PART 2: ECONOMIC OUTLOOK

OVERVIEW

The Australian economy is transitioning from strong resource investment-led growth to broader-based drivers of economic activity. The transition is being supported by historically low interest rates, the fall in the Australian dollar and low oil prices. Employment growth has strengthened as the economy transitions to more labour-intensive sectors such as services and has been supported by moderate wage growth. While business investment intentions currently remain subdued, conditions conducive to stronger business investment are in place.

Australia's real GDP growth has been revised down for 2015-16 from the Budget forecast of 2¾ per cent to 2½ per cent but is forecast to strengthen to 2¾ per cent in 2016-17. With business investment intentions in the non-mining sectors of the economy yet to strengthen, real GDP growth is forecast to pick up more gradually than anticipated at Budget.

Nominal GDP growth is also expected to be weaker than forecast at Budget at 2¾ per cent in 2015-16 and 4½ per cent in 2016-17. This reflects weaker commodity prices and a moderate outlook for inflation.

INTERNATIONAL ECONOMIC OUTLOOK

World economic growth is expected to pick up over the forecast horizon, but not to the extent forecast at Budget. Growth remains uneven, with the recovery in advanced economies being patchy. While emerging market economies have slowed in 2015, their growth is expected to pick up in 2016 and 2017. More than 70 per cent of world growth is expected to come from emerging market economies, predominantly those within the Asia-Pacific region.

Australia's major trading partner growth is expected to continue to exceed world growth at 4 per cent in 2015, 2016 and 2017. This reflects the relative strength of East Asian economies and the importance of this region as a destination for Australia's exports.

Risks to the global outlook are elevated, with the world economy struggling to regain sustained momentum. The significant transitions underway in the global economy, while welcome, may not be smooth. China's shift from investment-led growth to a greater reliance on consumption and services has implications for regional and global activity, while also presenting new opportunities for Australian businesses.

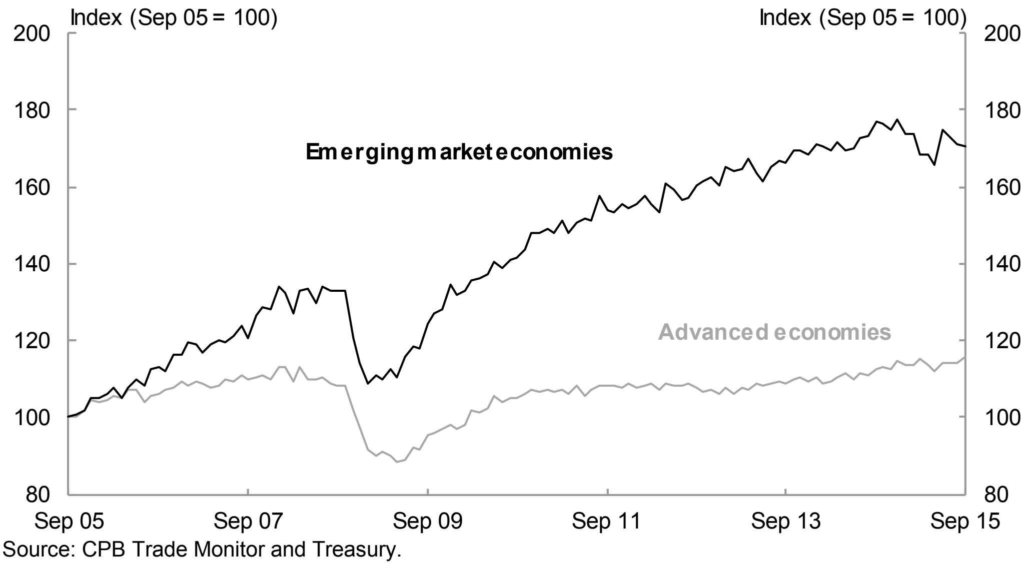
The prospect of normalisation of US monetary policy from near-zero interest rates has the potential to contribute to financial market volatility. Emerging market economies have accumulated large amounts of debt in recent years and could be exposed to sudden shifts in market sentiment. Financial market volatility was pronounced through the middle of the year and there is potential for further episodes.

Since the Budget, commodity prices have continued to fall reflecting both increasing supply and slowing demand growth. Both oil and iron ore spot prices have fallen by around a third since Budget in US dollar terms, while thermal coal and metallurgical coal spot prices have fallen by around 15 per cent and 10 per cent respectively. Lower commodity and oil prices are, on balance, likely to support global growth, despite being a drag on the economies of oil and commodity exporters.

Global inflation pressures remain weak, with the fall in oil prices over the past year suppressing headline inflation. Core inflation pressures (excluding food and energy) also remain weak in most major economies. Additionally, market expectations of medium and longer-term inflation have fallen in the major advanced economies. Against this background, global monetary policy remains very accommodative.

A further sign that the global economy is struggling to regain sustained momentum is slower growth in global trade, which is particularly evident in export-focused East Asian economies. So far in 2015, world merchandise trade volumes have expanded at their slowest rate since 2009, driven by a slowdown in emerging market economies (Chart 2.1). There are a number of factors contributing to slower global trade growth, including the shifting composition of China's growth.

Chart 2.1: Global merchandise trade volumes



Source: CPB Trade Monitor and Treasury.

For **China**, Australia's largest trading partner, forecasts are unchanged since Budget, with growth moderating as the economy transitions. The traditional drivers of growth, including investment, industrial production and exports, remain weak reflecting overcapacity in some sectors as well as a difficult global environment. In contrast, retail sales growth remains stable and the labour market is relatively robust.

The Chinese authorities have reaffirmed their commitment to double GDP as well as income *per capita* from 2010 levels by 2020. They will be attempting to achieve this target as the economy transitions.

Table 2.1: International GDP growth forecasts

	Actuals	Forecasts		
	2014	2015	2016	2017
China	7.3	6 3/4	6 1/2	6 1/4
India	7.1	7 1/4	7 1/2	7 1/2
Japan	0.0	3/4	3/4	1/2
United States	2.4	2 1/2	2 3/4	2 3/4
Euro area	0.9	1 1/2	1 3/4	1 3/4
Other East Asia(a)	4.1	3 3/4	4 1/4	4 1/4
Major trading partners	4.2	4	4	4
World	3.4	3	3 1/2	3 3/4

(a) Other East Asia comprises the newly industrialised economies of Hong Kong, South Korea, Singapore and Taiwan and the Association of Southeast Asian Nations group of five (ASEAN-5), comprising Indonesia, Malaysia, the Philippines, Thailand and Vietnam.
Note: 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.
Source: National Statistical Agencies, IMF World Economic Outlook October 2015, Thomson Reuters and Treasury.

Growth in the **ASEAN 5 economies** has slowed in 2015. The impact of China's transition is being felt in many of these economies, which are exposed to the slowing in Chinese investment and the slowing rate of growth in Chinese industrial production.

In **Japan**, growth is expected to pick up in 2015 and 2016 albeit at a slow pace. Japan continues to face significant structural challenges which present downside risks to growth.

Growth in the **United States** is forecast to be the strongest amongst the major advanced economies, but slower than expected at Budget. The labour market recovery continues. The domestically-oriented sectors remain strong, outweighing the pressure on externally-exposed sectors from a strong exchange rate and slower global growth. Growth is forecast to be 2½ per cent in 2015 and 2¾ per cent in 2016 and 2017.

The recovery in the **euro area** is expected to remain relatively subdued and expectations for growth in 2015 have been revised down marginally since Budget. During 2015 growth improved in Spain, Italy and Ireland while growth is lower than expected in Germany. Accommodative monetary policy, a weaker currency and lower commodity prices continue to support euro area activity. Immediate risks associated with Greece have abated, but structural challenges remain.

India continues to benefit from low commodity prices and is expected to remain the fastest growing major economy in 2015. Growth is expected to continue to be underpinned in coming years by the Indian Government's reform agenda, including the proposed reduction of company tax as well as measures to make doing business easier and more predictable.

DOMESTIC ECONOMIC OUTLOOK

Australia's real GDP growth is forecast to strengthen from 2½ per cent in 2015-16 to 2¾ per cent in 2016-17. This compares with forecasts at Budget of 2¾ per cent in 2015-16 and 3¼ per cent in 2016-17. While real GDP growth is weaker than forecast at Budget, the transition from resource investment-led growth towards broader-based drivers of economic activity appears to be underway, supported by historically low interest rates, the fall in the Australian dollar and lower oil prices. Employment growth has strengthened recently as the economy transitions to more labour intensive sectors such as services and has been supported by moderate wage growth.

Exports continue to grow strongly, with total export volumes in 2014-15 in line with expectations at Budget. Planned resource projects are nearing completion which is giving rise to an increase in production and exports of commodities. Exports of services continue to strengthen with sectors such as tourism and education benefiting from the lower Australian dollar and rising demand from East Asia. In 2015-16, rural exports are expected to fall as a result of adverse weather conditions associated with El Niño and as beef producers enter a period of restocking.

Imports are expected to fall by ½ per cent in 2015-16 and grow by 2½ per cent in 2016-17. Overall, net exports contributed 1.4 per cent to real GDP growth in 2014-15 and are expected to remain strong over the forecast horizon, contributing 1 percentage point to GDP growth in both 2015-16 and 2016-17.

Business investment fell 6.3 per cent in 2014-15 as resource investment continued to decline. Non-mining business investment grew modestly in 2014-15. The outlook for 2015-16 is more subdued than forecast at Budget as the transition towards broader-based growth is materialising at a slower pace than previously anticipated. While the Australian Bureau of Statistics' Capital Expenditure Survey indicates weak investment intentions, the National Australia Bank Business Survey has more firms intending to increase than to decrease investment in the 12 months from September 2015.

Conditions for investment continue to remain favourable with low borrowing costs leaving firms well placed to increase investment. Moreover, there has been a sustained lift in non-mining business conditions since Budget and rising capacity utilisation in the non-mining sector (Chart 2.2). As growth in domestic demand and exports gathers pace, businesses will have more opportunities to expand their productive capacity.

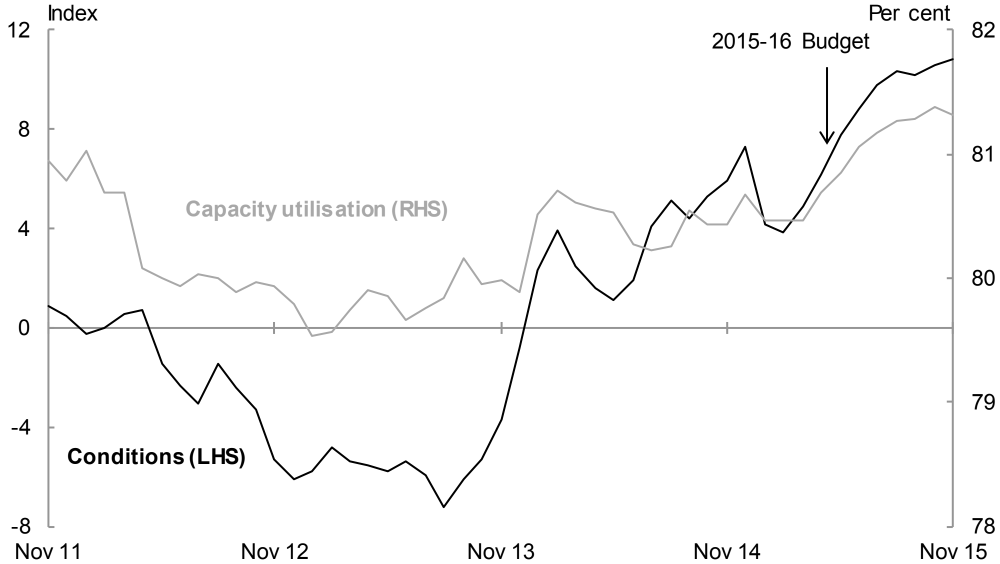
Table 2.2: Domestic economy forecasts[(a)]

	Outcomes(b)	Forecasts			
	2014-15	2015-16		2016-17	
		Budget	MYEFO	Budget	MYEFO
Real gross domestic product	**2.2**	**2 3/4**	**2 1/2**	**3 1/4**	**2 3/4**
Household consumption	2.5	3	2 3/4	3 1/4	3
Dwelling investment	7.7	6 1/2	8 1/2	4 1/2	2
Total business investment(c)	-6.3	-7	-9 1/2	-3 1/2	-4
By industry					
Mining investment	-17.3	-25 1/2	-26	-30 1/2	-25 1/2
Non-mining investment	1.0	4	- 1/2	7 1/2	4 1/2
Private final demand(c)	0.9	1 1/4	3/4	2 1/4	1 3/4
Public final demand(c)	-0.1	1 1/2	2	1 1/2	1 1/2
Change in inventories(d)	0.2	0	0	0	0
Gross national expenditure	0.8	1 1/2	1	2 1/4	1 3/4
Exports of goods and services	6.6	5	4 1/2	6 1/2	7
Imports of goods and services	0.1	-1 1/2	- 1/2	2 1/2	2 1/2
Net exports(d)	1.4	1 1/4	1	1	1
Nominal gross domestic product	1.6	3 1/4	2 3/4	5 1/2	4 1/2
Prices and wages					
Consumer price index(e)	1.5	2 1/2	2	2 1/2	2 1/4
Wage price index(f)	2.3	2 1/2	2 1/2	2 3/4	2 3/4
GDP deflator	-0.6	1/2	0	2 1/4	1 1/2
Labour market					
Participation rate (per cent)(g)	64.7	64 3/4	65	64 3/4	65
Employment(f)	1.5	1 1/2	2	2	1 3/4
Unemployment rate (per cent)(g)	6.0	6 1/2	6	6 1/4	6
Balance of payments					
Terms of trade(h)	-10.2	-8 1/2	-10 1/2	3/4	-2 1/4
Current account balance (per cent of GDP)	-3.6	-3 1/2	-5 1/4	-2 3/4	-5

(a) Percentage change on preceding year unless otherwise indicated.
(b) Calculated using original data unless otherwise indicated.
(c) Excluding second hand asset sales from the public sector to the private sector.
(d) Percentage point contribution to growth in GDP.
(e) Through the year growth rate to the June quarter.
(f) Seasonally adjusted, through the year growth rate to the June quarter.
(g) Seasonally adjusted rate for the June quarter.
(h) The forecasts are underpinned by spot prices of US$39 per tonne (FOB) for iron ore; US$73 per tonne (FOB) for metallurgical coal; and US$52 per tonne (FOB) for thermal coal.

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 61 and a $US exchange rate of around 72 US cents. Interest rates are assumed to move broadly in line with market expectations. World oil prices (Malaysian Tapis) are assumed to be US$43 per barrel.
Source: ABS cat. no. 5204.0, 5206.0, 5302.0, 6202.0, 6345.0, 6401.0, unpublished ABS data and Treasury.

Chart 2.2: Non-mining business conditions and capacity utilisation



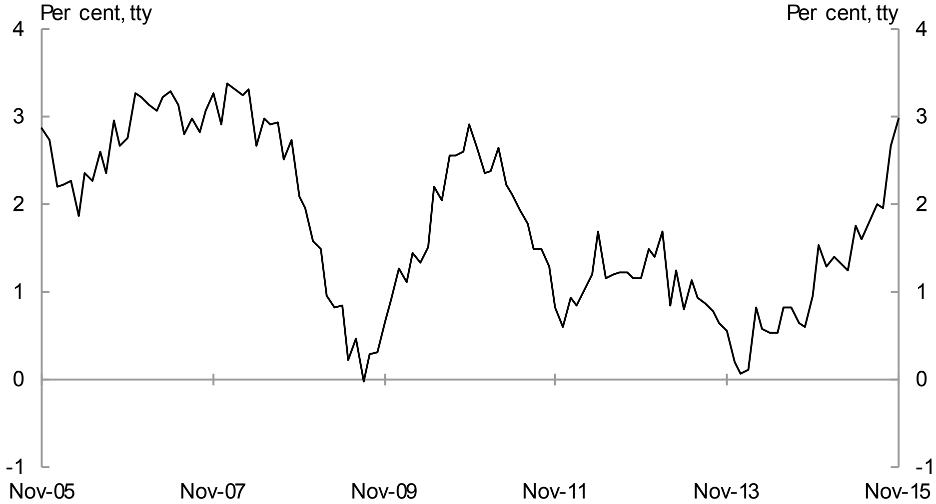
Note: Figures represent the 3-month moving average.
Source: NAB Monthly Business Survey and Treasury.

Dwelling investment grew more strongly in 2014-15 than expected at Budget rising by 7.7 per cent compared with the then forecast of 6½ per cent. With approvals, commencements and work yet to be done currently at or near record levels, dwelling investment is expected to maintain momentum throughout 2015-16. Dwelling investment is forecast to grow by 8½ per cent in 2015-16, with growth easing to 2 per cent in 2016-17.

The number of Australians with jobs rose by more than 340,000 over the past year, the strongest jobs growth in seven years (Chart 2.3). **Employment** is forecast to grow by 2 per cent through the year to the June quarter of 2016 and by 1¾ per cent to the June quarter of 2017. Consistent with lower forecast growth in real GDP and in line with slower population growth, expected employment growth in 2016-17 is lower than forecast at Budget. This results in lower forecast growth in compensation of employees. The unemployment rate is expected to have peaked at a lower level than previously forecast, remaining at around 6 per cent in the June quarters of 2016 and 2017.

The youth unemployment rate has fallen to 12.4 per cent from the peak of 14.5 per cent in November 2014 but remains substantially higher now than the 30 year lows reached before the global financial crisis.

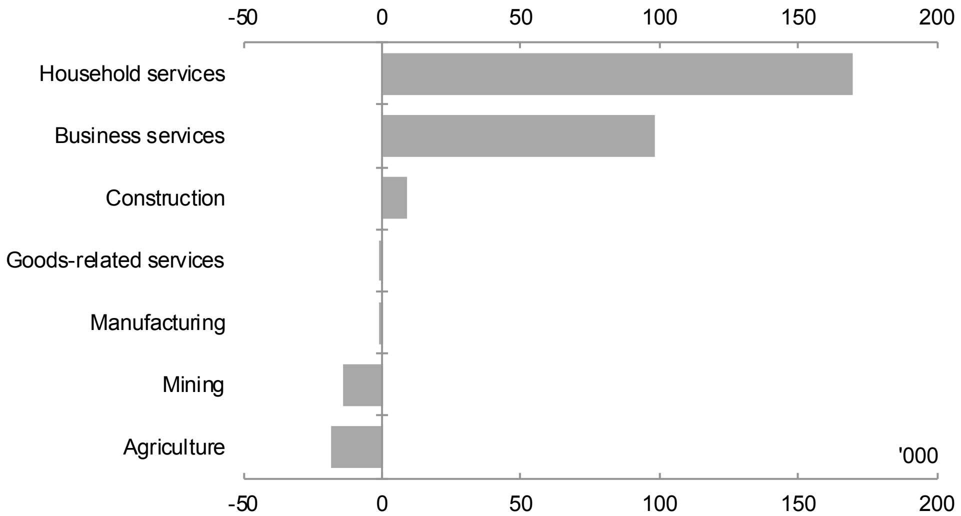
Chart 2.3: Employment growth



Source: ABS cat. no. 6202.0.

The transition in the economy from capital intensive mining to labour intensive service sectors is evident in the strength and composition of employment growth (Chart 2.4). While the economy has grown slower than its potential rate over the past year, employment growth has been significantly above the long run average, driven by the fast-growing household and business services sectors.

Chart 2.4: Growth in employment by industry in 2014-15



Note: Household services includes: accommodation and food services, education and training, health care and social assistance, arts and recreation services and other services. Business services includes: information media and telecommunications, financial and insurance services, rental, hiring and real estate services, professional, scientific and technical services, and administrative and support services. Goods-related services includes: electricity, gas, water, and waste services, wholesale trade, retail trade and transport, postal and warehousing.
Source: ABS cat. No. 6291.0.55.003.

The **participation rate** has increased to 65.3 per cent as those previously outside the labour market have responded to improving job opportunities. The participation rate is forecast to be 65 per cent over the forecast period.

Wage growth remains moderate, which continues to help the economy in its adjustment to broader-based growth. Moderate wage growth is supporting employment outcomes during a period of below potential GDP growth. Wage growth is forecast to be 2½ per cent through to the June quarter 2016 and 2¾ per cent through the year to the June quarter 2017.

Household **consumption** grew by 2.5 per cent in 2014-15, supported by strong growth in employment and lower petrol and electricity prices. Buoyant conditions in the housing market are also likely to have provided support for household consumption, contributing to an increase in household wealth and underpinning spending on household furnishings. Consistent with this outlook, recent surveys suggest that consumer sentiment is strengthening.

A strengthening labour market and a further modest decline in the household saving ratio are expected to support solid growth in household consumption, albeit at a slower rate than expected at Budget. Household consumption is forecast to grow by 2¾ per cent in 2015-16 and 3 per cent in 2016-17.

Headline CPI **inflation** is forecast to be 2 per cent through the year to the June quarter 2016 and 2¼ per cent to the June quarter 2017. The subdued outlook for inflation reflects moderate wage growth in combination with below potential GDP growth and lower oil prices.

The oil price, key commodity export prices and the exchange rate used to underpin the forecasts are based on a recent average, continuing the approach taken at the 2015-16 Budget. The average spot price for iron ore, metallurgical coal and thermal coal at the time of finalising MYEFO was $US39 per tonne free on board (FOB), $US73 per tonne (FOB) and $US52 per tonne (FOB) respectively.

Oil prices have continued to fall since the Budget, hitting six-year lows in November. While the sustained drop in oil prices is benefiting many parts of the Australian economy, it has a negative impact on LNG prices. As LNG export prices are linked to oil prices through long-term contracts, the large fall in the price of oil has resulted in lower LNG prices than forecast at Budget. With major Australian LNG projects coming on stream in the next few years, the lower oil price assumption is leading to lower forecast export values from these projects.

Falls in commodity prices since Budget continue to weigh on the **terms of trade**. As a result, the terms of trade are forecast to fall by 10½ per cent in 2015-16, compared with 8½ per cent at Budget. The terms of trade are expected to continue to fall by a further 2¼ per cent in 2016-17 compared with Budget forecasts of a small rise.

The **nominal GDP growth** outcome for 2014-15 was broadly in line with forecasts at Budget with growth of 1.6 per cent. Forecast nominal GDP growth has been revised down since Budget to be 2¾ per cent in 2015-16 and 4½ per cent in 2016-17. Declines in commodity prices have resulted in lower forecast company tax receipts, while moderate wages growth continues to weigh on personal income tax receipts.

There are continuing uncertainties in the outlook for commodity prices. The impact of the slowdown in the Chinese property market, along with overcapacity in resource and energy intensive sectors, is a downside risk to the prices of key Australian commodity exports.

There are also risks of financial market volatility associated with the prospect of the US Federal Reserve raising its policy rate for the first time in more than nine years.

In addition, there are risks around the momentum in consumer spending, with uncertainty over the global economic outlook having the potential to result in households being more cautious and saving more than expected. Changes to housing market conditions could also have an impact on household wealth and confidence and affect the outlook for household consumption.

The pace of the pick-up in non-mining business investment also remains a major source of uncertainty. As mining investment declines and the economy transitions to broader-based growth, business investment will be underpinned by a greater number of smaller investments in a diverse range of industries. These industries are generally less capital intensive, such as small businesses and businesses in the services sector, and lead times for investments are typically shorter than those for large mining projects. This adds to the difficulty in estimating both the timing and scale of the expected pick up in business investment.

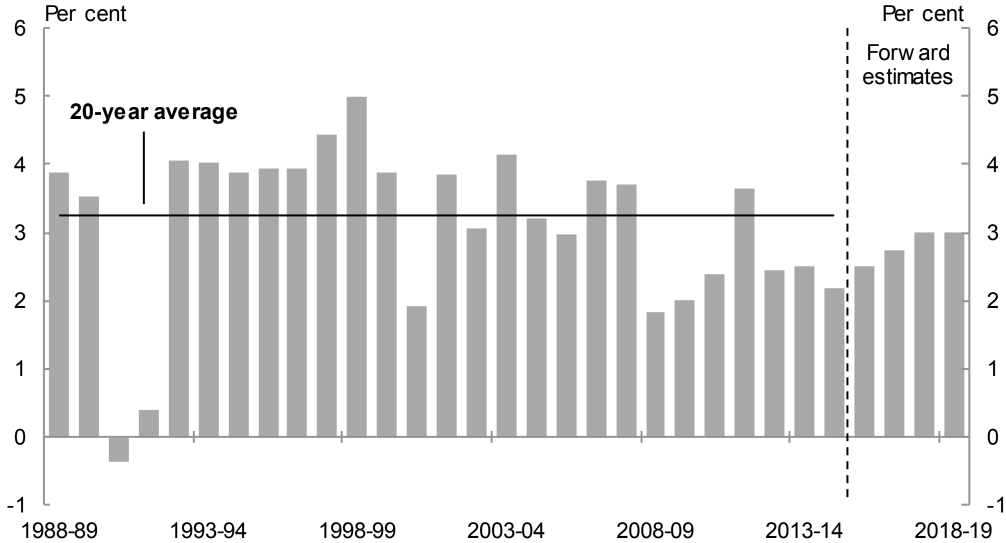
The uncertainty around the forecasts can be estimated based on past forecast errors. The real GDP growth rate in 2015-16 is expected to be around 2½ per cent, with the 70 per cent confidence interval ranging from 1¾ to 3¼ per cent. Nominal GDP growth forecasts carry with them additional uncertainty. The 70 per cent confidence interval for nominal GDP growth in 2015-16 ranges from 1½ to 3¾ per cent. Attachment A of Part 3 provides further detail on the confidence intervals around the forecasts.

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. Importantly, these projections are not forecasts, but rather reflect a set of medium-term assumptions.

The medium-term projection methodology (as outlined in the 2014-15 Budget) assumes that any spare capacity remaining in the economy at the end of the forecast period will be absorbed over the following five years[1]. As this occurs, labour market variables including employment and the participation rate are assumed to converge to their long-run potential levels. To absorb the forecast spare capacity in the economy, real GDP is projected to grow above potential for a period of five years from 2017-18 (Chart 2.5). By then the spare capacity is absorbed and real GDP is assumed to grow at its potential rate thereafter.

Chart 2.5: Real GDP growth



Source: ABS cat. no. 5206.0 and Treasury.

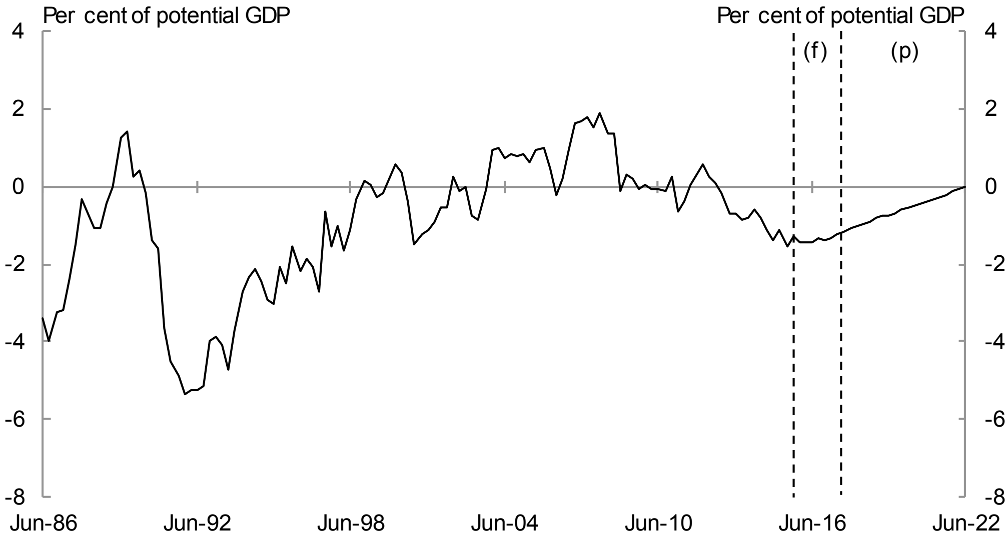
Potential GDP is estimated based on analysis of underlying trends for population, productivity and participation. The unemployment rate is projected to converge back to 5 per cent over the medium-term, Treasury's estimate of the non-accelerating inflation rate of unemployment. Inflation is projected to be 2½ per cent, consistent with the mid-point of the Reserve Bank of Australia's medium-term target band.

Since the release of economic projections in the 2015-16 Budget, downward revisions to Australia's current and projected population, as well as revised labour force estimates and projections, including a lower assessment of trend working hours, indicate that the economy's productive capacity is somewhat lower than estimated at last Budget. Incorporating this new information into the same methodological approach used in the 2014-15 and 2015-16 Budgets, results in downward revisions to the estimate of Australia's current potential output level, as well as to projected growth in potential output, which is now estimated to be 2¾ per cent over the next few years. As a result, the current estimate of the divergence between the economy's actual and potential output level — known as the output gap — is less than estimated at the 2015-16

1 Further information on the medium term projection methodology can be found at http://treasury.gov.au/PublicationsAndMedia/Publications/2014/Tsy-Medium-Term-Projection.

Budget (Chart 2.6) necessitating lower projected growth to absorb the lower forecast of spare capacity in the economy.

Chart 2.6: Level of output gap



Note: Forecasts represented by (f), projections are represented by (p).
Source: ABS cat. no. 5206.0 and Treasury.

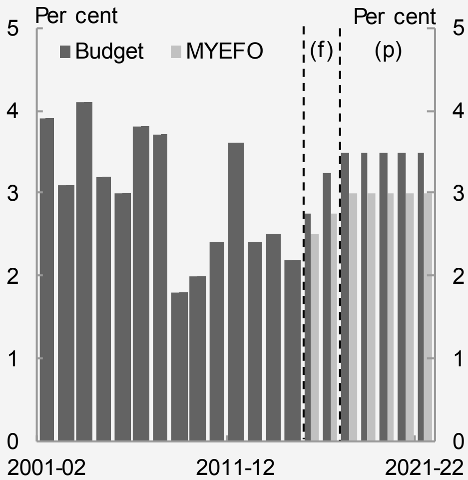
Additional information on the medium-term projections changes are in Box A.

Box A: Medium-term economic projections

Treasury has lowered its estimates of potential GDP in light of downward revisions to Australia's population and updated labour force data.[2]

As a result of lower estimated potential GDP, the rate of economic growth over the medium term has been revised down from 3½ per cent to 3 per cent (Chart A).

Chart A: Impact on real GDP projections



Source: ABS Cat. No. 5206.0 and Treasury

Revised population and labour force

Revised population data showed that growth in Australia's working-age population over recent years was slower than initially reported by the Australian Bureau of Statistics (ABS).

This reflected lower than expected net overseas migration (NOM) in line with declines in temporary visas (in particular, graduate and 457 visas) and lower net migration from New Zealand.

The revised data show that the working-age population expanded by 1½ per cent over the year to June 2015, lower than the 1¾ per cent growth assumed at Budget and the average 1¾ per cent growth in the past decade.

Taking account of these historical revisions and lower NOM projections by the Department of Immigration and Border Protection, the working-age population is now projected to grow at around 1½ per cent over the next three years.

Estimates of trend average hours worked have also been reviewed in light of new ABS labour force data. These data suggest a larger share of the recent decline in average hours worked is likely to be related to trend rather than cyclical factors, including the continued rise of part-time work and dual income families.

Impact on GDP projections

Growth in potential GDP is now estimated at 2¾ per cent over the next few years, down from 3 per cent at Budget.

As a result, real GDP is projected to be lower each year from 2017-18 than at Budget, in line with the downward revisions to estimated potential GDP.

Similarly, nominal GDP is also projected to be lower over this period than at Budget, which has flow-on effects for the fiscal outlook. Fiscal impacts are discussed in Part 3, Box A.

2 Further information on the impact of revised population and labour force data can be found at: www.treasury.gov.au/PublicationsAndMedia/Speeches/2015/The-Macroeconomic-Context.