

PART 2: ECONOMIC OUTLOOK

OVERVIEW

Since the 2013 PEFO there has been a substantial deterioration in the domestic outlook for both real and nominal GDP growth. The Australian economy is expected to transition from resources to non-resources drivers of growth. But this transition is likely to be slower than previously forecast. Resources investment is expected to fall more sharply, while activity in the non-resources sectors has been subdued, with positive signs in those sectors thus far limited largely to the established housing market, above average measures of consumer sentiment and improving business sentiment. Despite this, sustained low interest rates, particularly if combined with further falls in the exchange rate, should support a recovery across the economy more broadly.

Forecast wage growth has also been revised lower, further weighing on forecast nominal GDP and, in turn, forecast tax receipts and the budget position.

The softness in the non-resources sectors of the economy is weighing on the labour market. Employment growth remains subdued, and the unemployment rate is forecast to rise to 6¼ per cent by mid-2015. The participation rate is falling as older workers leave the workforce and younger workers delay their entry. Wages are growing well below previous expectations – while weighing on household income, this will assist in supporting employment.

The outlook for global growth is subdued, although growth is expected to accelerate over the forward estimates.

The weaker outlook for real GDP growth, coupled with the softer outlook for wage and domestic price growth, has resulted in a substantial downward revision to forecast nominal GDP growth in 2014-15. Higher-than-expected iron ore and other key commodity prices are providing some near-term support to nominal GDP growth. However, the strength in commodity prices is expected to be temporary, with a large increase in supply expected to drive prices lower over the forecast period and beyond.

INTERNATIONAL ECONOMIC OUTLOOK

Global growth remains subdued but is expected to pick up across the forward estimates. World GDP is expected to grow by 2¾ per cent in 2013, well below trend, before picking up gradually to 3½ per cent in 2014 and 3¾ per cent in 2015 (Table 2.1).

Forecast growth in Australia's major trading partners (MTPs) is largely unchanged from the 2013 PEFO, and is expected to remain solid at 4¼ per cent in 2013 and 4½ per cent in both 2014 and 2015. A gradual improvement in Europe and the United States is expected to lead to an increase in external demand flowing through to

China's growth, to Australia's other MTPs in Asia, and to the global economy. Higher growth forecasts for Australia's MTPs compared with the global economy reflect the increasing weight of fast-growing Asian emerging market economies in our MTPs.

Table 2.1: International GDP growth forecasts^(a)

	Actuals 2012	Forecasts					
		2013		2014		2015	
		PEFO	MYEFO	PEFO	MYEFO	PEFO	MYEFO
China(b)	7.7	7 1/4	7 3/4	7 1/2	7 1/2	7 1/2	7 1/4
India(b)	3.8	5	2 3/4	6 1/2	4 3/4	6 1/2	5 1/4
Japan	1.9	1 3/4	1 3/4	1	1 1/4	1	1
United States	2.8	1 1/2	1 3/4	2 1/2	2 1/2	2 1/2	2 3/4
Euro area	-0.6	- 3/4	- 1/2	3/4	3/4	1 1/4	1 1/4
Other East Asia(c)	3.9	3 3/4	3 3/4	4 3/4	4 1/2	5	4 3/4
Major trading partners	4.1	4	4 1/4	4 1/2	4 1/2	4 3/4	4 1/2
World	3.2	3	2 3/4	3 3/4	3 1/2	4	3 3/4

(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* October 2013, Thomson Reuters and Treasury.

For **China**, the outlook has improved and stabilised. Economic growth strengthened to 7.8 per cent through the year to the September quarter 2013, partly reflecting the increase in state-supported infrastructure spending that was introduced in the middle of the year. Accordingly, the forecast for 2013 has been revised up to 7¾ per cent.

Continued solid growth is expected for China over the forecast horizon, but China's long-term prospects depend on whether authorities can successfully implement necessary structural reforms, including those related to the financial system. While supporting economic growth in 2013, state-led investment is expected to progressively give way to a more market-driven system of allocating capital, consistent with recent policy announcements by the Chinese authorities at their Third Plenum. Although likely to improve China's long-term growth prospects, these market-oriented reforms and the transition away from state-led investment are expected to weigh on aggregate investment in the near term, with economic growth forecast to moderate to 7½ per cent in 2014 and 7¼ per cent in 2015.

The prospect of far-reaching economic reforms in China also raises the risk of a policy misstep by the authorities, as they try to overcome economic and political difficulties in implementing their agenda. Meanwhile, the possibility of a sharp rise in bad loans following the very large and rapid credit expansion in recent years and poor outcomes in advanced economies present continuing risks to China's growth outlook.

The **United States** has continued its modest but steady recovery and, barring further adverse developments, is poised for stronger economic outcomes. In the short term,

the recent fiscal impasse had only a minor impact on the recovery and the 10 December announced budget deal, while small in scale, will most likely avert another shutdown in 2014. Of more concern is the continued uncertainty around fiscal policy, which has raised questions about the ability of the United States political system to compromise to achieve workable solutions to longer-term fiscal challenges.

The strength of economic data over coming months will eventually determine the start date for tapering of the United States Federal Reserve's Asset Purchase Program. The normalisation of monetary policy is likely to be accompanied by financial market adjustments which could be beneficial to other countries but may also produce volatility, particularly for emerging markets. However, a stronger United States economy will be beneficial for the global economy. Part of the challenge for policy makers is managing expectations, particularly given the previous wrong-footing of market expectations of a September start date for tapering of the Asset Purchase Program.

The **euro area** has been experiencing some respite, with the most sustained period of financial market calm since the start of the crisis. This has been accompanied by some encouraging data including, in the June quarter 2013, the first positive GDP growth after six consecutive quarters of contraction.

Still, the outlook for the euro area remains subject to considerable risk. In reaffirming its accommodative monetary policy stance, and cutting its key policy rate in early November, the European Central Bank characterised the recovery as weak, fragile and uneven. The euro area unemployment rate remains at a record high, credit conditions remain tight, and fiscal consolidation will continue to weigh on growth. The banking sector is a persistent vulnerability, and the banking union remains a long-term project beset by political differences. The comprehensive assessment of euro area banks, in particular the Asset Quality Review, led by the European Central Bank and due to be completed by October 2014, could lead to a re-escalation of the region's crisis if it is not seen as credible or reveals serious concerns about the viability of euro area banks while policy responses remain inadequate. While broadly factored in by markets, the prospect of further Greek debt restructuring could reignite euro area political tensions and raise global financial market volatility.

In **Japan**, the short-term outlook has been substantially boosted by fiscal and monetary stimulus, but a sustained recovery relies on structural reforms to lift long-term growth. While the initial tranche of the Japanese Government's structural reforms has been legislated, its benefits and the prospects for further reform remain unclear.

A looming challenge for Japan will be supporting growth and confidence in the recovery following the increase in the consumption tax in April 2014. While the tax increase is accompanied by fiscal stimulus and makes an important contribution towards longer-term fiscal consolidation, there is uncertainty around its near-term impact on the economy. Further quantitative easing from the Bank of Japan could also

be in prospect if needed to support growth and meet its 2 per cent inflation target in 2015.

Since May, expectations that the United States Federal Reserve would soon begin to taper its asset purchase program have led to large capital outflows and currency depreciation in a number of emerging market economies. Economies with large current account deficits and a large presence of foreign investors in their equity and bond markets, like India and Indonesia, have been particularly affected. While the impact has been manageable to date, and there has been some relief with the delay in tapering, risks remain.

Amid these developments, there has been a reassessment of the medium-term growth prospects of emerging market economies. **India** in particular faces structural impediments to growth and much needed private investment. In conjunction with the subdued global environment and weak growth outcomes, this has led to large downward revisions to Indian growth across the forecast period. Solid monsoon rains and improving net exports may underpin a modest recovery in India but, given global volatility, significant downside risks remain. While **ASEAN** economies also face tight financial conditions and structural impediments to growth, a gradual pickup in exports to advanced economies and relatively resilient domestic demand and policy settings are expected to support continued growth at reasonably robust levels.

DOMESTIC ECONOMIC OUTLOOK

Since the 2013 PEFO, there has been a significant downgrade to forecast nominal GDP growth, reflecting lower forecast growth in the real economy, wages and domestic prices. The downward revision to forecast nominal GDP growth flows through to lower forecast tax receipts and a further deterioration in the budget bottom line.

The Australian economy is forecast to grow by 2½ per cent in both 2013-14 and 2014-15 as it transitions from resources to non-resources drivers of growth. This transition is unlikely to be seamless, with data since the 2013 PEFO suggesting a slower-than-anticipated recovery in the non-resources sectors of the economy and a sharper decline in resources investment over the forecast period. As a consequence, employment growth is expected to remain subdued, and wage growth is forecast to remain well below trend. The implied forecasts for calendar year 2013 and 2014 are broadly consistent with Consensus forecasts and the IMF (Charts 2.1 to 2.4).

The key driver of economic growth in recent years has been very strong **resources investment**. Over the past decade, investment in the resources sector has more than quadrupled as a share of GDP and the capital stock is now three times larger. The latest Private New Capital Expenditure and Expected Expenditure (CAPEX) survey suggests that resources investment will remain at elevated levels in 2013-14, supported by investment in Liquefied Natural Gas (LNG) projects. However, from 2014-15, resources investment is expected to start sharply detracting from growth. The forecast

decline in resources investment is now steeper than it was at the 2013 PEFO, with the sector having become increasingly focused on containing costs.

With the resources boom continuing its transition to the production phase, **resources exports** will begin to make up a greater share of real GDP growth. Already, they are making a sizeable contribution to growth, underpinned by rapidly expanding iron ore supply. LNG exports should also make a significant contribution to export growth from around the middle of the decade.

While resources exports will grow strongly over the forecast period, activity outside the resources sector will need to increase to fill the gap created by falling resources investment. Recovering global economic growth, low interest rates and a somewhat lower exchange rate will support this recovery. There are signs that confidence is picking up in the business sector, including in the National Australia Bank's indicator of business confidence and other private sector business surveys.

Nevertheless, this is yet to be fully reflected in current levels of activity and **business investment** has been downgraded since the 2013 PEFO. Businesses in the non-resources sectors are continuing to exercise caution in their investment decisions. While the latest CAPEX data suggest that investment intentions in the non-resources sectors of the economy have improved in recent months, firms outside of the resources sectors only expect to invest around the same amount (in nominal terms) as they did in 2006-07.

Dwelling investment has also been weaker than expected at the 2013 PEFO, with investment falling unexpectedly in the September quarter. Still, established house prices, auction clearance rates, and new dwellings approvals have all grown strongly recently, and suggest a pick-up in investment in coming months. Finance commitments for new dwellings are now 12.4 per cent higher than a year ago and building approvals have improved noticeably from their trough in early 2012. Higher house prices could initiate a stronger investment response, in part by encouraging the development of existing land holdings. Suggestions of risks emanating from an over-exuberant housing sector remain premature.

With the slower-than-expected recovery in the non-resources sectors, **employment growth** across the economy remains subdued. Forecast employment growth has been revised down to $\frac{3}{4}$ of a per cent through the year to the June quarter 2014, but is still expected to strengthen in 2014-15, supported by lower forecast wage growth and the additional incentive this creates for firms to employ workers. The **unemployment rate** is expected to drift up to $6\frac{1}{4}$ per cent by the June quarter of 2015.

The recent rise in the unemployment rate has been limited by the fall in the **participation rate**. The fall in the participation rate reflects both demographic factors as the first of the baby-boomer generation reach retirement age and a 'discouraged worker' effect, with some younger workers opting out of the difficult search for work in the non-resources sectors of the economy.

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Forecast **wage growth** has been revised down to $2\frac{3}{4}$ per cent through the year to the June quarters of both 2014 and 2015. Wage flexibility is an important adjustment mechanism that supports employment during periods of slower economic growth. The current environment of slow wage growth is the flip side of the experience in the mid-2000s when wages grew strongly and capacity constraints emerged as the resources investment boom gathered steam. The subdued outlook for employment and wage growth means that total compensation of employees is expected to continue growing at its slowest rate since the early 1990s.

Slowing wage growth and household concerns around rising unemployment are restraining **consumer spending**, though growth in household consumption has been supported by growth in household wealth as house and equity prices rise. Still, with wages growing, in through the year terms, at their slowest rate since the March quarter 2000, forecast growth in consumer spending in 2013-14 has been revised lower to 2 per cent.

The **household saving ratio** has remained high relative to the period immediately before the global financial crisis, and it is clear that there has been a structural increase in household savings. The household saving ratio is forecast to drift down a little over the forecast period, but remain well above levels seen before the global financial crisis. There is a risk of weaker consumption spending should households continue to save at current levels.

The easing in wage growth and softness in the non-resources sectors is helping to contain inflationary pressure. **Headline and underlying inflation** are expected to be $2\frac{3}{4}$ per cent through the year to the June quarter of 2014.

Domestic price growth is expected to remain well below average over the forecast period, consistent with weak wage growth and ongoing competitive pressure, particularly in the traded sectors.

Forecasts of the **terms of trade** have been revised a little higher in the near-term, with robust industrial production in China supporting commodity prices, in particular iron ore. Despite this, over coming years, prices for Australia's key commodity exports are expected to ease, in line with growing world supply.

The removal of the carbon tax is expected to lower headline and underlying inflation by less than $\frac{1}{4}$ of a percentage point in 2014-15, relative to the 2013 PEFO, which had factored in the previous Government's policy of moving to a carbon trading system. The removal of the carbon tax is also expected to support household consumption growth in the short term and make a small contribution to national income growth over the longer term.

Forecast **nominal GDP growth** has been revised lower since the 2013 PEFO. This reflects the weaker outlook for real GDP, wages and domestic prices. Nominal GDP is expected to grow by $3\frac{1}{2}$ per cent in 2013-14 and $3\frac{1}{2}$ per cent in 2014-15.

There is always a degree of uncertainty around the forecasts, which can be estimated based on past forecast errors and presented using confidence intervals. The average annualised real GDP growth rate over the two years 2012-13 to 2014-15 is expected to be 2½ per cent, with the 70 per cent confidence interval ranging from 1¾ to 3¼ per cent. Nominal GDP growth forecasts carry with them additional uncertainty. The 70 per cent confidence interval for average annual nominal GDP growth over the forecast period ranges from 2 per cent to 5 per cent. Attachment B of Part 3 provides further detail on the confidence intervals around the forecasts.

There are some clear risks to the domestic outlook. Should the pace of rebalancing toward non-resources drivers of growth disappoint further, real GDP growth and employment growth will be weaker and the unemployment rate higher. The anticipated fall in resources investment could also be sharper than expected, requiring a greater contribution from the non-resources sectors to maintain forecast real GDP growth.

Other risks could result in stronger outcomes. The non-resources sectors could rebound more quickly than expected in response to continued low interest rates or a further depreciation of the Australian dollar. Australian exports may be stronger than anticipated if global growth surprises on the upside, or if resources production ramps up more quickly than expected.

Economic projections

The fiscal aggregates are underpinned by a set of forward estimates consisting of short-term forecasts and two years of projections based on medium-term trends rather than two years of detailed forecasts. Real GDP is projected to grow at its trend rate of around 3 per cent a year over the medium term in line with underlying trends in employment and productivity, though there is a higher than usual risk of below-trend growth in 2015-16 given resources investment is expected to sharply detract from growth. Inflation is projected to be 2½ per cent, the mid-point of the Reserve Bank's target band.

As is standard practice, forecast methodologies and projection assumptions are reviewed from time to time. In this MYEFO, a new assumption for the projected unemployment rate has been adopted and a new methodology for the terms of trade has been developed.

At the end of the forecast period (2014-15), the level of GDP is forecast to be below potential GDP (a negative output gap), and the unemployment rate is forecast to exceed the non-accelerating inflation rate of unemployment (NAIRU). The projection assumption of real GDP growing at trend means the output gap remains unchanged over the projection period. To better align the projected unemployment rate in 2015-16 and 2016-17 with the assumption for real GDP and the output gap, the unemployment

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rate is now assumed to remain at its last forecast level of 6¼ per cent in the two projection years.¹

This new assumption for the projected unemployment rate increases the number of unemployment benefit recipients in the projection period and contributes to the deterioration in the budget bottom line since the 2013 PEFO by \$3.7 billion over the forward estimates.

The revision to the terms of trade methodology is outlined in Box A.

¹ The projection methodology is currently being reviewed with consideration being given to extending the forecast period. A longer forecast period would allow for a more realistic approach to closing output gaps than is available under the current projection methodology.

Table 2.2: Domestic economy forecasts^(a)

	Outcomes(b)	Forecasts			
	2012-13	2013-14		2014-15	
		PEFO	MYEFO	PEFO	MYEFO
Panel A - Demand and output(c)					
Household consumption	2.0	2 1/2	2	3	2 3/4
Private investment					
Dwellings	-0.4	5	3	5 1/2	5 1/2
Total business investment(d)	6.1	1 1/2	-1 1/2	- 1/2	-2
Non-dwelling construction(d)	13.8	1	-1 1/2	-4 1/2	-7
Machinery and equipment(d)	-4.3	1/2	-4 1/2	3	4 1/2
Private final demand(d)	2.8	2 1/4	1 1/4	2 1/2	1 3/4
Public final demand(d)	-1.3	3/4	1	1	1
Total final demand	1.9	2	1 1/4	2	1 1/2
Change in inventories(e)	-0.3	0	0	0	0
Gross national expenditure	1.6	2	1 1/4	2	1 1/2
Exports of goods and services	6.0	6 1/2	5	7	6 1/2
Imports of goods and services	0.3	4	-1	3	2
Net exports(e)	1.2	1/2	1 1/4	1	1
Real gross domestic product	2.7	2 1/2	2 1/2	3	2 1/2
Non-farm product	2.8	2 1/2	2 1/2	3	2 1/2
Farm product	-3.9	4	2	1	1
Nominal gross domestic product	2.5	3 3/4	3 1/2	4 1/2	3 1/2
Panel B - Other selected economic measures					
External accounts					
Terms of trade	-9.8	-5 3/4	-5	-3 3/4	-5
Current account balance (per cent of GDP)	-3.6	-3 3/4	-3 3/4	-3 3/4	-4
Labour market					
Employment(f)	1.3	1	3/4	1 1/2	1 1/2
Unemployment rate (per cent)(g)	5.6	6 1/4	6	6 1/4	6 1/4
Participation rate (per cent)(g)	65.3	65 1/4	64 3/4	65 1/4	64 3/4
Prices and wages					
Consumer price index(h)	2.4	2 1/2	2 3/4	2	2
Gross non-farm product deflator	-0.3	1 1/4	1	1 1/4	3/4
Wage price index(f)	2.9	3 1/4	2 3/4	3 1/4	2 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 for the June quarter.

(h) Through-the-year growth rate to the June quarter.

Source: ABS cat. no. 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 70 and a United States dollar exchange rate of around 91 US cents. Interest rates are assumed to move in line with market expectations. World oil prices (Malaysian Tapis) are assumed to remain around US\$118 per barrel. The farm sector forecasts are based on an assumed return to average seasonal conditions.

Chart 2.1: Consensus real GDP forecasts for calendar year 2013

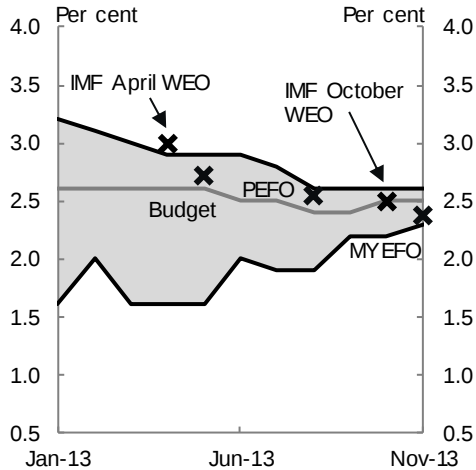
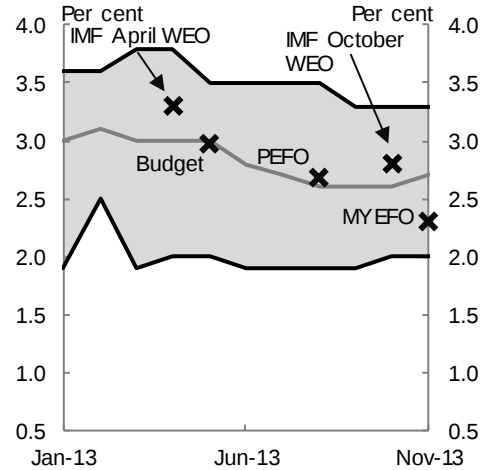


Chart 2.2: Consensus real GDP forecasts for calendar year 2014



Note: The top and bottom lines represent range of Consensus forecasts. The centre line represents Consensus mean forecast.

Source: Consensus Economics and Treasury.

Chart 2.3: Consensus unemployment rate forecasts for calendar year 2013

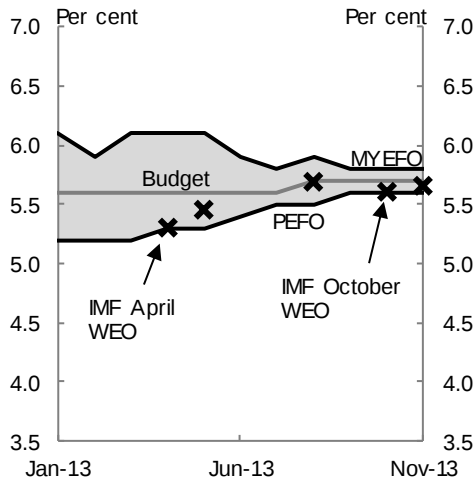
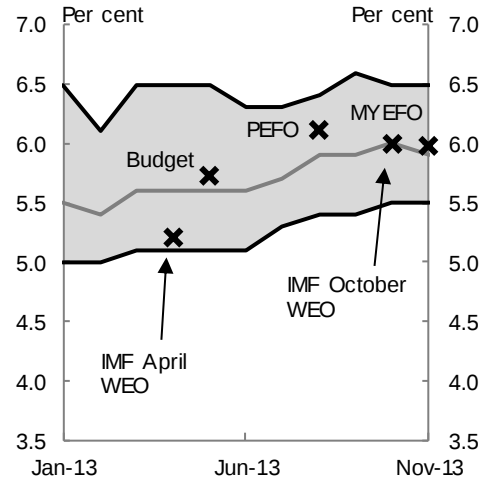


Chart 2.4: Consensus unemployment rate forecasts for calendar year 2014



Note: The top and bottom lines represent range of Consensus forecasts. The centre line represents Consensus mean forecast.

Source: Consensus Economics and Treasury.

Box A: Medium-term projection of the terms of trade

A new methodology for projecting the terms of trade over the medium term has been adopted in MYEFO (Chart 1). Since the 2010-11 Budget, the terms of trade have been assumed to fall by 20 per cent over 15 years from the beginning of the projection period. This approach was silent on when the expected decline would end and the level they would settle at in the long run.

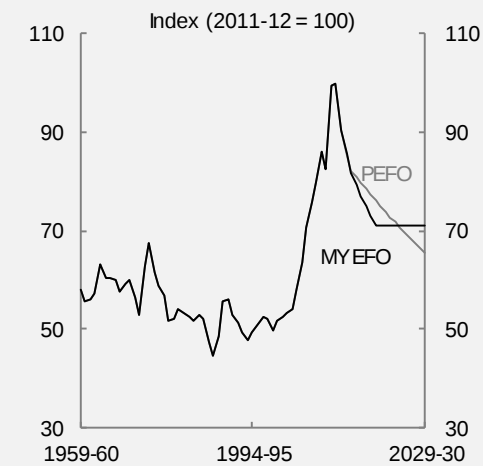
The new methodology takes into account the three phases of the mining boom. The initial *demand phase* over which there was a rapid rise in prices and a modest increase in supply; the current *supply phase* during which the capacity built over the demand phase is employed thereby rapidly increasing supply and lowering prices; and an expected *balanced growth phase* (or long-run path) where demand and supply are expected to move together, and the terms of trade display no secular trend.

The new methodology is based on a bottom-up forecasting framework. Each element of the terms of trade (that is, trade volumes and prices for major export categories) has been modelled using extensions of existing short-run econometric forecasting models, expert advice and credible publicly available information. A critical element of the framework is modelling the evolving global demand and supply balance for the three major bulk commodities (iron ore, metallurgical coal and thermal coal).

This framework suggests the supply phase will end around 2017-18 with the long-run terms of trade settling around their level in 2006-07. There are a number of downside risks to this outlook including uncertainty around the global economy, the nominal exchange rate and non-bulk commodity price forecasts. Applying prudent judgement to the model's outcome results in a long-run terms of trade that settles at the level observed in 2005-06 by 2019-20.

This change reduces nominal GDP growth in the projection period and contributes to the deterioration in the budget bottom line since the 2013 PEFO by \$2 billion over the forward estimates.

Chart A: Projections of Australia's terms of trade



Source: ABS cat. no. 5204.0 and Treasury.

