PART 2: ECONOMIC OUTLOOK

OVERVIEW

Against the backdrop of weaker global economic growth, the Australian economy continues to grow solidly. The outlook is for an improvement in Australia's real GDP growth, which is unchanged since Budget.

Exports and dwelling investment have been growing strongly and there are tentative signs of recovery elsewhere. Interest rates at historic lows are supportive of growth. The depreciation of the Australian dollar and recently signed free trade agreements are improving the prospects for the trade-exposed sectors of the economy.

In contrast, nominal GDP growth in 2014-15 is expected to be weaker than forecast at Budget and the weakest growth in a financial year in over 50 years. This reflects a substantial fall in commodity prices, particularly iron ore prices (which fell by more than all major forecasters expected) and further moderation in wage growth. This has led to lower forecast company and individuals' income tax receipts and government payments have increased.

INTERNATIONAL ECONOMIC OUTLOOK

The global economy is expected to recover but at a slower rate than expected at Budget. The United States is leading advanced economy recoveries, but there has been a loss of momentum in both the euro area and Japan.

China's economic transition towards more sustainable growth, and a slowdown in its property market, are weighing on iron ore and coal prices.

The majority of world growth is still expected to come from emerging market economies, predominantly those in our region, with **world growth** expected to pick up to 3¾ per cent in 2015 and 4 per cent in 2016.

Australia's major trading partner growth is expected to continue to exceed world growth, with forecasts of 4½ per cent in 2015 and 2016. This reflects the relative and increasing importance of fast-growing east Asian economies within our export markets.

The most immediate risk to the global recovery is the euro area, which faces the possibility of a long period of subdued growth and low inflation. The long period of relatively calm financial markets and rising asset prices could be reversed by a variety of triggers, such as increased geopolitical tensions. Any such reversal could potentially weigh on confidence and growth.

Finally, while China's transition to more moderate but sustainable growth will underpin increasing prosperity and a burgeoning middle class, this transition may not be smooth.

Table 2.1: International GDP growth forecasts[(a)]

	Actuals	Forecasts		
	2013	2014	2015	2016
China(b)	7.7	7 1/4	6 3/4	6 1/2
India(b)	4.7	5 1/4	5 1/2	6
Japan	1.5	1/2	1	3/4
United States	2.2	2 1/4	3	3
Euro area	-0.4	3/4	1	1 1/2
Other East Asia(c)	4.3	4	4 3/4	4 3/4
Major trading partners	4.3	4 1/2	4 1/2	4 1/2
World	3.3	3 1/4	3 3/4	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 2014, Thomson Reuters and Treasury.

The **United States** (which is our third largest trading partner) has been a source of optimism in the global economy, with a return to strong growth following the first quarter contraction. Fundamentals are improving: household finances are healthy, the labour market is improving and business investment is growing. Forecast growth is 3 per cent in 2015 and 2016.

In line with the recovery, the United States Federal Reserve has brought to a close its program of net asset purchases. This has been done without generating the volatility in financial markets that had been feared, with attention now on the likely timing and pace of interest rate rises. The pace and timing of these rises and the communication strategy by the Federal Reserve may again raise the prospect of volatility in financial markets.

In **China**, growth is moderating to a more sustainable rate as the economy matures and the benefits of past stimulus fade. While forecasts have been revised down, reflecting this moderation in growth and headwinds from the property market, China is still expected to be the fastest growing and by far the largest of Australia's major trading partners. The composition of growth in China is also as important to the evolution of Australia's trading relationship as the pace of growth.

A key development for our trade with China has been the slowdown in the property market, which has added to broader and significant downward pressure on iron ore prices (Box A). Adding to this has been pre-existing Chinese overcapacity in resource and energy intensive sectors such as steel and cement. While the impact on growth has

been partly offset by supportive policy and improving external demand, the net effect on key commodities has been weaker demand and lower prices.

Looking ahead, solid and sustained growth in China will be underpinned by the transition already underway from investment-led to consumption-led growth. This phase of growth is expected to be less resource intensive and, together with recently signed Free Trade Agreements with China, Japan and Korea, should expand export opportunities for Australia in other goods and services. An important component of the medium-term reform agenda is financial system deregulation. This is critical to improve the efficient allocation of capital across the economy, but carries with it risks as it will require the management of impaired loans in the system.

Forecast growth for China has been downgraded to 6¾ per cent in 2015 and 6½ per cent in 2016 reflecting further signs of weakness since the Budget forecasts were prepared, and since the IMF's World Economic Outlook in October. There are downside risks given the transitions that are taking place, although these are moderated to some degree by the policy buffers at the authorities' disposal. The recent monetary policy easing demonstrates the authorities' preparedness to support growth.

Elsewhere in emerging Asia, **India** is recovering from an extended downturn, with a steady but promising reform agenda expected to lift medium-term growth. Forecast growth has been upgraded to 5½ per cent in 2015 and 6 per cent in 2016. The ASEAN-5 are expected to benefit from lower commodity prices, with Indonesia and Malaysia notable exceptions as fellow commodity exporters.

The **euro area** recovery lost some momentum this year. Parts of the European periphery are growing strongly, albeit with a lot of ground to make up, but growth in Germany, France and Italy has been weak. Forecast growth has been downgraded to ¾ per cent in 2014 and 1 per cent in 2015, but held at 1½ per cent for 2016. There is a risk of long-lasting damage to potential growth in the euro area, with depressed business investment and a near-record high unemployment rate.

As a result of this economic weakness, the euro area is facing persistent low inflation and falling inflation expectations. The European Central Bank has pursued further easing measures in response to these pressures. While highly accommodative monetary policy is expected to support a gradual recovery in activity, progress on fiscal and structural reforms remains key to prospects across the euro area.

In **Japan** (our second largest trading partner), the recovery faltered following the consumption tax increase in April, with two consecutive quarters of negative growth, suggesting underlying economic weakness rather than a temporary setback. In response, the Bank of Japan has provided further considerable monetary easing, while the Government has pursued a fresh electoral mandate. More broadly, Japan faces significant structural challenges which present downside risks to growth. Forecast growth has been downgraded to ½ per cent in 2014, left at 1 per cent for 2015 and downgraded to ¾ per cent in 2016.

DOMESTIC ECONOMIC OUTLOOK

The outlook for real GDP growth is unchanged since Budget, and the economy is forecast to grow at 2½ per cent in 2014-15, before increasing to near-trend growth of 3 per cent in 2015-16. The economy continues to transition from resources investment-led growth towards broader-based drivers of activity. Exports and housing construction are growing strongly. With interest rates at historic lows, the decline in the Australian dollar and new market opportunities becoming available, the Australian economy is expected to strengthen.

Exports volumes are growing strongly. The transition of the resources investment boom to its production phase has seen Australian iron ore export volumes grow more quickly than expected, as new mines and capacity expansions in the Pilbara reached production targets faster than expected. Going forward, exports should be supported by a lower dollar and by stronger demand for services and other exports from the expanding Asian middle class.

Imports, especially of capital goods, declined in 2013-14, largely reflecting the reduction in resources investment. The fall in the Australian dollar will encourage consumers and businesses to switch from imports to domestically produced goods, with imports now expected to continue to fall slightly in 2014-15 and grow by only ½ per cent in 2015-16.

Business investment growth in 2013-14 was weaker than expected, amid a fast decline in resources investment since the recent peak. However, the outlook for non-resources investment has improved. Non-mining business conditions and confidence have been high over much of this year. In addition, historically low interest rates and a lower exchange rate will support investment going forward, though at this stage it has yet to be reflected in strong investment plans.

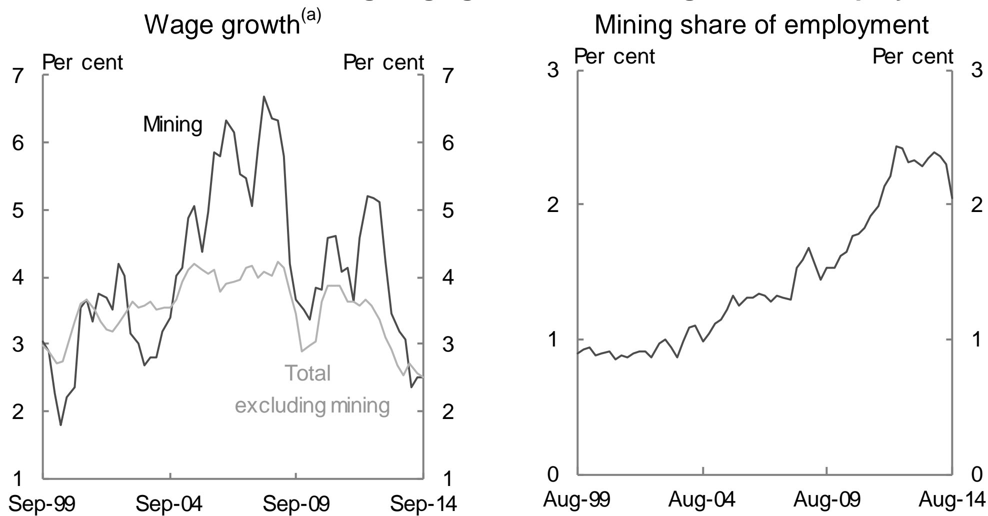
Dwelling investment has been growing strongly, rising by 5.1 per cent in 2013-14, supported by low interest rates and rising house prices. While dwelling investment fell unexpectedly in the September quarter, building approvals point to a strong outlook in the near term.

In 2014, the average number of jobs created per month has been more than double that of 2013. However, below trend real GDP growth continues to mean that **employment growth** has not been strong enough to keep up with growth in the labour force. This has led the **unemployment rate** to rise slightly. An increase in job advertisements and low wage growth highlights upside risks to employment growth. Nevertheless, with the unemployment rate currently a little higher than expected at Budget, the unemployment rate is now expected to peak at 6½ per cent. The implied unemployment rate forecasts for calendar years 2014 and 2015 are within the range of consensus forecasts.

Wage growth has been very subdued, reflecting the spare capacity in the labour market and a significant reduction in wage growth in the mining sector. Wage growth is expected to pick up as the economy strengthens.

With the transition from mining construction towards the less labour-intensive production phase of the resources boom well underway, wage growth in the mining sector and the share of employment in the mining sector have declined (Chart 2.1).

Chart 2.1 Declines in mining wage growth and mining share of employment



(a) Through the year growth.
Source: ABS cat. no. 6345.0, 6291.0.55.003 and Treasury.

Looking through recent volatility, **consumption** has been growing a little below trend. While some measures of consumer confidence have been around long-run averages, and retail trade has picked up recently, lower wage growth and employment growth are expected to impact on consumption. Growth in consumer spending in 2014-15 has been revised down to 2½ per cent, before picking up in 2015-16, supported by rising household wealth.

Subdued wage growth and the removal of the carbon tax is helping to contain inflationary pressure, notwithstanding the inflationary effects of the fall in the Australian dollar. Headline and underlying **inflation** are forecast to be 2½ per cent through the year to both the June quarter of 2015 and the June quarter of 2016.

Since Budget, key **commodity prices** have fallen significantly driven by supply increases and slower demand growth. Iron ore prices are now more than 30 per cent lower than at Budget as a result of increased production by Australian and other suppliers together with the slowing in the Chinese property market. Further details on iron ore price developments are in Box A.

Box A: Iron ore price developments

After being around US$125/tonne on average over 2013, the iron ore price has fallen substantially since the beginning of the year (down roughly 50 per cent). The iron ore price is currently around 50 per cent lower than it was at the 2013-14 Budget, delivered 18 months ago, and the Pre-Election Economic and Fiscal Outlook. That said, a large part of this fall has occurred since the 2014-15 Budget, after which the iron ore price has declined by more than 30 per cent. The iron ore price is currently US$63/tonne free on board (FOB) (as at 9 December 2014), around its lowest level since 2009 (Chart 2.2). The extent of the fall in the price was widely unexpected.

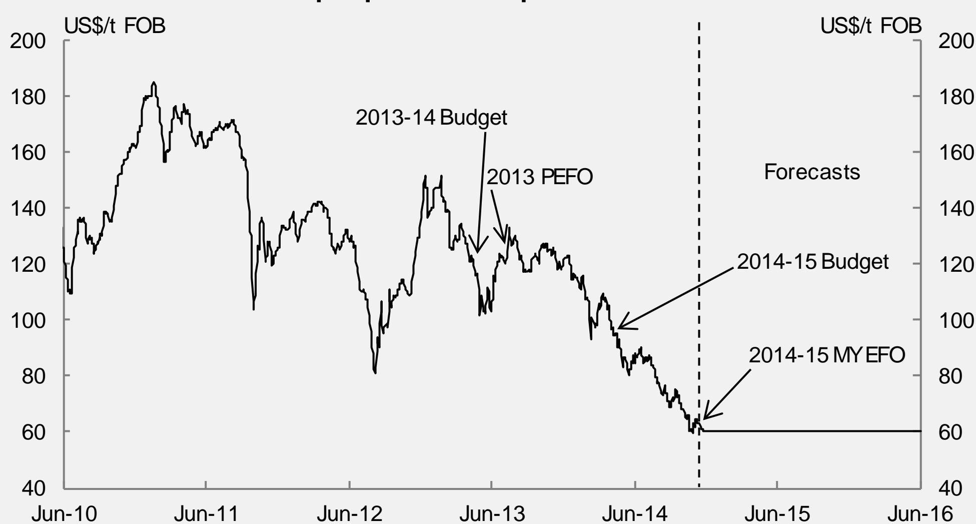
At Budget, Treasury expected the iron ore price to fall in line with increasing global supply, primarily from Australia, and softening demand from China. The spot price was expected to fall from around US$95/tonne at the time of the 2014-15 Budget to US$92/tonne by June 2016, having started the year at over US$120/tonne.

At the time, the Budget outlook for iron ore prices was considered to be conservative as it was below market expectations, with the median consensus forecast predicting a price of US$98/tonne in June 2016.

The sharper-than-anticipated fall in the iron ore price over 2014 reflects a number of factors. Firstly, the early completion of major projects in the Pilbara region, assisted by favourable weather conditions, led to a greater than anticipated expansion of supply.

Secondly, it was expected that the lower prices associated with increased Australian supply would displace high-cost production elsewhere, providing a natural floor for the price. While some unprofitable supply did exit the market, the response has been surprisingly limited to date, with much of China's high-cost production (which accounts for roughly 15 per cent of global production) remaining in the market.

Chart 2.2 Spot price developments and forecasts



Source: Platts and Treasury.

Box A: Iron ore price developments (cont.)

Finally, the softening economic conditions in China have also placed downward pressure on iron ore prices since Budget. Most notably, the outlook for the Chinese property sector — the single largest consumer of steel — has deteriorated sharply over 2014, while tighter credit conditions have placed pressure on Chinese steel mills. This has weighed on demand at a time when ample supply of iron ore is available.

Whilst low cost mines in Australia and Brazil are expected to continue to expand global supply, on the demand side, China's growth outlook for 2015 has been downgraded from Budget. The associated weakness in the property sector and the ongoing transition from resource-intensive growth is expected to constrain Chinese steel demand.

The price of iron ore is consequently expected to remain around US$60/tonne over the forecast period. This is lower than consensus forecasts which were published in October 2014, with many forecasts in consensus likely finalised well before the publication date. Prices have fallen considerably since then, implying potential downgrades for consensus forecasts going forward.

There is considerable uncertainty around this forecast, but this is assessed to be broadly balanced.

Using the sensitivity analysis in Scenario 1 in Part 3, Attachment A, the analysis in Table 2.2 below examines the effects on nominal GDP and receipts of altering the iron ore price forecast. These scenarios provide a rule of thumb indication of the impact of changes in the price. They represent partial economic analysis only and do not attempt to capture all the economic feedback and other policy responses related to changed economic conditions. In particular, the analysis assumes no change in the exchange rate, interest rates or policy over the forecast period. As such the impacts are merely illustrative.

The analysis suggests a US$10/tonne reduction in the forecast iron ore spot price results in a 2 per cent fall in the terms of trade and a ½ per cent reduction in nominal GDP by 2015-16. This would imply a rule of thumb decline in tax receipts of $0.8 billion in 2014-15 and $2.8 billion in 2015-16.

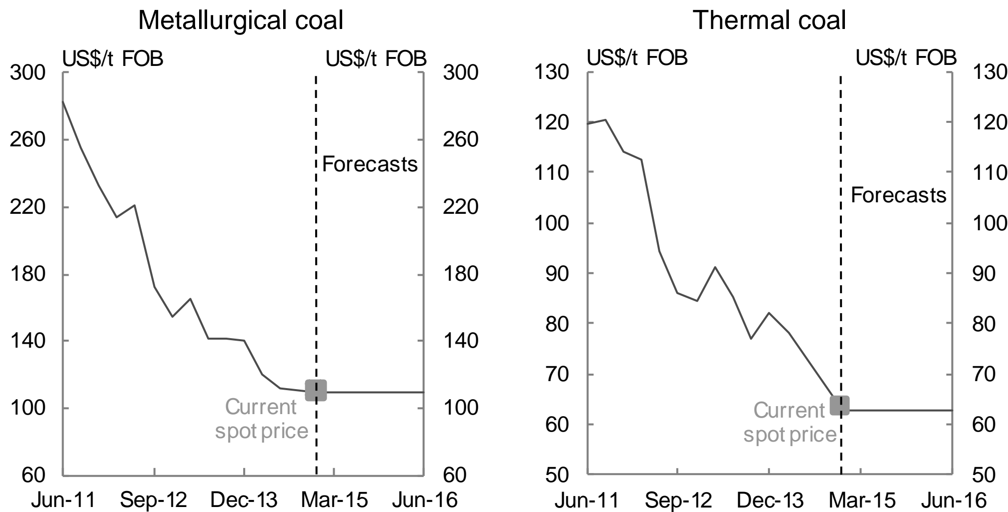
Table 2.2 Illustrative impact of different iron ore price forecasts (compared to US$60/tonne baseline)[a]

	US$50/tonne FOB[b] spot price		US$70/tonne FOB spot price	
	2014-15	2015-16	2014-15	2015-16
Nominal GDP ($billion)	-3.5	-8.4	3.5	8.4
Receipts ($billion)	-0.8	-2.8	0.8	2.8

(a) Key aggregates are shown relative to the 2014-15 MYEFO iron ore spot price forecast of US$60/tonne.
(b) FOB is the free-on-board price which excludes freight costs.
Source: Treasury.

The price for thermal coal has also fallen by around 15 per cent since the Budget, while metallurgical coal prices remain subdued (Chart 2.3). Thermal and metallurgical coal spot prices are expected to be US$63 and US$110 over the forecast horizon. Without a sustained price recovery, some high-cost operations may close. However, productivity gains and a lower Australian dollar are expected to alleviate some of the pressure of weak prices on the resources sector more broadly.

Chart 2.3 Metallurgical coal and thermal coal prices



Source: Platts, Bloomberg and Treasury.

Increases in global oil supply and lower demand have also resulted in a significant fall in the price of oil since the Budget, with oil prices down by around 35 per cent and retail petrol prices down by around 20 cents per litre. The oil price is assumed to remain lower across the forecast period. Cheaper fuel costs will benefit domestic consumers, by freeing up income to spend on other goods and services.

A sustained lower oil price is also expected to eventually feed through into lower prices for Australian LNG exports, which are contractually linked to oil prices. This will become particularly important as Australian LNG export capacity starts to come online over the forecast period, to become our second largest export.

Wheat prices, which were elevated around the time of Budget amid geo-political tensions, have declined by around 20 per cent since Budget and have been relatively stable over recent months.

These commodity price falls have led to a substantial downward revision to the **terms of trade** which is now expected to fall by 13½ per cent in 2014-15 and 3¾ per cent in 2015-16. We are now 25 per cent off the peak level for the terms of trade which occurred in the September quarter 2011. **The forecast decline in the terms of trade would be the largest fall in the terms of trade in a financial year since the Australian Bureau of Statistic's Annual National Accounts started in 1959-60.**

Nominal GDP growth has been weak over recent years, reflecting the lower terms of trade and weaker wage growth. As such, forecast nominal GDP growth has been downgraded significantly since Budget. Declines in commodity prices have resulted in lower forecast company tax receipts, while weaker wage growth is leading to softer income tax receipts. These developments have been primarily responsible for the $31.6 billion write down in tax receipts since Budget.

Key risks to the outlook relate to movements in commodity prices, the household saving ratio and the outlook for business investment. A stronger than anticipated moderation in Chinese growth could lead to weaker commodity prices than forecast, while the departure of high cost suppliers from the market could result in stronger prices. Uncertainty over the economic outlook could lead households to save more than expected, leading to lower consumption growth, while lower electricity and fuel costs will benefit households. There is also substantial uncertainty over the outlook for non-mining business investment. While conditions are favourable for a pick-up in business spending, so investment could be stronger than expected, the pace of new investment will depend on how demand evolves.

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 from 2013-14 to 2015-16 is expected to be 2¾ per cent, with the 70 per cent confidence interval ranging from 2 to 3¼ per cent. Nominal GDP growth forecasts carry with them additional uncertainty. The 70 per cent confidence interval for average annualised nominal GDP growth over the two years from 2013-14 to 2015-16 ranges from 1½ per cent to 4½ per cent. Attachment B of Part 3 provides further detail on the confidence intervals around the forecasts.

Table 2.3: Domestic economy forecasts[(a)]

	Outcomes(b)	Forecasts			
	2013-14	2014-15		2015-16	
		Budget	MYEFO	Budget	MYEFO
Panel A - Demand and output(c)					
Household consumption	2.2	3	2 1/2	3 1/4	3
Private investment					
Dwellings	5.1	7 1/2	8	5 1/2	5 1/2
Total business investment(d)	-5.0	-5 1/2	-4 1/2	-3 1/2	-3
Non-dwelling construction(d)	-2.0	-9 1/2	-10	-12 1/2	-12
Machinery and equipment(d)	-12.6	-2	3 1/2	7	8 1/2
Private final demand(d)	0.9	1 1/2	1 1/2	2	2
Public final demand(d)	1.5	1 1/2	1 1/2	1	1
Total final demand	1.0	1 1/2	1 1/2	1 3/4	1 3/4
Change in inventories(e)	-0.3	1/4	0	0	0
Gross national expenditure	0.7	1 3/4	1 1/2	1 3/4	1 3/4
Exports of goods and services	5.8	5 1/2	5 1/2	7	6 1/2
Imports of goods and services	-2.1	2	- 1/2	2 1/2	1/2
Net exports(e)	1.6	1	1 1/4	1 1/4	1 1/4
Real gross domestic product	2.5	2 1/2	2 1/2	3	3
Non-farm product	2.4	2 3/4	2 1/2	3	3
Farm product	5.1	-4	-6	1	2
Nominal gross domestic product	4.0	3	1 1/2	4 3/4	4 1/2
Panel B - Other selected economic measures					
External accounts					
Terms of trade	-3.7	-6 3/4	-13 1/2	-1 3/4	-3 3/4
Current account balance (per cent of GDP)	-3.0	-4	-4 1/2	-3 3/4	-4 3/4
Labour market					
Employment(f)	0.8	1 1/2	1	1 1/2	1 3/4
Unemployment rate (per cent)(g)	6.0	6 1/4	6 1/2	6 1/4	6 1/2
Participation rate (per cent)(g)	64.7	64 1/2	64 1/2	64 1/2	64 1/2
Prices and wages					
Consumer price index(h)	3.0	2 1/4	2 1/2	2 1/2	2 1/2
Gross non-farm product deflator	1.0	1/2	- 3/4	1 3/4	1 1/2
Wage price index(f)	2.6	3	2 1/2	3	3

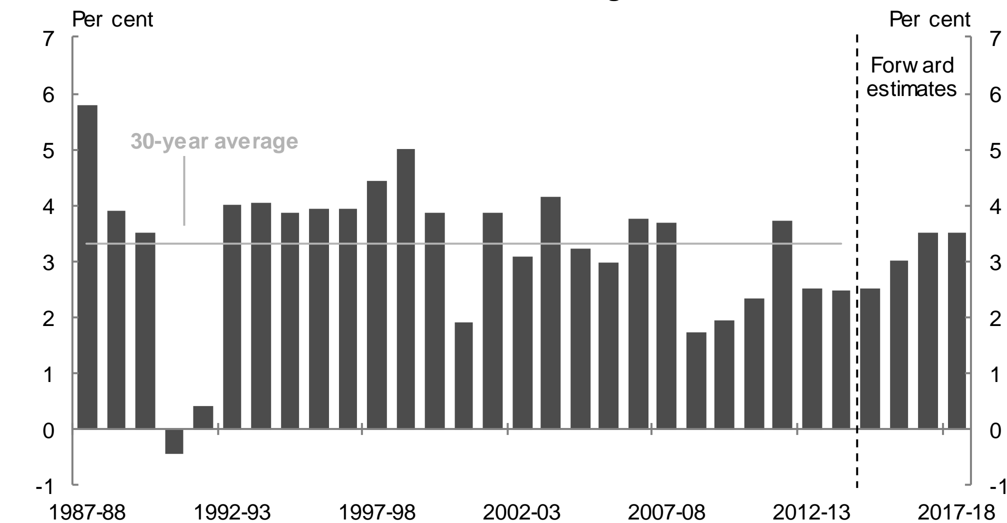
(a) Percentage change on preceding year unless otherwise indicated.
(b) Calculated using original data unless otherwise indicated.
(c) Chain volume measures except for nominal gross domestic product which is in current prices.
(d) Excluding second-hand asset sales between the public sector and the private 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.
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 68 and a United States dollar exchange rate of around 84 US cents. Interest rates are assumed to move in line with market expectations. World oil prices (Malaysian Tapis) are assumed to remain around US$76 per barrel. The farm sector forecasts are based on an assumed return to average seasonal conditions.
Source: ABS cat. no. 5206.0, 5302.0, 6202.0, 6345.0, 6401.0, unpublished ABS data and Treasury.

Medium-term economic projections

The fiscal aggregates in the MYEFO are underpinned by a set of forward estimates, containing economic forecasts for the budget year and the subsequent financial year, and projections for the next two financial years. These projections are not forecasts, but rather are based on a set of medium-term assumptions.

The medium-term projection methodology outlined in the 2014-15 Budget implies that spare capacity in the economy is absorbed over the five years following the two-year forecast period. As this occurs, labour market variables, including employment and the participation rate, converge to their long-run trend levels. To absorb the forecast spare capacity in the economy, real GDP is projected to grow above trend for a period of five years from 2016-17. By then the spare capacity is absorbed and real GDP grows at trend thereafter.

Chart 2.4: Real GDP growth



Source: ABS cat. no. 5206.0 and Treasury.

Trend GDP is estimated based on analysis of underlying trends for population, productivity and participation. The unemployment rate is projected to converge back to 5 per cent over the medium term, consistent with Treasury's estimate of the non-accelerating inflation rate of unemployment. Inflation is projected to be 2½ per cent, consistent with the Reserve Bank of Australia's medium-term target band. The terms of trade is projected to continue to decline, falling to its level in 2005-06 by 2019-20.