-13 and 2013-14.

Non-rural commodity exports are expected to grow strongly over the next two years as ongoing expansions in mines, ports and rail capacity facilitate greater production and export volumes. There are currently a number of major expansions underway in Western Australia and along the east coast, which are expected to significantly boost iron ore and coal exports over the next two years, notwithstanding some expected delays, particularly in regard to metallurgical coal. Non-rural commodity exports are expected to grow 7½ per cent in 2012-13 and 5½ per cent in 2013-14.

Rural exports are expected to increase 8 per cent in 2011-12 and remain at historically high levels over the next two years, in line with a strong outlook for farm production. Favourable seasonal conditions for the winter crop, particularly in Western Australia, are expected to result in a record crop, notwithstanding lower yields in the eastern states associated with adverse weather conditions. Recent rainfall is bringing increased availability of irrigation water and improved sub-soil moisture levels and is expected to support a strong summer crop in 2012-13.

Elaborately transformed manufactures exports are expected to rise modestly over the next two years. While demand is expected to rise in line with the strong outlook for Australia's major trading partners, the high exchange rate is expected to continue to weigh on growth. Elaborately transformed manufactures exports are expected to increase 2½ per cent in 2012-13 and 3 per cent in 2013-14.

Services exports have been trending downwards for the past two years, and this weakness is expected to continue in the near term. The high Australian dollar is weighing heavily on some sectors, particularly tourism and exports of education-related travel services. Exports of services are expected to fall 5½ per cent in 2011-12 before recovering slowly, growing 1½ per cent in 2012-13 and 3 per cent in 2013-14.

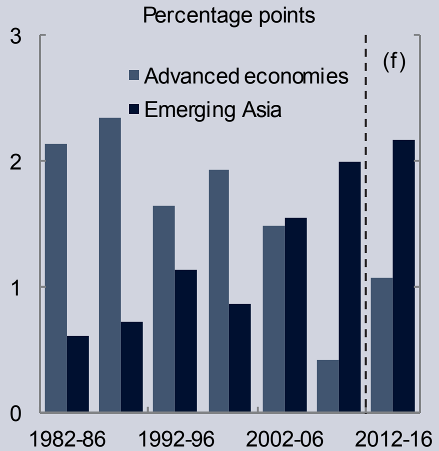
Box 6: The impact of emerging Asia on Australian exporters

The global economy is undergoing a dramatic structural change with the weight of economic activity shifting quickly towards Asia.

Emerging economies, particularly in Asia, have become a key driver of global growth (Chart A). Emerging economies are expected to contribute around three quarters of the world's economic growth over the next five years.

Australia's natural resource base and location in the Asian region have allowed our exporters to take advantage of the expanding markets of emerging Asia at a time of relative weakness in the world's advanced economies.

Chart A: Contributions to global growth (5-yr annual average)

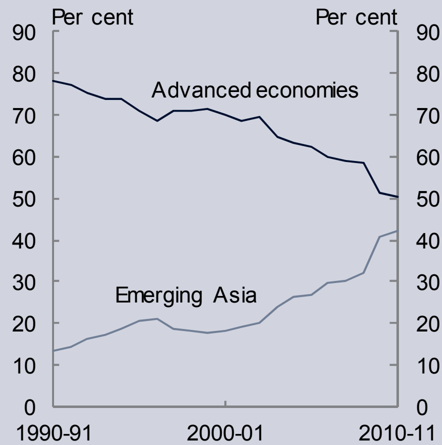


Note: IMF forecasts 2012-16.
Source: IMF and Treasury.

While China has been a significant contributor due to its size and strong growth, all the key emerging economies of Asia (including India, Indonesia, Malaysia and Vietnam) have grown more rapidly than the advanced economies.

Australian businesses have been re-orientating their exports toward emerging Asia for many years and this shift has been even more marked since the global financial crisis (Chart B).

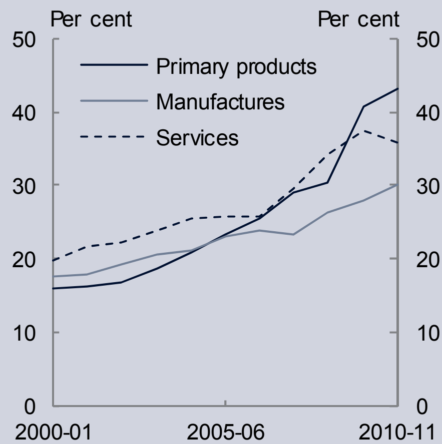
Chart B: Merchandise export shares



Source: ABS cat. no. 5368.0 and Treasury.

The re-alignment is most stark for commodities but is evident in all major export classes (Chart C).

Chart C: Emerging Asia's share of major export classes



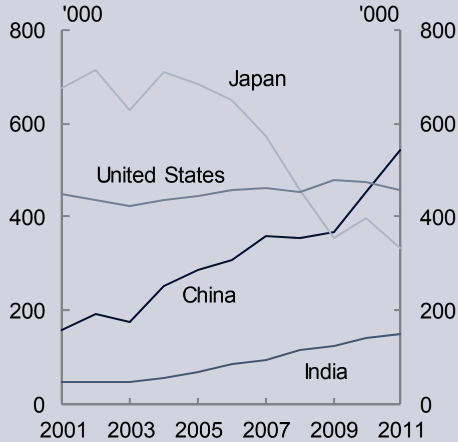
Source: Department of Foreign Affairs and Trade and ABS cat. no. 5368.0.55.003.

Box 6: The impact of emerging Asia on Australian exporters (continued)

The emergence of Asia is likely to provide increasing opportunities for Australia's manufacturing and service sectors. With large populations and strong incomes growth, China and India are expected to experience a surge in middle income consumers in coming years. By 2030 there are expected to be over 3 billion people in the middle income bracket in the Asia Pacific region. As their incomes increase they will spend more on high-value manufactured goods (such as medical and pharmaceutical products) and services (such as health, education, finance and tourism), and food, providing opportunities for Australian businesses.

These changes are already underway. For example, over the past decade Chinese visitor arrivals have increased from around 160,000 per year to around 540,000 per year and Indian visitor arrivals have increased from around 50,000 per year to around 150,000 per year (Chart D).

Chart D: Overseas arrivals



Note: Includes visitors for purposes of education and employment who intend to stay in Australia for less than one year.
Source: ABS cat. no. 3401.0.

The strong growth in Asia is providing strong support for exporters at a time of a high exchange rate and weakness in the advanced economies. These opportunities will continue to expand — for resources companies, high-end manufacturers, service providers and rural commodity producers — as the Asian Century proceeds.

Imports are forecast to increase strongly over the next two years, underpinned by record levels of import-intensive investment in the resources sector and the high Australian dollar. The resources investment boom is fuelling significant demand for imports, particularly capital goods imports for the liquefied natural gas sector where around two-thirds of capital investment is imported. Outside the resources sector, imports of consumption goods and travel services are also expected to record solid growth as consumers continue to take advantage of the high Australian dollar. Total import volumes are forecast to grow 7½ per cent in 2012-13 and 5½ per cent in 2013-14.

Terms of trade

The terms of trade are likely to have peaked in the September quarter of 2011 and are expected to fall over the next two years as prices for Australia's key commodity exports ease in line with growing world supply (Chart 8). Despite the forecast decline in prices, the terms of trade are expected to remain close to historical highs over the forecast period. The terms of trade are expected to decline gradually over the medium term.

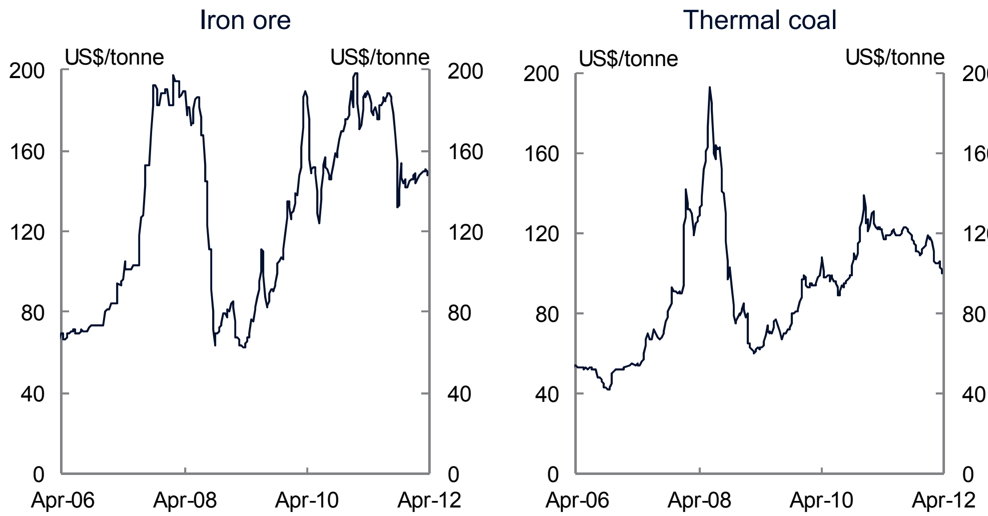
Chart 8: Terms of trade

Source: ABS cat. no. 5206.0 and Treasury.

The prices of Australia's key non-rural commodity exports experienced significant falls during the financial turmoil in the second half of 2011. However, since then, iron ore and coal prices have been relatively stable (Chart 9).

Strong growth in Asia, particularly China, is expected to continue to support strong demand for iron ore and coal. However, increasing global supply, led by Australia, is expected to weigh on prices over the next two years. Accordingly, despite the continued positive outlook, the terms of trade are forecast to fall 5¾ per cent in 2012-13 and 3¼ per cent in 2013-14.

Chart 9: Bulk commodity prices

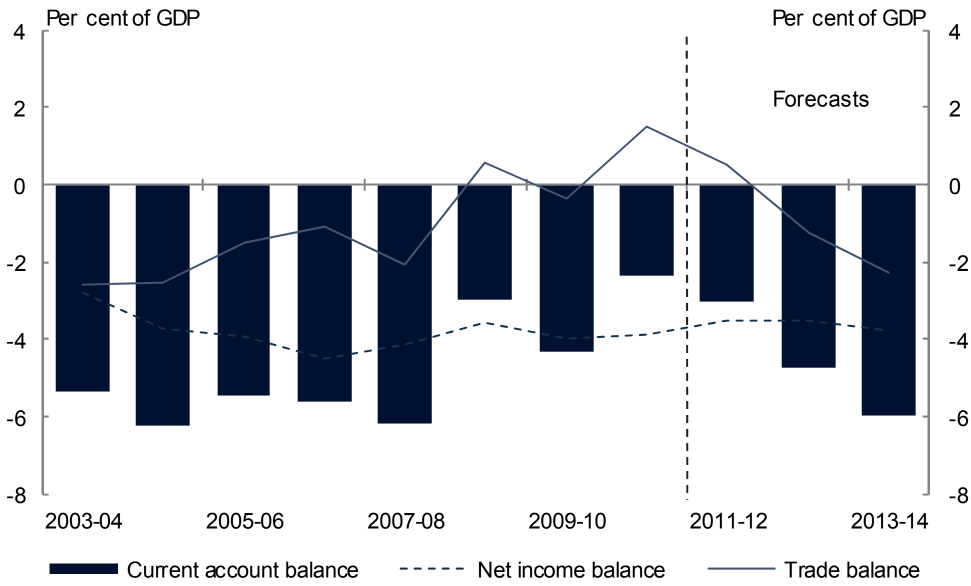


Source: Bloomberg.

Current account balance

The current account deficit is expected to widen to 4¾ per cent of GDP in 2012-13 and 6 per cent of GDP in 2013-14 (Chart 10), as the trade balance moves into deficit, driven by declining non-rural commodity prices and surging import volumes associated with the resources investment boom (Box 7).

Chart 10: Current account balance



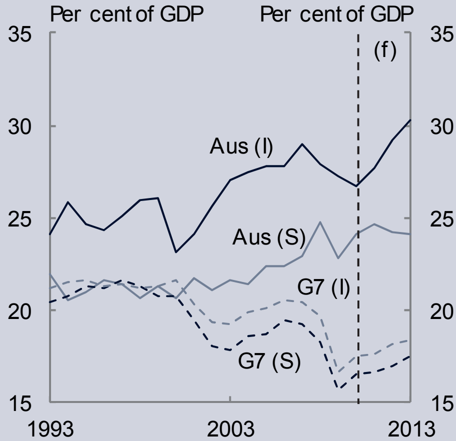
Source: ABS cat. no. 5206.0, 5302.0 and Treasury.

Box 7: Resources investment and the current account

The resources boom is driving unprecedented levels of investment in Australia. This is leading to a surge in capital goods imports and an expected temporary widening of the current account deficit. High levels of investment are boosting Australia's production capacity.

Historically, Australia has been a large net importer of capital, running current account deficits for most of its history, driven by our very high investment rates. Both Australia's investment rate and saving rate are high compared with the major advanced economies (Chart A).

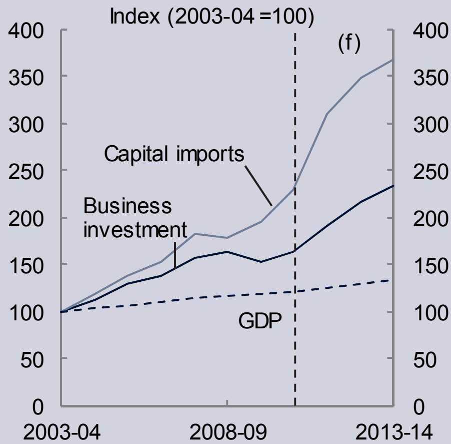
Chart A: Gross saving/investment



Note: Australia data refer to financial years beginning 1993-94. Data for G7 refer to calendar years beginning 1993.
Source: ABS cat. no. 5206.0 IMF and Treasury.

After a temporary GFC-related decline, resources investment is now growing strongly. As resources investment is highly import-intensive, imports have also surged, with imports of capital goods more than doubling since the start of the boom (Chart B).

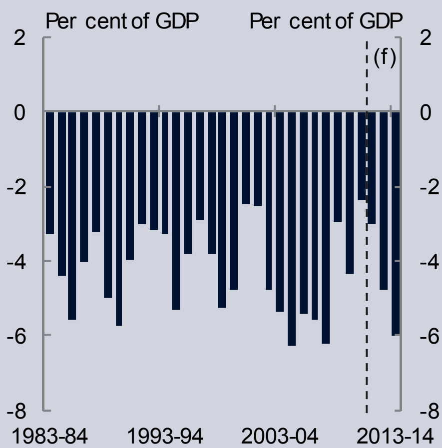
Chart B: Investment and imports



Source: ABS cat. no. 5206.0, 5302.0 and Treasury.

Over the next two years, new business investment and capital imports are expected to reach record highs as a percentage of GDP and the current account deficit is expected to widen (Chart C).

Chart C: The current account



Source: ABS cat. no. 5206.0, 5302.0 and Treasury.

As the boom matures, exports should strengthen in line with the increased productive capacity of the resources sector and capital imports should ease, returning the current account to more normal levels.

Labour market

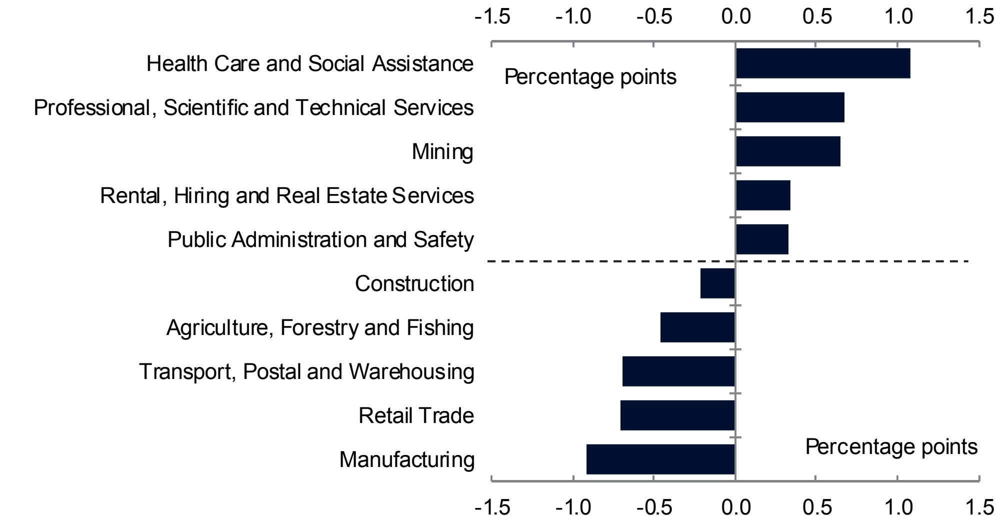
Despite ongoing global weakness and uncertainty, Australia's unemployment rate has remained low and stable and is well below rates in most advanced economies. At close to 5 per cent, it is currently half that in Europe and significantly less than in the United States (Box 1). Employment growth has averaged around 1¾ per cent per year over the past three years and over 500,000 jobs have been created.

However global uncertainty, the impact of the high exchange rate, consumer caution, and shifting patterns of demand have all made employers more hesitant to hire new workers. Following strong employment growth in 2010, there was little employment growth in 2011.

Instead, employers have responded to increased labour demand by increasing the average number of hours employees work each week. Had average hours not increased, there would have been around 66,000 additional jobs created in the 12 months to March 2012.

Aggregate employment outcomes conceal the ongoing transition in employment that is occurring at a sectoral level. Resources-related sectors (such as mining and mining-related construction) and public, social and some service-related sectors (such as health care and social assistance, professional, scientific and technical services, and rental, hiring and real estate services) all recorded significant increases in their shares of employment over the past three years. However, other sectors (such as manufacturing, retail trade, and transport, postal and warehousing) recorded substantial declines in their shares over the same period (Chart 11).

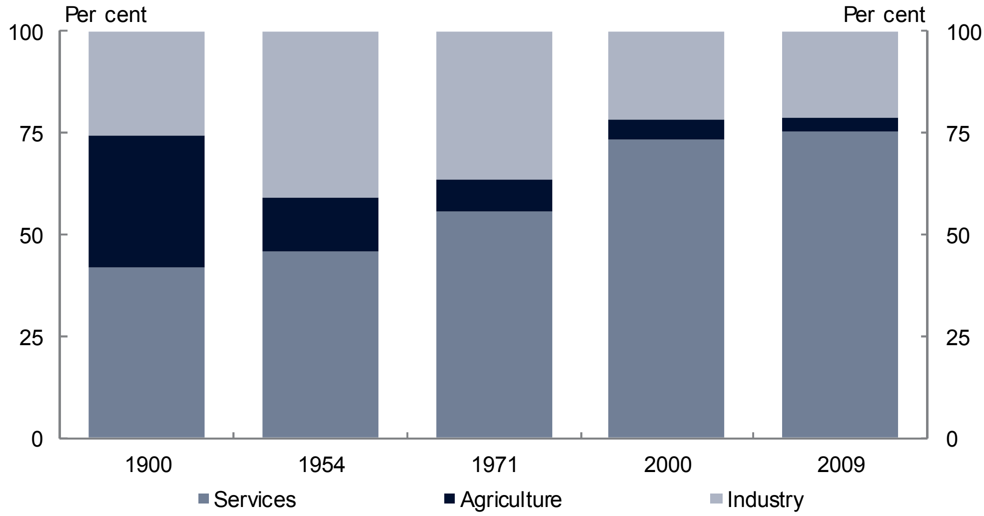
Chart 11: Change in employment share — February 2009 to February 2012



Note: This chart shows the five industry categories with the largest increase in employment share over the past three years and the five categories with the largest decrease over the same period.
Source: ABS cat. no. 6291.0.55.003.

With patterns of demand changing and the economy in a long-term transition, the shift in resources towards the fast-growing sectors of the economy is likely to continue with solid, albeit weaker, employment growth expected in the services sector and strong employment growth in the rapidly expanding but less labour-intensive resources and resources-related sectors over coming years (Chart 12).

Chart 12: Employment share by activity over time



Source: Feinstein (1999), OECD Statistics and Treasury.

The solid growth in the services sector and other sectors benefiting from the resources boom is expected to be partly offset by the continued movement of resources out of some of the labour-intensive sectors such as retail and manufacturing. Nevertheless, overall employment growth is expected to strengthen, though remain modest. Employment is forecast to grow 1¼ per cent through the year to the June quarter of 2013 and 1½ per cent through the year to the June quarter of 2014. Over 360,000 jobs are expected to be created over the forecast period. This builds on the more than 750,000 jobs created since late 2007.

The unemployment rate is expected to drift up slightly over coming quarters, in line with the modest growth in employment, reaching 5½ per cent in the June quarters of both 2013 and 2014. However, the uneven pattern of sectoral growth is expected to continue to pose a downside risk to the labour market, with the possibility that frictional unemployment could temporarily rise as businesses adjust to changing patterns of demand and workers look to find new opportunities in emerging parts of the economy.

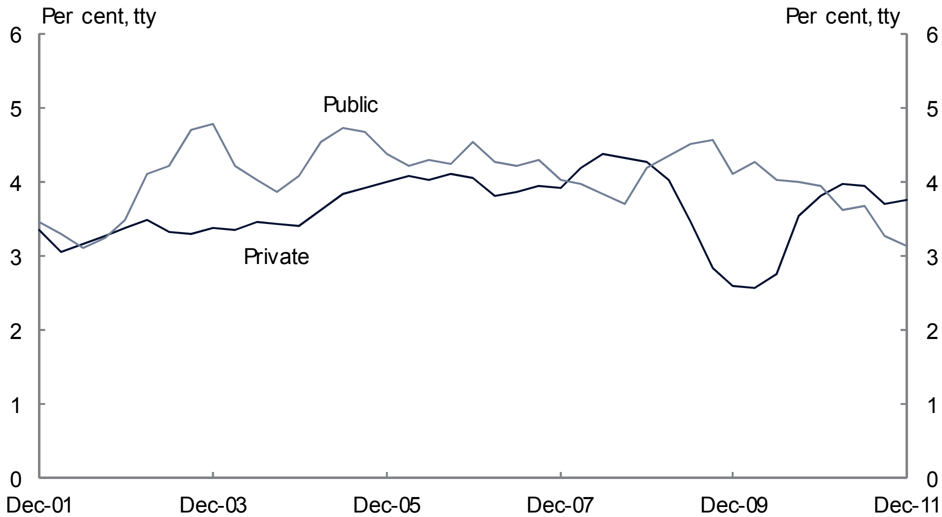
The labour force participation rate has declined over the past year, falling around ½ of a percentage point, partly reflecting the first baby boomers leaving the workforce. Despite these falls, the national participation rate continues to be high in historical terms, and is expected to remain at around 65¼ per cent over the next two years.

Wages

Wages growth stabilised in 2011, with private sector wages growing at a faster rate than public sector wages throughout 2011 (Chart 13). Wages growth is currently below trend, and is expected to remain modest over the next two years in line with the slight rise in the unemployment rate and contained inflation.

The Wage Price Index is expected to grow 3½ per cent through the year to the June quarter of 2012 and by 3¾ per cent through the year to the June quarter of both 2013 and 2014.

Chart 13: Growth in the wage price index



Source: ABS cat. no. 6345.0.

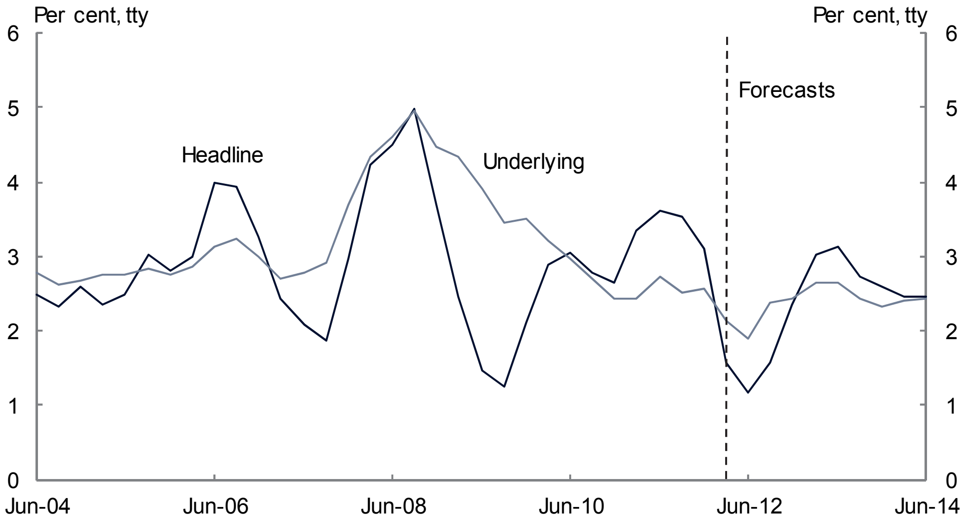
Consumer prices

Headline and underlying measures of inflation are expected to remain contained over the next two years, consistent with an economy growing around trend and the relatively stable labour market outlook, notwithstanding the one-off price increases associated with the introduction of the carbon price on 1 July 2012.

Underlying inflation was moderate during 2011, despite the temporary price rises associated with the natural disasters. Looking ahead, underlying inflation is forecast to be 2 per cent through the year to the June quarter of 2012, and 2¾ per cent through the year to the June quarter of 2013 (including a one-off carbon price impact of ¼ of a percentage point) before easing to 2½ per cent through the year to the June quarter of 2014.

Headline inflation has eased in recent quarters as the temporary price effects of the 2011 natural disasters have washed out and is expected to be just 1¼ per cent in through-the-year terms to the June quarter of 2012. Headline inflation is then expected to rise temporarily to 3¼ per cent in through-the-year terms to the June quarter of 2013, (including a one-off carbon price impact of ¾ of a percentage point) before easing back to 2½ per cent in through-the-year terms to the June quarter of 2014 (Chart 14).

Chart 14: Headline and underlying inflation



Note: The underlying inflation measure is the average of the trimmed mean and weighted median.
Source: ABS cat. no. 6401.0 and Treasury.

Box 8: The effect of carbon pricing on the economy

The carbon price modelling, outlined in the update to the *Strong growth, low pollution* report issued by the Treasury on 21 September 2011, shows the Australian economy will continue to prosper as Australia moves to a clean energy future. It shows that GDP and Gross National Income will continue to grow solidly under the policy.

The forecasts incorporate the impact of the carbon price as outlined in the modelling. The carbon price is not expected to have a material impact on the domestic economic outlook with real GDP growth and employment growth expected to be reduced by less than ¼ of a percentage point in 2012-13, with no discernible impact on the forecast unemployment rate.

After the initial introduction of the scheme, smaller changes in the carbon price are expected to result in correspondingly smaller impacts on GDP growth in subsequent years.

The carbon price is expected to result in a one-off 0.7 per cent increase in consumer prices in 2012-13. Nine out of 10 households will receive assistance to help with the cost of living impact of the carbon price through increases in Government payments and/or tax cuts.

For almost 6 million households the assistance will be sufficient to cover their average expected price impact.

Assistance through Government payments will begin to be delivered with the Clean Energy Advance to be paid in May and June, and tax cuts will take effect from 1 July 2012.

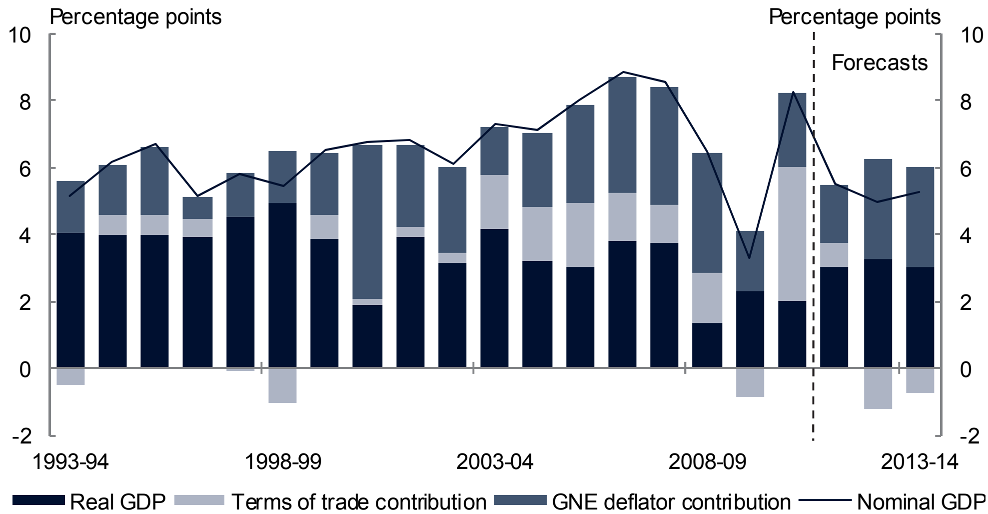
Lower and middle income families typically have higher marginal propensity to consume than high income earners, so the targeted household compensation payments to this group should support aggregate consumption spending. Accordingly, the policy change is expected to have only minimal effects on aggregate household real consumption.

A carbon price is the cheapest and most efficient means of gradually transforming the economy to a clean energy future. It creates incentives for business to invest in clean technology or find smarter, less energy-intensive way of operating. Around $100 billion of investment in new clean energy sources such as solar, wind and geothermal will be unleashed over the period to 2050.

Incomes

Nominal GDP is forecast to grow 5 per cent in 2012-13 and 5¼ per cent in 2013-14. This reflects the expected decline in the terms of trade over the period, combined with around-trend real GDP and domestic prices growth (Chart 15). Nominal GDP is distributed throughout the economy mainly as compensation of employees, gross operating surplus and gross mixed income.

Chart 15: Components of nominal GDP growth



Note: The small discrepancy between nominal GDP and the sum of its components is due to interactions which cannot be attributed to individual components.
Source: ABS cat. no. 5206.0 and Treasury.

Gross operating surplus is forecast to grow 4¾ per cent in 2012-13 and 5¼ per cent in 2013-14. Growth is expected to slow from the robust rates experienced over recent years as the softening terms of trade and patchiness in the non-resources economy weigh on profit growth. Compensation of employees is forecast to grow 5 per cent in 2012-13 and 5½ per cent in 2013-14, reflecting the more subdued outlook for wages and employment over the period. The decline in the terms of trade is expected to result in a decline in the profits share (and a corresponding rise in the wages share) of income over the next two years.

Gross mixed income, which includes the wages and profits of farms and other unincorporated enterprises, is forecast to grow 3¼ per cent in 2012-13 and 4¼ per cent in 2013-14.

Medium-term projections

The fiscal aggregates in the Budget are underpinned by a set of forward estimates consisting of short-term economic forecasts and projections based on medium-term assumptions.

The economy is projected to operate at capacity over the projection period. Real GDP is projected to grow at its trend rate of around 3 per cent per year over the two projection years of the forward estimates (Chart 16).

Beyond the forward estimates, GDP is projected to grow at around 3 per cent until 2018-19, when trend growth is projected to slow as population ageing generates a gradually falling participation rate.

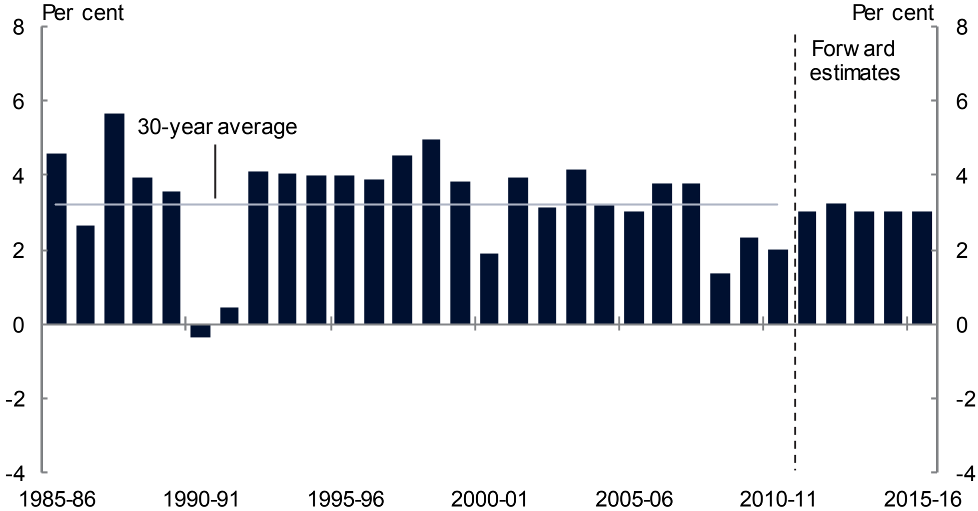
The unemployment rate is projected to be 5 per cent over the medium term. This assumption has long been used for medium-term projections and is near current estimates of the non-accelerating inflation rate of unemployment.[1] Inflation is projected to be 2½ per cent, consistent with the Reserve Bank 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, settling around 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 around its recent average level 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. This technical assumption was introduced in the 2011-12 Budget to provide greater internal consistency during the projection period. The current terms of trade projections imply a fall in the real exchange rate of 0.9 per cent per annum over the projection period.

1 The Treasury's estimates are based on a methodology detailed in Gruen, Pagan and Thompson (1999), 'The Phillips curve in Australia', Journal of Monetary Economics, and updated in Kennedy, Luu and Goldbloom (2008), 'Examining full employment in Australia using the Phillips and Beveridge Curves', The Australian Economic Review.

Chart 16: Real GDP growth over the forward estimates period



Source: ABS cat. no. 5206.0 and Treasury.