STATEMENT 2: ECONOMIC OUTLOOK

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

CONTENTS

STATEMENT 2: ECONOMIC OUTLOOK

OVERVIEW

Australia is in its 26th consecutive year of economic growth. In 2017-18, growth is expected to rebound to 2¾ per cent after slowing in 2016-17 as a result of weather-related factors in early 2016-17 and more recently Tropical Cyclone Debbie.

The lift in economic growth is expected to occur as the drag from falling mining investment diminishes, growth in household consumption improves and exports continue to grow strongly. Non-mining business investment is also forecast to strengthen. Accommodative monetary policy, a lower exchange rate and a flexible labour market are all helping to facilitate the economic adjustment that has been underway for some time following the peak of the investment phase of the mining boom.

Global growth is expected to recover over the forecast horizon. Last year, the global economy recorded its lowest growth rate since the global financial crisis (GFC) but there are encouraging signs that the outlook is firming. China has entered 2017 with good momentum and the United States economy is performing well. There have also been signs of improvement in other advanced economies and in some of the emerging economies that were affected by previous sharp falls in commodity prices. Some of the major advanced economies are growing above potential, gradually pushing down their unemployment rates. In the United States, this has enabled the Federal Reserve to continue to adjust its monetary policy settings.

Domestically, Australia's transition towards broader-based activity is well advanced. It is anticipated that growth will lift following the impact of a number of weather-related events in 2016-17. Real GDP growth is expected to be 2¾ per cent in 2017-18 and 3 per cent in 2018-19. Australia's economic performance continues to compare favourably with most advanced economies, including other major commodity exporters.

Economic performance across the States and Territories continues to vary widely. The impact of shifts away from mining investment and towards resource exports is being experienced most strongly in Western Australia and Queensland. New South Wales and Victoria are growing faster than their decade averages, supported by lower interest rates, solid population growth and a lower exchange rate.

Mining investment has fallen for the past three financial years and has detracted more than one percentage point a year, on average, from real GDP growth over this period. At the same time, resource exports have made a strong contribution to growth as the adjustment from the investment phase to the production phase of the mining boom has continued. The drag on growth from mining investment is expected to diminish over the forecast horizon and resource exports are forecast to continue to support growth. The last of the major iron ore and liquefied natural gas (LNG) projects are set to reach expected capacity over the forecast period. Other categories of exports are also supporting growth. Service exports are forecast to continue to grow solidly, supported by the sustained depreciation in the exchange rate and strong demand for tourism and education, particularly from Asia. Rural exports are forecast to grow strongly in 2016-17, given the record winter crop, before falling in 2017-18 with an expected return to average seasonal conditions.

Non-mining business investment is expected to benefit as negative spill-overs from the mining sector wane. It will also be supported by a strengthening in domestic demand, solid business conditions and low financing costs. Non-mining business investment is forecast to grow by 4½ per cent in both 2017-18 and 2018-19.

Household consumption growth has been relatively moderate in recent years compared with long-run historical growth rates. It is expected to pick up over the forecast horizon to 2¾ per cent in 2017-18 and 3 per cent in 2018-19. It is expected that consumption will continue to grow by more than household income, resulting in a further decline in the household saving rate.

Dwelling investment is expected to provide near-term support to the economy, with a strong pipeline of residential construction work yet to be done, predominantly in New South Wales and Victoria. As the pipeline comes to completion, growth in dwelling investment is forecast to slow to 1½ per cent in 2017-18. Dwelling investment is expected to fall by 4 per cent in 2018-19.

Over recent years, a slowing in wage and price growth and a significant decline in commodity prices has constrained income growth across the economy. This is affecting households and businesses as well as having a large impact on Government revenue.

The slowdown in wage growth has been widespread across industries and States. Wages growth is expected to improve as domestic demand strengthens but the outlook for wage growth remains subdued in the near term, reflecting spare capacity in the labour market. The near-term outlook for inflation is also subdued.

The prices of some of Australia's major commodity exports rose sharply over the past six months and are providing a temporary boost to national income. Higher commodity prices are expected to lead to a near-term improvement in the trade balance. As in the 2016-17 Mid-Year Economic and Fiscal Outlook (MYEFO), the forecasts are based on the judgment — supported by broad and deep market and industry consultation — that it is prudent to assume that prices for metallurgical coal and iron ore will not be sustained at recent levels.

Higher commodity prices late last year are forecast to result in a sharp rise in Australia's terms of trade in 2016-17. The terms of trade are then forecast to fall in 2017-18 and 2018-19. Led by movements in the terms of trade, nominal GDP is expected to grow by 6 per cent in 2016-17 and 4 per cent in both 2017-18 and 2018-19.

As always, there are a number of uncertainties around the forecasts. Heightened policy uncertainty has emerged in a number of countries, including growing support for policies that could restrict global trade and hence growth. High levels of debt, potential financial imbalances and overcapacity in some sectors also remain as risks to China's economy and Europe continues to face legacy issues following the GFC. The recalibration of interest rates in the United States is also a source of uncertainty for the outlook. In addition, there is greater concern surrounding a number of regional and global strategic issues.

Domestically, the outlook for commodity prices is a key uncertainty for the outlook for nominal GDP. There are also risks to the real economy around the momentum in household consumption, as well as uncertainty around dwelling investment and non-mining business investment. With a significant number of medium-to-high density dwellings due for completion over the forecast horizon, a faster than expected decline in dwelling investment could also constrain overall real output growth. The timing and pace of the recovery in non-mining business investment also remains a risk to the domestic outlook.

Table 1: Domestic economy forecasts(a)

	Outcomes(b)	Forecasts		
	2015-16	2016-17	2017-18	2018-19
Real gross domestic product	**2.6**	**1 3/4**	**2 3/4**	**3**
Household consumption	2.9	2 1/2	2 3/4	3
Dwelling investment	10.6	4 1/2	1 1/2	-4
Total business investment(c)	-10.3	-6	0	3
By industry				
Mining investment	-27.5	-21	-12	-3
Non-mining investment	1.4	1 1/2	4 1/2	4 1/2
Private final demand(c)	0.8	1	2 1/4	2 1/2
Public final demand(c)	3.4	4	2 1/2	3
Change in inventories(d)	-0.1	0	0	0
Gross national expenditure	1.3	1 3/4	2 1/2	2 3/4
Exports of goods and services	6.7	5 1/2	5	4
Imports of goods and services	-0.3	3	3	3
Net exports(d)	1.4	1/2	1/2	1/4
Nominal gross domestic product	2.3	6	4	4
Prices and wages				
Consumer price index(e)	1.0	2	2	2 1/4
Wage price index(f)	2.1	2	2 1/2	3
GDP deflator	-0.3	4	1	1
Labour market				
Participation rate (per cent)(g)	64.8	64 1/2	64 1/2	64 1/2
Employment(f)	1.9	1	1 1/2	1 1/2
Unemployment rate (per cent)(g)	5.7	5 3/4	5 3/4	5 1/2
Balance of payments				
Terms of trade(h)	-10.2	16 1/2	-2 3/4	-4 1/4
Current account balance (per cent of GDP)	-4.4	-1 1/2	-1 1/2	-2

(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 price assumptions for iron ore, metallurgical coal and thermal coal (see Box 4).

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 65 and a US$ exchange rate of around 76 US cents. Interest rates are assumed to move broadly in line with market expectations. World oil prices (Malaysian Tapis) are assumed to remain around US$55 per barrel.
Source: ABS cat. no. 5204.0, 5206.0, 5302.0, 6202.0, 6345.0, 6401.0, unpublished ABS data and Treasury.

OUTLOOK FOR THE INTERNATIONAL ECONOMY

In 2016, the global economy recorded its lowest growth since the GFC, but there are encouraging signs that growth is strengthening in 2017. This marks a welcome break from the prolonged period of downgrades to global growth forecasts since the GFC. Major trading partner growth is forecast to remain higher than for the wider global economy over the forecast period, with Australia's Asian trading partners forecast to grow strongly.

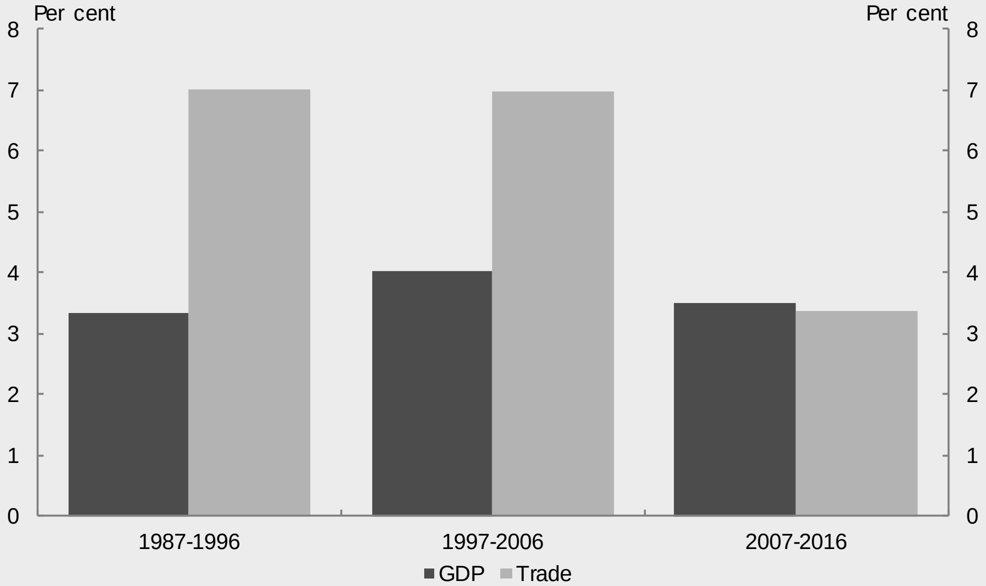
After prolonged weakness, global trade volumes have picked up in recent months and there are signs of an improving outlook for business investment and industrial production in a number of major economies. Business and market sentiment have strengthened as confidence in global prospects has improved.

Box 1: Global trade growth

In the two decades to 2006, the world economy grew at an average annual rate of 3.7 per cent. Over the same period, world trade volumes grew at almost double that rate, averaging 7.0 per cent per year. Trade growth was driven in significant part by the emerging Asian economies pursuing export-oriented growth strategies and increased economic integration in Europe. Exports as a share of the global economy increased from around 18 per cent in 1986 to around 30 per cent in 2006.

In the past decade, world GDP growth has struggled to regain sustained momentum following the GFC, slowing to an annual average rate of 3.5 per cent. Over the same period, growth in trade volumes has more than halved to an annual average rate of 3.4 per cent. Since 2011, export growth has slowed even in the emerging Asian economies. The slowdown in global trade growth has been attributed to a range of factors including soft growth in global industrial production and business investment in the wake of the GFC.

Chart A: Average yearly global GDP and trade volume growth by decade



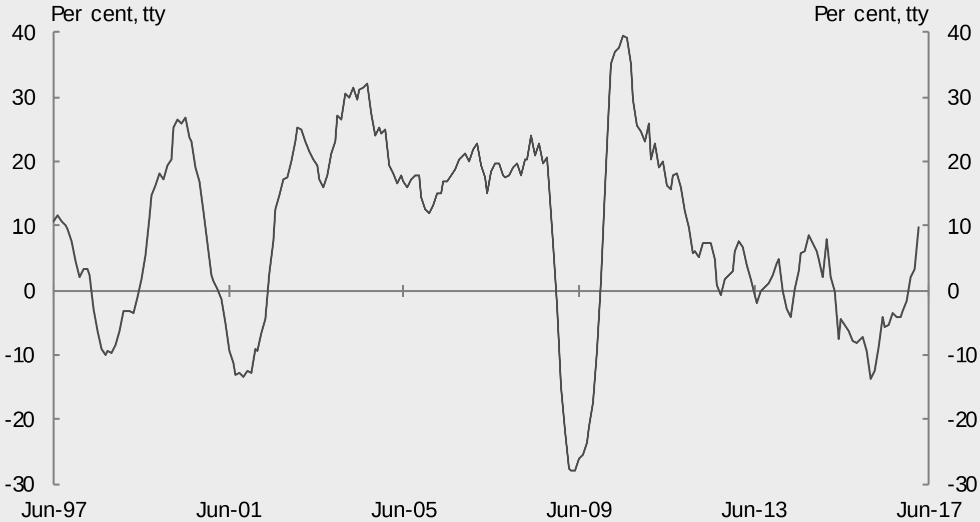
Note: GDP in constant prices and trade in volumes terms.
Source: Thomson Reuters, IMF World Economic Outlook (April 2017).

Box 1: Global trade growth (continued)

More recently, there have been encouraging signs that trade momentum is starting to recover. World merchandise export volumes have picked up over the past six months according to the CPB World Trade Monitor. This lift is broad-based across both advanced and emerging economies. Stronger trade growth will be an important foundation for a more vibrant world economy. This is particularly true for Australia as trade is an important source of growth in the Asian region.

Indeed, there are positive signs in some of Australia's key trading partners in Asia, with China, Japan and South Korea recording recoveries in export value growth in recent months. This follows a period of weakness over the past couple of years that is similar in magnitude to other significant trade downturns of the past 20 years. The recovery in export values partly reflects foreign exchange and commodity price movements, with oil prices regaining some ground over the past year from lows seen in early 2016. However, there is evidence of stronger growth in exports of capital goods from these countries, providing some positive indicators about global demand for investment goods.

Chart B: Growth in combined export values of China, Japan and South Korea



Note: 3-month moving average.
Source: Thomson Reuters, national statistical agencies, Treasury.

Still, a range of uncertainties surround the forecasts for global growth. Heightened policy uncertainty has emerged in a range of countries. High levels of debt, potential financial imbalances and overcapacity in some sectors remain as risks to China's economy, while Europe continues to face a range of persistent issues following the GFC and the European sovereign debt crisis.

In addition, structural drivers of growth are expected to continue to ease in coming years. In many advanced and some key emerging market economies, ageing populations are weighing on potential growth. Productivity growth also remains slow.

Thus, despite relatively subdued growth rates of recent years, major economies including the United States, Japan and the euro area have been growing above potential and drawing down spare capacity in the labour market.

Policy settings will be crucial for sustaining the near-term recovery in the global outlook and to support improvements in productivity and living standards. Reforms required to support productivity growth have proved difficult to achieve and, of more concern, there appears to be growing support in some countries for policies that would restrain global trade. Central banks will need to continue to support the recovery while, in some cases, withdrawing the degree of accommodation of the past few years.

Headline inflation rates have picked up in several major advanced economies, driven in part by an increase in commodity prices. Financial market-based measures of inflation expectations have risen from lows seen over the past year. But core inflation rates have remained more subdued.

Monetary policy settings remain accommodative in advanced economies. In late 2016 the Bank of Japan supplemented its quantitative and qualitative easing programs with a target for longer-term Japanese Government bond yields. The European Central Bank and the Bank of England have also continued quantitative easing programs as well as maintaining policy rates around zero.

By contrast, the United States Federal Reserve has gradually raised interest rates. To date, this process has been relatively smooth. Still, there is a risk of a more abrupt adjustment in markets if economic developments were to force the Federal Reserve to tighten monetary policy beyond current expectations.

Table 2: International GDP growth forecasts(a)

	Actuals	Forecasts		
	2016	2017	2018	2019
China	6.7	6 1/2	6 1/4	6
India	7.5	7	7 3/4	7 3/4
Japan	1.0	3/4	1/2	1/2
United States	1.6	2 1/4	2 1/4	2 1/4
Euro area	1.7	1 1/4	1 1/4	1 1/4
Other East Asia(b)	3.9	4	4 1/4	4 1/4
Major trading partners	3.9	4	4	4
World	3.1	3 1/4	3 1/2	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) Other East Asia comprises Hong Kong, South Korea, Singapore and Taiwan and the Association of Southeast Asian Nations group of five (ASEAN-5): Indonesia, Malaysia, the Philippines, Thailand and Vietnam.

Source: National statistical agencies, IMF World Economic Outlook (April 2017), Thomson Reuters and Treasury.

The economic expansion in the **United States** following the GFC is forecast to extend to a decade of continuous annual growth. Consumption and housing investment should support growth, while consumer sentiment has increased markedly in recent months.

The US unemployment rate has fallen back to near pre-GFC lows. While wages have previously been slow to respond to the strengthening labour market, there are encouraging signs that wage growth is now picking up as the labour market has neared full employment. Business investment has remained relatively weak, although there have recently been some positive signs across a range of indicators, including business sentiment and spending intentions.

The policy platform of the new US Administration includes measures that could have a range of effects on the US and global economies. The exact impact will depend on the final mix of policies and how they are implemented.

Growth in **China** has gained some momentum over late 2016 and early 2017. This has been underpinned by increasing credit intensity with an associated build-up of risks in the property and financial sectors. Economic stability is expected to remain a top priority for authorities in the short term, with a growth target of 'around 6.5 per cent or higher if possible' in 2017. Growth is expected to moderate thereafter. The Chinese authorities are likely to face policy challenges in managing the risks around a gradual slowing in growth, amid structural shifts in the economy, a declining working age population and high levels of debt. However, authorities still have policy space at their disposal to manage these challenges.

India's economy has shown remarkable resilience in recent years and is expected to remain the world's fastest growing major economy over the forecast period. Growth slowed slightly following the withdrawal and exchange of high-denomination currency from circulation beginning in November 2016 but a recovery is expected through 2017, supported by improved liquidity. The Indian Government's significant program of structural reform — which includes the introduction of a national GST, a new bankruptcy code and measures to promote financial inclusion and improve business conditions — should support high growth over the medium term.

Japan is forecast to continue to grow at a low rate compared with other advanced economies. There has been some pickup in growth over the past year, led by the corporate sector, with strong exports and investment related to the 2020 Olympics and the unemployment rate has fallen to multi-decade lows. Japan's growth is forecast to return to lower rates over the next few years. In the medium term, demographic headwinds, persistent low inflation and high government debt are expected to constrain Japan's growth. The Japanese government is scheduled to increase its consumption tax rate again in October 2019.

The **euro area** economy has registered relatively steady growth over the past couple of years after recovering from the turmoil of 2011-12. Consumption continues to underpin growth and the unemployment rate has been falling from elevated levels. However, there remains a large divergence between key economies. Growth in the region continues to face headwinds associated with the financial weakness of many European banks, potentially limiting their ability and willingness to increase lending.

The euro area and UK economies have remained resilient to date following the June 2016 'Brexit' referendum, although the medium-term effects of Brexit will depend on the exact nature of the final agreement between the UK and EU. An increase in trade barriers following UK-EU negotiations would have negative effects on the euro area and UK economies.

Growth among the **ASEAN-5** economies is forecast to strengthen. Private consumption is expected to support growth in Indonesia. Both Indonesia and Malaysia are benefiting from recent higher commodity prices. Among commodity importers, growth in Thailand is expected to remain subdued but will be supported by public investment and tourism. Strong service exports and manufacturing are expected to support high growth rates in the Philippines and Vietnam.

OUTLOOK FOR THE DOMESTIC ECONOMY

Economic growth is forecast to rebound

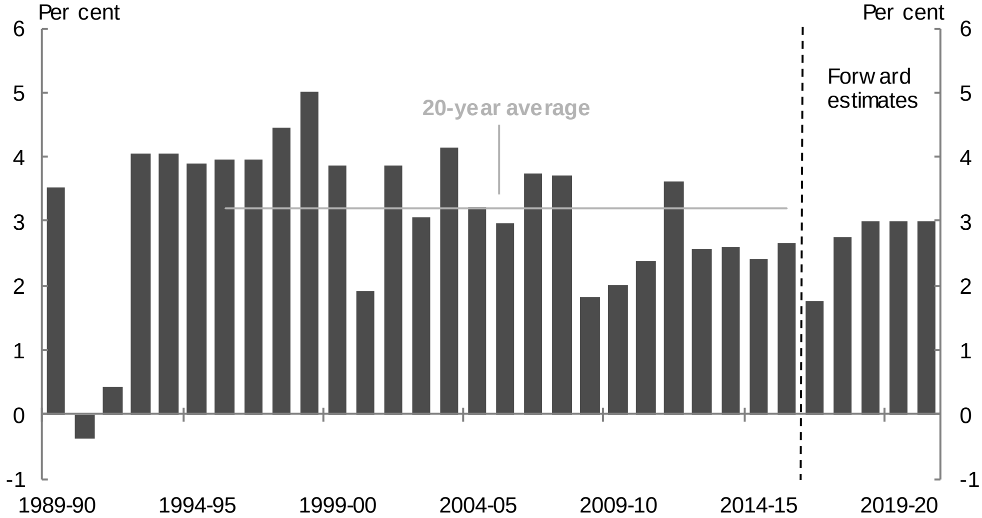
Australia is in its 26th consecutive year of economic growth. As shown in Chart 1, **real GDP growth** is expected to rebound to around its potential rate in 2017-18 and 2018-19 after slowing in 2016-17 owing to weather-related events. Real GDP growth in 2016-17 is forecast to be 1¾ per cent.

The rebound in growth is expected to be driven by a reduction in the extent to which mining investment detracts from growth and an improvement in growth in household consumption and non-mining business investment. Exports are also expected to support growth, while dwelling investment is forecast to contribute to growth in the near term but peak during the forecast period.

Growth is being supported by historically low interest rates, with the Reserve Bank of Australia's (RBA) official cash rate at 1.5 per cent. The accommodative stance of monetary policy is supporting the economy by keeping borrowing costs low for businesses and households. Lending rates faced by businesses are around their lowest levels in at least two decades and have been assisting the modest recovery in non-mining business investment. The standard variable mortgage rate is at its lowest level since the mid-1960s and has supported record levels of dwelling investment and strong increases in house prices in Sydney and Melbourne.

While the Australian dollar has appreciated since the end of 2015, against both the US dollar and on a trade-weighted basis, it remains around 30 per cent lower than its 2011 peak against the US dollar. This has assisted the transition away from resources investment-led growth to broader-based sources.

Chart 1: Real GDP growth



Source: ABS cat. no. 5206.0 and Treasury.

Box 2: Estimated economic impact of Tropical Cyclone Debbie

Tropical Cyclone Debbie hit Australia on 28 March 2017 resulting in loss of life and widespread damage and flooding in Queensland and northern New South Wales.

In terms of the effect on economic activity, the cyclone has significantly disrupted Australia's coal exports and has adversely affected the agricultural and tourism industries.

After significant damage to major coal haulage networks and a number of coal mines in Queensland having issued *force majeure* notices, coal exports have been disrupted. Reflecting the significance of the coal industry in Queensland, which exports more than half of the world's seaborne trade, the metallurgical coal price doubled in the weeks after the cyclone.

There have also been agricultural losses in Queensland and northern New South Wales. The Mackay region, which produces a range of fruit and vegetables, was among the worst hit by the cyclone. This region produces a notable share of Australia's capsicums, sugar cane and fresh tomatoes. A portion of these crops is expected to be lost.

As a result of these agricultural losses, fruit and vegetable prices are expected to rise but the impact on overall inflation is not expected to be significant. The price rises are expected to add less than ¼ of a percentage point to the CPI over the June and September quarters of 2017.

Box 2: Estimated economic impact of Tropical Cyclone Debbie (continued)

The tourism sector has also been affected by the cyclone. The Whitsundays area — which includes major resorts on Daydream, Hamilton and Hayman Islands — has reported infrastructure and environmental damage.

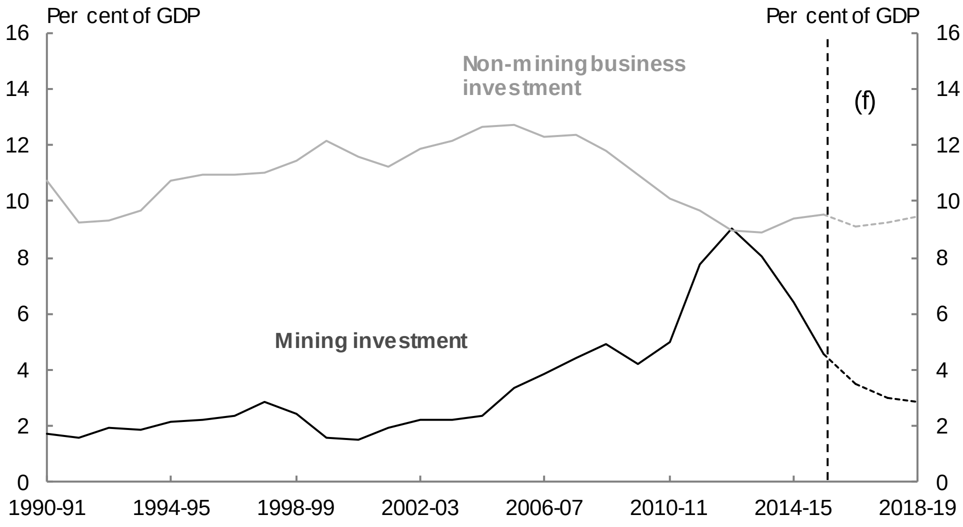
Overall, Tropical Cyclone Debbie is expected to reduce real GDP growth by ¼ of a percentage point in the June quarter of 2017, predominantly through lost coal exports. Reconstruction and the resumption of economic activity are expected to add to real GDP growth in subsequent quarters.

The economic impact of Tropical Cyclone Debbie is expected to be smaller than that of Tropical Cyclone Yasi and the Queensland floods of 2011. Tropical Cyclone Yasi and the Queensland floods together detracted ¾ of a percentage point from real GDP growth in 2010-11 and added ½ of a percentage point to inflation over the March and June quarters of 2011.

The economic drag from falling mining investment is fading

Business investment is forecast to fall in the near term, driven by further declines in mining investment as large resource projects are completed. **Mining investment** has fallen for the past three financial years. In doing so it has detracted more than one percentage point annually, on average, from real GDP growth over this period. With much of this adjustment now complete, the impact on the broader economy from falling investment in the mining sector is expected to wane in 2017-18 and 2018-19. Chart 2 shows the significant movements in mining and non-mining business investment as a share of GDP.

Chart 2: Mining and non-mining business investment as a share of GDP



Source: ABS cat. no. 5204.0 and Treasury.

At the same time, **non-mining business investment** is expected to pick up, supported by strengthening demand, solid business conditions and low financing costs. Overall, total private business investment is forecast to remain flat in 2017-18 and to expand moderately by 3 per cent in 2018-19.

As in many other economies, the subdued recovery in non-mining business investment in Australia remains something of a puzzle, as supportive conditions have been in place for some time. Business borrowing costs are near record lows, business confidence is solid and capacity utilisation in the non-mining sector is above its long-run average.

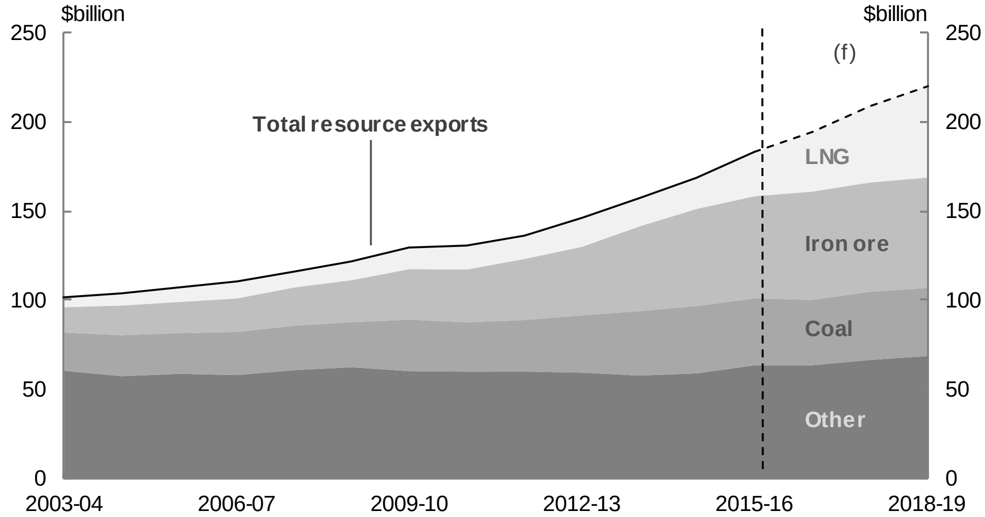
A diminishing drag from mining investment should provide a more supportive environment for non-mining businesses, particularly in the mining-exposed States. Weakness in non-mining investment has been concentrated in Queensland and Western Australia, where non-mining businesses are likely to be more exposed to the scaling back of large mining construction projects. In contrast, non-mining investment in New South Wales and Victoria has been stronger in recent years.

The pace and timing of a pickup in non-mining business investment remains a key source of uncertainty for the outlook. The sensitivity of the forecasts to a different outlook for business investment is discussed in Statement 8.

Mining and services exports will continue to contribute to growth

Total **exports** are forecast to increase by 5 per cent in 2017-18 and 4 per cent in 2018-19. The production phase of the mining boom is well underway and the last of the major iron ore and LNG projects are forecast to reach expected capacity over the forecast period. Accordingly, **resource exports** continue to underpin growth in Australia's outbound trade. As shown in Chart 3, they are expected to grow strongly, rising by 8 per cent in 2017-18 and 5 per cent in 2018-19.

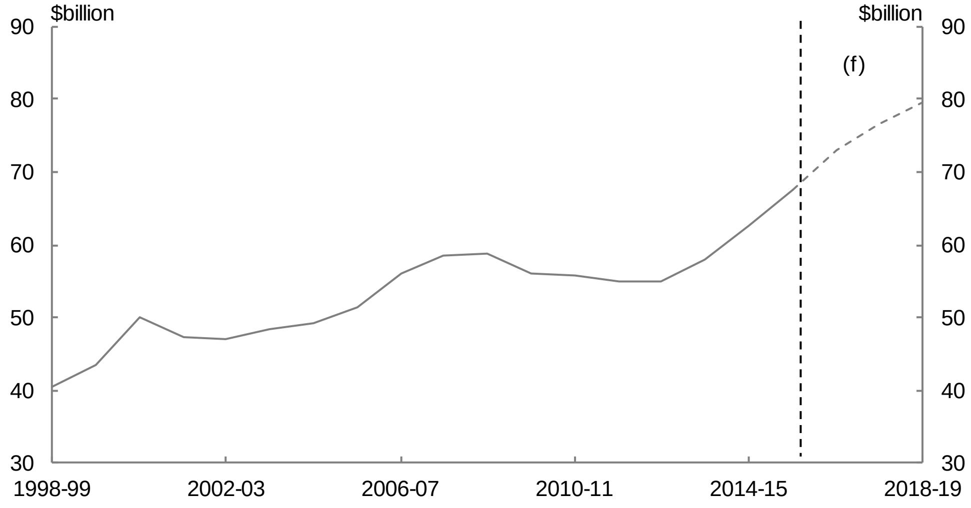
Chart 3: Resource exports



Note: 2014-15 prices. Other category includes a combination of smaller commodities such as metals, metal ores and mineral fuels.
Source: ABS cat. no. 5302.0, ABS Trade Data and Treasury.

Strong demand from Asia for Australia's tourism and education services continues to drive rapid growth in **services exports,** underpinned by robust growth in short-term visitors. A lower exchange rate since its peak in 2011 and streamlining of student visa policy arrangements have also made Australian education exports more attractive in recent years. Services exports are forecast to grow by 4½ per cent in 2017-18 and 4 per cent in 2018-19, as shown in Chart 4.

Chart 4: Services exports



Note: 2014-15 prices.
Source: ABS cat no. 5302.0 and Treasury.

In the rural sector, favourable seasonal conditions have led to unprecedented yields and a record high winter crop in many parts of Australia, providing a welcome income boost to various regional areas of Australia following more subdued activity in recent years. Reflecting this, **rural exports** are expected to grow by a solid 6 per cent in 2016-17 and provide support to economic growth in the near term.

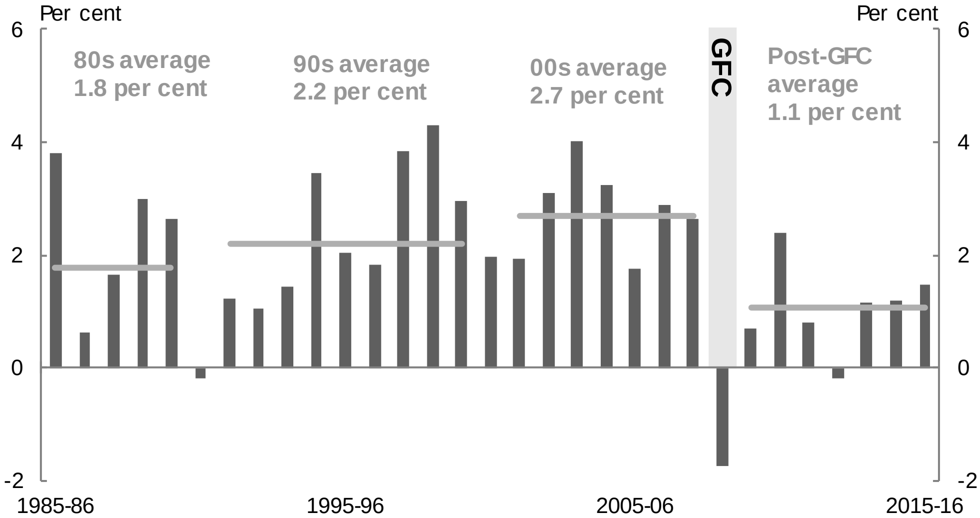
A return to average seasonal conditions is expected to underpin a fall in rural exports in 2017-18. The normalisation of crop production is expected to be mitigated by a pickup in livestock exports.

Imports continue to reflect the transition of the economy to broader-based growth. While capital imports are unlikely to return to levels seen at around the peak of the mining investment boom, other imports are rising in line with growth in the broader economy. Total imports are expected to grow by 3 per cent in both 2017-18 and 2018-19.

Household spending and income growth are subdued

Reflecting subdued growth in household income, **household consumption** growth has been relatively slow in recent years compared with long-run historical growth rates. In the period since the GFC, average consumption per capita growth has fallen to 1.1 per cent. This is well below the averages of the past few decades and this partly reflects weaker per capita income growth than in prior periods (Chart 5).

Chart 5: Real consumption growth per capita pre and post-GFC



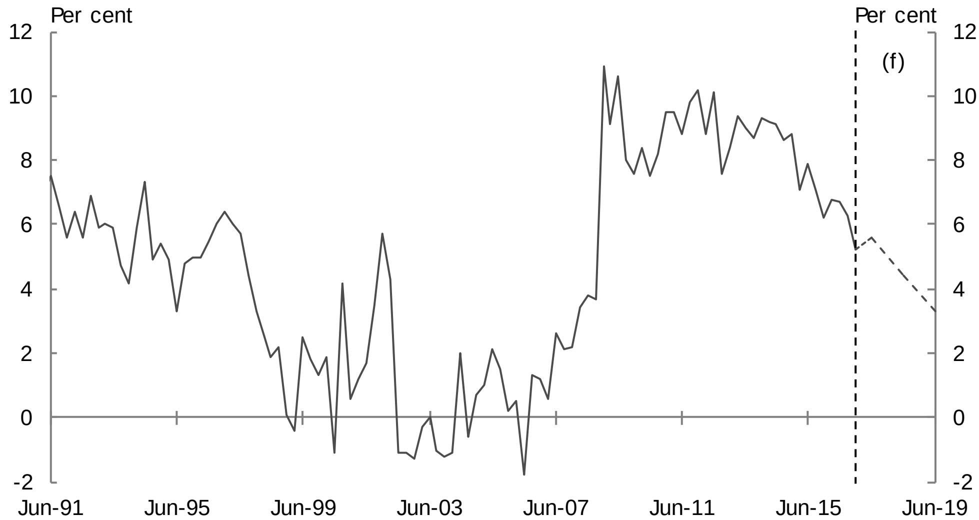
Note: The average growth rate depicted for the 1980s covers the period 1980-81 to 1989-90 due to data availability.
Source: ABS cat. no. 3101.0, 5206.0 and Treasury.

Household consumption expenditure is forecast to continue to grow faster than household income over the forecast horizon. This is expected to result in a lower household saving rate, which is forecast to fall to 3¼ per cent in 2018-19, as shown in

Chart 6. Household consumption is forecast to grow by 2¾ per cent in 2017-18 and 3 per cent in 2018-19.

The extent to which the household saving rate declines is an important source of uncertainty around the forecasts. A change in households' attitudes toward saving or a change in the factors that have driven the decline in the household saving rate over the past few years could lead to household consumption being weaker than forecast.

Chart 6: Household saving ratio



Note: Forecasts are financial year averages.
Source: ABS cat. no. 5206.0 and Treasury.

Although full-time employment has strengthened recently, **labour market conditions** have generally softened after strong employment growth in 2015, with the majority of employment increases since the end of 2015 being in part-time employment. The unemployment rate is currently 5.9 per cent, having partially reversed the decline that occurred through 2015 and most of 2016. In addition, the underemployment rate has edged up, reaching 8.7 per cent in February 2017.

There is some uncertainty around the outlook for the labour market. The modest rise in the unemployment rate is consistent with slower GDP growth on average in the second half of 2016. But other indicators such as job advertisements, vacancies and business survey measures suggest that labour market conditions will improve in the period ahead. Taking all this together, **employment** is forecast to grow by 1 per cent through the year to the June quarter 2017. Employment growth is forecast to be 1½ per cent through the year to the June quarters of 2018 and 2019. The **unemployment rate** is forecast to decline modestly through the forecast period, consistent with the forecast that GDP growth will rebound. The outlook for labour force **participation** is relatively stable, with the participation rate forecast to be at 64½ per cent in the June quarter 2019.

Wage growth has recently been low by historical standards in both the public and private sectors. The Wage Price Index grew by 1.9 per cent through the year to the December quarter 2016, reflecting spare capacity in the labour market. Subdued wage growth has been a feature of many advanced economies over the past few years, even in countries such as the United States, Japan and the United Kingdom, all of which have relatively low unemployment rates. The Wage Price Index is forecast to increase by 2 per cent through the year to the June quarter 2017, before increasing to 2½ per cent through the year to the June quarter 2018 and 3 per cent through the year to the June quarter 2019.

Support from housing construction is moderating

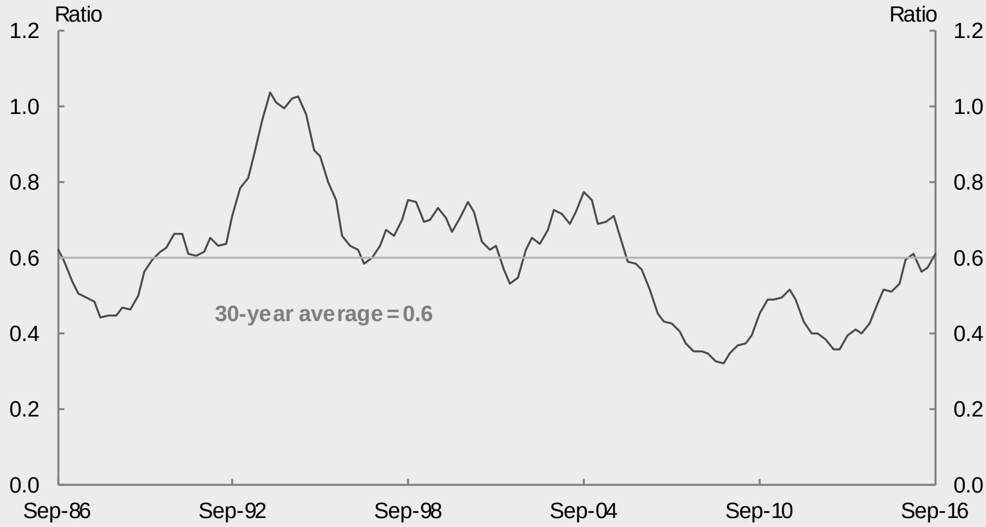
Dwelling investment has grown strongly over the past three years, providing support for the economic transition while starting to address an undersupply of housing stock in some areas. It grew by 10.6 per cent in 2015-16 — the fastest growth observed since the early 2000s — with strong activity in medium-to-high density dwelling construction. Dwelling investment is expected to continue to support growth in the near term, with a strong pipeline of residential construction work yet to be done (Box 3).

Building approvals have softened since around mid-2016, with a moderation in detached house approvals and significant falls observed in approvals for medium-to-high density dwellings (Box 3). As a result, the level of dwelling investment is expected to grow by only 1½ per cent in 2017-18 and to fall by 4 per cent in 2018-19 once the current elevated pipeline of building work comes to completion.

Box 3: Housing market

Australia experienced a period of subdued residential construction activity relative to population growth during the mid-to-late 2000s leading to a state of pent-up demand in the housing market, as the ratio of dwelling completions to population change fell to record lows (Chart A).

Chart A: Ratio of dwelling completions to population change

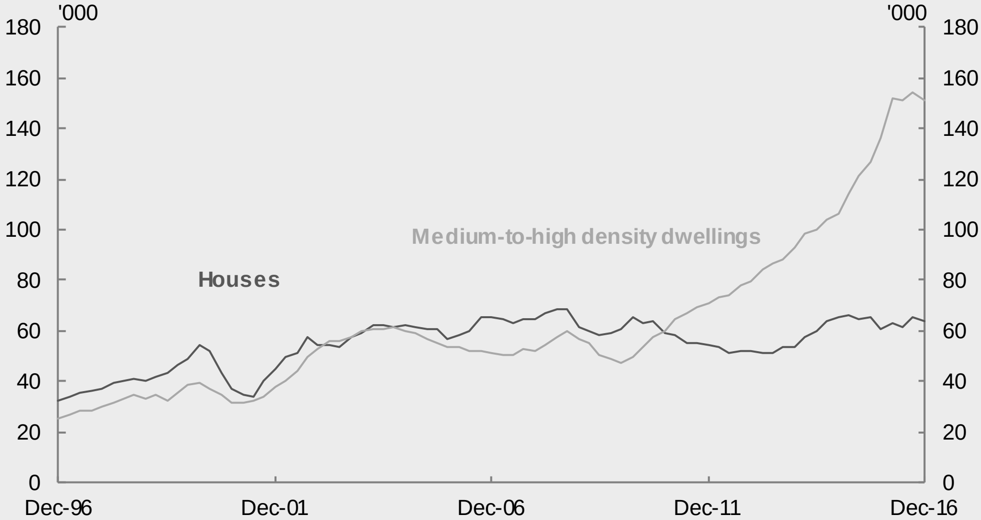


Note: The ratio is of completions to population change, both calculated as 6 quarter moving averages.
Source: ABS cat. no. 3101.0 and 8752.0 and Treasury.

After a decade of lacklustre growth in housing construction, there has been a strong rise in dwelling investment since 2012. A significant proportion of this investment has been in the medium-to-high density segment of the market, particularly in four-or-more storey apartments. As these dwellings typically take longer to complete than detached houses, this has resulted in a large increase in the pipeline of dwellings under construction (Chart B).

Box 3: Housing market (continued)

Chart B: Number of dwelling units under construction



Source: ABS cat. no. 8752.0.

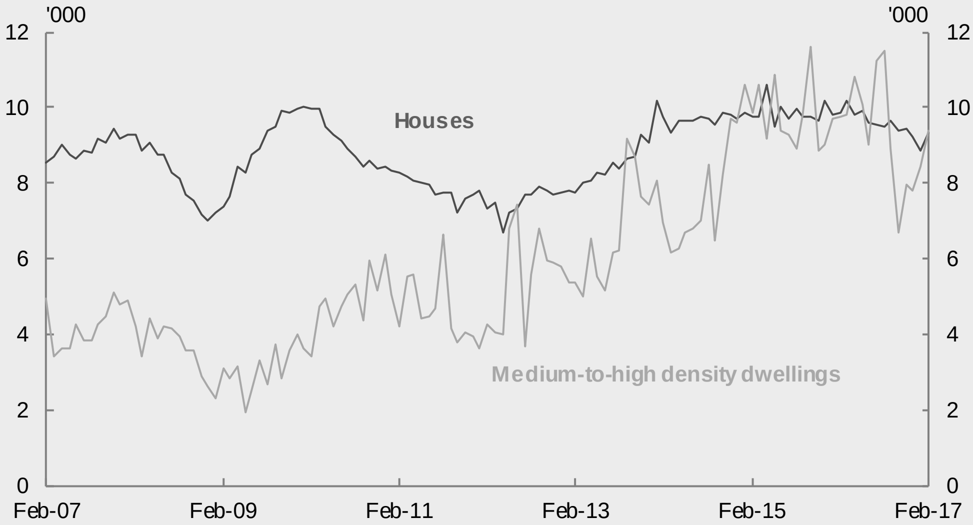
Much of the strength in dwelling construction over the current cycle has been driven by the east-coast States, where demand has been stronger, partly because of higher population growth. Meanwhile, markets in other States have been more subdued, especially in Western Australia.

In the near term, the significant pipeline of work yet to be done is expected to support residential construction activity. That said, building approvals seem to have peaked in mid-2016. As housing projects in the pipeline progressively come to completion over the next two years, dwelling investment is expected to decline as a share of the economy.

A key risk to the outlook for the housing market is the pace of the moderation in dwelling investment. The shift to higher-density residences, such as apartment blocks, has made dwelling approvals more difficult to predict over recent years and introduced more volatility to the housing cycle (Chart C). Additionally, the large increase in prices in some areas has reduced prospective yields. This may eventually weigh on new investment. A sharper than expected fall in higher density approvals would see dwelling investment decline more quickly than anticipated. Equally, a sharper than expected slowing in house price inflation would slow investor demand.

Box 3: Housing market (continued)

Chart C: Building approvals



Source: ABS cat. no. 8731.0.

Rising asset prices have strengthened household balance sheets since the GFC, with household assets now more than five times higher than debt. Notwithstanding this, household debt has grown more rapidly than incomes over the past few years and is elevated by both historical and international standards. Much of the increase in debt has been housing-related, alongside notable house price growth in some metropolitan areas.

Developments in the housing market are a source of uncertainty for the outlook for household consumption and dwelling investment. As such, the Government and regulators are closely monitoring developments in the housing market to ensure that the risks are being effectively managed. The Australian Prudential Regulation Authority has implemented a range of carefully calibrated measures to underpin the quality of residential mortgage lending, particularly to investors.

Commodity prices to boost nominal GDP in the short term

Nominal GDP is expected to grow by 6 per cent in 2016-17, largely as a result of a strong rise in non-rural commodity prices late last year. Nominal GDP is expected to grow by 4 per cent in both 2017-18 and 2018-19 as the terms of trade fall.

The level of nominal GDP is expected to be about $18.8 billion higher over the four years to 2019-20 than at the 2016-17 MYEFO, with upgrades in the outlook for profits, including mining profits and downgrades to the outlook for compensation of employees. Forecast tax receipts, excluding new policy, have been revised down by $5.5 billion over the four years to 2019-20 compared with the 2016-17 MYEFO, in part reflecting these compositional changes (see Statement 5, including Box 1, for further details).

After growing by 2.1 per cent over the year to the March quarter 2017, **consumer prices** are expected to grow by 2 per cent through the year to the June quarters of 2017 and 2018 and by 2¼ per cent through the year to the June quarter 2019.

Downward pressures on inflation are expected to come from subdued wage growth and heightened competition in the retail sector. It is also expected that the damage wrought by Tropical Cyclone Debbie will place upward pressure on fruit and vegetable prices in the near term.

Over recent years, the slowing in wage and price growth has constrained nominal GDP growth. If inflation and wage growth are lower than forecast, slower nominal GDP growth would constrain taxation receipts with a partial offset in payments. For example, if inflation outcomes were consistent with the lower bound of the range presented in the RBA's Statement on Monetary Policy, nominal GDP could be around 0.6 per cent lower than forecast by 2018-19, resulting in a deterioration in the underlying cash balance of around $3 billion by 2018-19.

A near-term boost to national income is expected from the upgraded forecast for the **terms of trade** in 2016-17, as large **commodity price** gains have lifted resource export values. Expected movements in the terms of trade and commodity prices are shown in Chart 7.

As in the 2016-17 MYEFO, the commodity price forecasts are based on the judgment — supported by broad and deep market and industry consultation — that it is prudent to assume that prices for metallurgical coal and iron ore will not be sustained at recent levels.

Significant supply disruptions and changes in Chinese policy in 2016 saw substantial rises in coal prices in the first half of 2016-17.

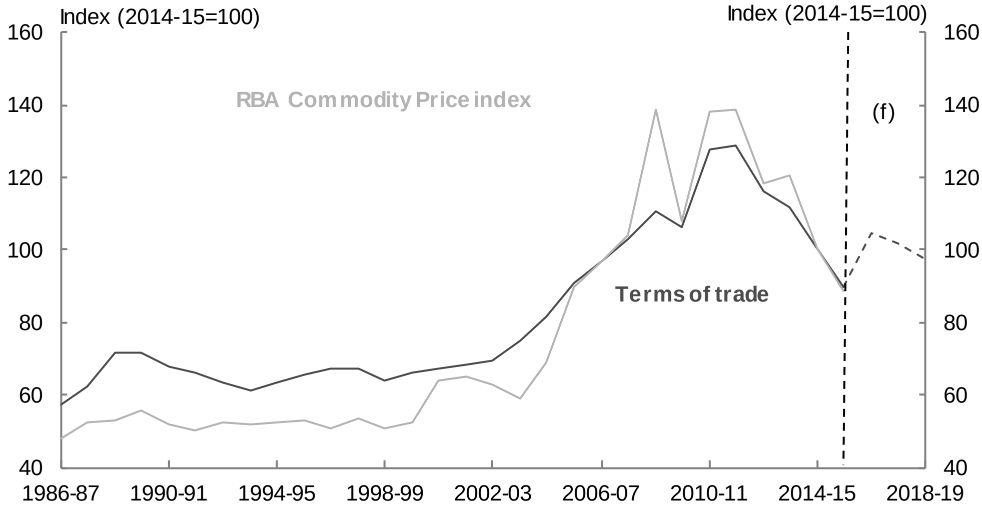
Metallurgical coal prices fell significantly in the first half of 2017 but have risen sharply in response to supply disruptions in Australia's coal sector following Tropical Cyclone Debbie. As a result, the metallurgical coal price remains assumed to decline from US$200 per tonne free-on-board (FOB) over the September and December quarters 2017 to reach US$120 per tonne FOB in the March quarter 2018. Thermal coal prices are higher than expected at MYEFO. This has resulted in an upgrade to the flat price assumption for thermal coal to US$85 per tonne FOB, which reflects a recent average. This is also broadly consistent with the expected current Japanese fiscal year annual contract price.

After strong gains in late 2016 and early 2017, iron ore prices have fallen sharply. The iron ore price is assumed to decline from a recent average of around US$66 per tonne FOB over the September and December quarters of 2017 to reach US$55 per tonne FOB in the March quarter 2018.

These changes have seen a net upgrade to commodity price forecasts in the short term, with the terms of trade now expected to rise by 16½ per cent in 2016-17.

Uncertainty around the outlook for commodity prices continues to pose challenges for the forecasts, projections and in turn the outlook for revenue. Further details on commodity price movements are provided in Box 4. The sensitivity of the forecasts to an alternative path for commodity prices is discussed in Statement 8.

Chart 7: Terms of trade and RBA commodity price index



Source: Reserve Bank of Australia, ABS cat. no. 5206 and Treasury.

Box 4: Recent developments in commodity markets and analysis of price sensitivity

Commodity prices have been volatile through 2016-17. This has had a large impact on the terms of trade and nominal GDP forecasts for that year.

Movements in the coal sector continue to be driven by supply fundamentals

Coal prices surged in late 2016 to levels not seen since the terms of trade boom in 2011. In November 2016, metallurgical coal prices peaked at around US$310 per tonne FOB, while thermal coal prices peaked at around US$115 per tonne FOB.

The significant increases were largely driven by a mix of global supply dynamics. Substantial supply disruptions in global coal markets over 2016 stemmed from flooding and logistical issues in key coal producing regions of the world, including China and Australia, among others. This was amplified by Chinese policy measures to address overcapacity in the sector, which saw a notable contraction in Chinese coal production.

Chart A: Metallurgical coal price

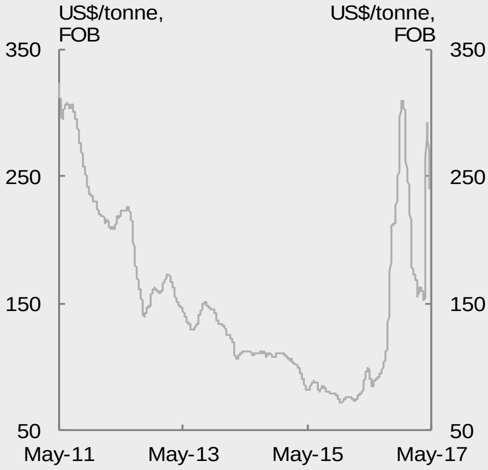


Chart B: Thermal coal price

Note: Spot price data are presented as a seven-day moving average and are expressed in FOB terms which exclude the cost of freight.
Source: S&P Global Platts and Treasury.

A large part of these price increases were unwound through early 2017, as some of the factors contributing to price gains in the coal sector dissipated. This included Chinese authorities adjusting their policy settings to help reduce price pressures.

Subsequently, supply disruptions resulting from Tropical Cyclone Debbie drove a renewed increase in metallurgical coal prices. Queensland's coal production accounts for more than half of global seaborne metallurgical coal trade and the cyclone has caused extensive damage to mining rail infrastructure in the region. This rapidly curbed global supply and sparked a significant rebound in metallurgical coal prices to be briefly above US$300 per tonne FOB. Elevated prices are not expected to be sustained. See Box 2 on the impact of Tropical Cyclone Debbie.

Box 4: Recent developments in commodity markets and analysis of price sensitivity (continued)

Thermal coal prices also increased in early 2017, as weather-related disruptions in Indonesia (the world's largest thermal coal exporter) contributed to tightness in supply. A price assumption of around US$85 per tonne FOB is assumed. This is in line with recent average spot prices and expected annual contract pricing.

Iron ore prices have been volatile

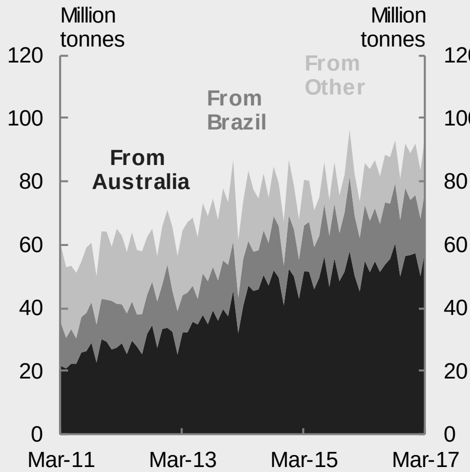
Iron ore prices strengthened after MYEFO, with spot prices peaking at almost US$90 per tonne FOB in early 2017 — levels not seen since mid-2014.

Prices have fallen noticeably more recently as narrowing steel margins and accumulated iron ore inventories are beginning to soften demand (Chart C). Growing global supply, primarily from Australia and Brazil, is another factor that will continue to weigh on the price outlook in coming years. In addition, mining companies may find ways to further reduce costs of production, which would also lower prices.

Chart C: Iron ore price

Note: Spot price data are presented as a seven-day moving average and are expressed in FOB terms which exclude the cost of freight.
Source: S&P Global Platts and Treasury.

Chart D: Chinese imports of iron ore



Source: Bloomberg, General Administration of Customs China and Treasury.

Box 4: Recent developments in commodity markets and analysis of price sensitivity (continued)

Impacts of altered commodity price forecasts on the Budget

Movements in commodity prices can have significant impacts on nominal GDP and government revenue. The below analysis provides an indication of how GDP and revenue could be impacted by altered timing around the metallurgical coal and iron ore price assumptions.

If **metallurgical coal** prices were to remain elevated at US$200 per tonne FOB for two quarters longer, before falling abruptly to US$120 per tonne FOB, nominal GDP could be around $4.4 billion higher than forecast in 2017-18, resulting in an increase in tax receipts of around $0.5 billion in both 2017-18 and 2018-19 (Table A).

By contrast, if metallurgical coal prices were to fall immediately to US$120 per tonne FOB two quarters earlier, nominal GDP could be around $4.2 billion lower than forecast in 2017-18, resulting in a decrease in tax receipts of around $0.5 billion in both 2017-18 and 2018-19.

Table A: Sensitivity analysis of an earlier and later step down in metallurgical coal spot prices

	Later fall to US$120/tonne FOB(a)		Earlier fall to US$120/tonne FOB	
	2017-18	2018-19	2017-18	2018-19
Nominal GDP ($billion)	4.4	-	-4.2	-
Tax receipts ($billion)	0.5	0.5	-0.5	-0.5

(a) FOB is the free on board price which excludes freight costs.
Source: Treasury.

Similarly, if **iron ore** prices were to remain elevated at US$66 per tonne FOB for two quarters longer, before falling abruptly to US$55 per tonne FOB, nominal GDP could be around $3.2 billion higher than forecast in 2017-18, resulting in an increase in tax receipts of around $0.4 billion in 2017-18 and around $0.3 billion in 2018-19 (Table B).

By contrast, if iron ore prices were to fall immediately to US$55 per tonne FOB two quarters earlier, nominal GDP could be around $3.1 billion lower than forecast in 2017-18, resulting in a decrease in tax receipts of around $0.4 billion in 2017-18 and $0.3 billion in 2018-19.

Table B: Sensitivity analysis of an earlier and later step down in iron ore spot prices

	Later fall to US$55/tonne FOB(a)		Earlier fall to US$55/tonne FOB	
	2017-18	2018-19	2017-18	2018-19
Nominal GDP ($billion)	3.2	-	-3.1	-
Tax receipts ($billion)	0.4	0.3	-0.4	-0.3

(a) FOB is the free on board price which excludes freight costs.
Source: Treasury.

Medium-term projections

The fiscal aggregates in this year's Budget are underpinned by economic forecasts for the budget year and the subsequent financial year, and then by economic projections for the following two financial years. These projections are not forecasts. Rather, they are based on a medium-term methodology and some key assumptions.

The current medium-term projection methodology assumes that the spare capacity in the economy is absorbed over five years following the forecast period. The sensitivity of the projections to different adjustment periods is analysed in Statement 8.

As spare capacity is absorbed, labour market variables, including employment and the participation rate, converge to their long-run trend levels. To absorb the spare capacity in the economy, from 2019-20 until 2023-24, real GDP is projected to grow faster than potential at 3 per cent.

Potential GDP is estimated based on an analysis of underlying trends for population, productivity and participation. The growth rate of potential GDP is estimated to be 2¾ per cent over the next few years. The unemployment rate is projected to converge back to 5 per cent over the medium term consistent with estimates of the non-accelerating inflation rate of unemployment. Inflation is projected to be 2½ per cent, consistent with the RBA's medium-term target band. The terms of trade are projected to remain flat at around their 2005 level from 2020-21.