PART 2: ECONOMIC OUTLOOK

OVERVIEW

The Australian economy is expected to grow at a solid pace in 2017-18. Non-mining business investment has been increasing, while the drag on growth from falling mining investment has been diminishing and has nearly run its course. Labour market conditions have strengthened, with over 380,000 jobs created in the past year, but growth in household consumption has been modest and inflation and wage growth remain subdued.

Real GDP growth is forecast to lift as the drag from falling mining investment diminishes. In 2016-17, mining investment made its smallest detraction from growth in three years. Non-mining business investment, household consumption, public final demand and exports are also expected to provide solid support to growth in 2017-18. Dwelling investment is forecast to fall slightly. Real GDP is forecast to grow by 2½ per cent in 2017-18 and 3 per cent in 2018-19 compared to 2.0 per cent achieved in 2016-17 and Budget forecasts of 2¾ per cent and 3 per cent at Budget for 2017-18 and 2018-19 respectively.

The slightly lower real GDP growth forecast in 2017-18 compared with Budget reflects recent modest growth in household consumption, while business investment is expected to grow at a slightly stronger pace than expected at Budget. Non-mining business investment is forecast to grow by 5 per cent in both 2017-18 and 2018-19. There has been a strengthening in business conditions and non-mining capital expenditure intentions over the past year.

Nominal GDP is forecast to grow by 3½ per cent in 2017-18 and 4 per cent in 2018-19. The 2017-18 forecast is lower compared with Budget, largely reflecting recent subdued outcomes for wage growth and domestic prices. Wages are forecast to grow by 2¼ per cent through the year to the June quarter 2018 and 2¾ per cent through the year to the June quarter 2019. At the same time, the unemployment rate is expected to be lower than forecast at Budget as a result of recent strong labour market outcomes.

INTERNATIONAL ECONOMIC OUTLOOK

Global growth has strengthened significantly over the course of the year. While the strengthening in growth was anticipated at Budget, it has accelerated by more than forecast. The forecast for global growth has been upgraded to 3½ per cent in 2017 and remains at 3½ per cent in 2018 and 3¾ per cent in 2019. The forecast for major trading partner growth has also been upgraded in 2017, with momentum in China, Japan and other East Asian economies.

The drivers of global growth have become increasingly broad based. Growth has strengthened in most advanced and emerging economies over the year, producing a more synchronised global expansion. The signs of stronger business sentiment that were emerging at the time of the Budget have been reflected in increased business investment and industrial production in some countries. Consequently, growth in global trade has also increased, especially in Asia.

Stronger growth has resulted in a significant absorption of spare capacity in major advanced economies. Labour market conditions have tightened, with Japan and the United States reporting unemployment rates that have not been experienced in around two decades. The euro area unemployment rate is at its lowest level since 2009.

Despite tightening labour market conditions, inflation remains below central bank targets in many advanced economies and there remains uncertainty around the outlook for inflation and wage growth. As the major advanced economies continue to press up against capacity constraints, some cyclical response in inflation is expected. Monetary policy settings remain accommodative but the process of slowly withdrawing stimulus has begun in some advanced economies, most notably in the United States.

Short-term risks to the global outlook are more balanced than they have been for some time. Global growth has strengthened and appears to be more sustainable. There is a risk that the momentum experienced in 2017 continues at a stronger-than-expected pace into 2018 and advanced economies press up against capacity constraints sooner. Stronger growth in 2018 could mean weaker growth in 2019. The recalibration of monetary policy in several major advanced economies may be challenging in this environment.

Geopolitical uncertainty remains elevated, including on the Korean Peninsula, and a range of medium-term risks remain. High levels of debt, potential financial imbalances, and overcapacity in some sectors remain key vulnerabilities to China's economy. Broader structural challenges, including demographic change and slower productivity growth in many countries, will continue to weigh on global growth potential over the medium to longer term.

Table 2.1: International GDP growth forecasts(a)

	Actuals	Forecasts		
	2016	2017	2018	2019
China	6.7	6 3/4	6 1/4	6
India	7.9	6 1/4	7 1/2	7 3/4
Japan	0.9	1 1/2	1	3/4
United States	1.5	2 1/4	2 1/4	2 1/4
Euro area	1.8	2 1/4	1 3/4	1 1/2
Other East Asia(b)	3.9	4 1/4	4 1/4	4 1/4
Major trading partners	4.0	4 1/4	4	4
World	3.2	3 1/2	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, 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 (October 2017), Thomson Reuters and Treasury.

The **United States** economy continues to grow at above-potential rates. As a result, the unemployment rate has fallen to 17-year lows. While inflation remains below the Federal Reserve's target it is expected to increase over the next few years and the Federal Reserve has begun to raise short-term interest rates slowly. It has also begun the process of winding back its quantitative easing program by initiating graduated reductions in the rollover of maturing securities. There is a degree of uncertainty around the US outlook, particularly with ongoing negotiations around tax reform.

Euro area economies have recorded strong growth since the Budget and there have been continued reductions in unemployment rates across the bloc. Consumption, investment and trade have all contributed to growth. While the political makeup and policy direction of some European countries have been resolved through the year, uncertainty remains for other key euro area economies. Negotiations concerning the exit of the UK from the EU continue and fragilities persist in the banking sectors of a number of economies. While the euro area previously struggled to sustain economic momentum in the period following the Global Financial Crisis, the balanced nature of growth across countries and a supportive external environment are positive factors.

Japan is benefiting from strong economic momentum, with the unemployment rate falling to new lows. A surge in global electronics demand has boosted exports, while investment has been assisted by Olympics-related infrastructure spending. There is growing pressure on corporates to use retained earnings more productively, in particular by lifting wages in order to support household consumption. Unfavourable demographics continue to weigh on Japan's long-term growth outlook and core inflation remains well below target.

China maintained strong growth through 2017, supported by momentum in the property and services sectors. Exports and imports strengthened alongside the recovery in global trade flows. Growth is expected to moderate in coming years, reflecting slowing infrastructure investment growth by local governments and a gradual tightening of financial conditions as authorities address financial sector risks. The recent National Party Congress emphasised the need to shift from recent rapid growth towards high-quality growth and to focus on addressing financial risks.

A recovery in global trade has contributed to stronger activity in many of the **ASEAN-5** economies, particularly in Malaysia, but also in the Philippines, Thailand and Vietnam. Continued strength in external demand for these economies' exports of electronics and consumer products would support growth into next year. Less export-oriented than many of its regional neighbours, Indonesia is expected to continue to rely on domestic demand to drive growth.

Growth has moderated in **India** during 2017, mainly due to subdued investment and disruption associated with the implementation of a nationwide goods and services tax (GST). The Indian Government is taking steps to free up capital flows, particularly with the announcement of a large public sector bank recapitalisation plan. Growth accelerated in the September quarter and is expected to return to the rates seen in recent years as the transitional impact of the GST fades and the benefits of the Government's reform package support the economy.

DOMESTIC ECONOMIC OUTLOOK

Australia's economy has now completed its 26th consecutive year of economic growth and is expected to grow at a solid pace in 2017-18 as the drag on growth from falling mining investment nears completion. Support to growth is expected from non-mining business investment, household consumption, public final demand and exports. After the 2016-17 outcome of 2.0 per cent, real GDP is forecast to grow by 2½ per cent in 2017-18 and 3 per cent in 2018-19.

Table 2.2: Domestic economy forecasts[(a)]

	Outcomes(b)	Forecasts			
	2016-17	2017-18		2018-19	
		Budget	MYEFO	Budget	MYEFO
Real gross domestic product	**2.0**	**2 3/4**	**2 1/2**	**3**	**3**
Household consumption	2.4	2 3/4	2 1/4	3	2 3/4
Dwelling investment	2.6	1 1/2	-1 1/2	-4	-1 1/2
Total business investment(c)	-4.0	0	2	3	3
By industry					
Mining investment	-24.2	-12	-8	-3	-3
Non-mining investment	6.0	4 1/2	5	4 1/2	5
Private final demand(c)	1.3	2 1/4	1 3/4	2 1/2	2 1/2
Public final demand(c)	5.0	2 1/2	4	3	3
Change in inventories(d)	0.1	0	0	0	0
Gross national expenditure	2.2	2 1/2	2 1/2	2 3/4	2 3/4
Exports of goods and services	5.4	5	3	4	4
Imports of goods and services	4.8	3	3	3	2 1/2
Net exports(d)	0.0	1/2	0	1/4	1/4
Nominal gross domestic product	5.8	4	3 1/2	4	4
Prices and wages					
Consumer price index(e)	1.9	2	2	2 1/4	2 1/4
Wage price index(f)	1.9	2 1/2	2 1/4	3	2 3/4
GDP deflator	3.7	1	1	1	3/4
Labour market					
Participation rate (per cent)(g)	64.9	64 1/2	65	64 1/2	64 3/4
Employment(f)	1.9	1 1/2	1 3/4	1 1/2	1 1/2
Unemployment rate (per cent)(g)	5.6	5 3/4	5 1/2	5 1/2	5 1/4
Balance of payments					
Terms of trade(h)	14.5	-2 3/4	-2	-4 1/4	-5
Current account balance (per cent of GDP)	-1.9	-1 1/2	-2	-2	-2 1/2

(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 spot prices of US$55 per tonne (FOB) for iron ore and US$85 per tonne (FOB) for thermal coal. Metallurgical coal prices are assumed to decline towards US$120 per tonne (FOB) by the September quarter 2018. (Box A contains analysis on the sensitivity of nominal GDP forecasts to metallurgical coal price movements).

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 64 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$65 per barrel.
Source: ABS cat. no. 5206.0, 5302.0, 6202.0, 6345.0, 6401.0, unpublished ABS data and Treasury.

Slightly lower real GDP growth in 2017-18 compared with Budget forecasts reflects recent modest growth in household consumption. In contrast, business investment is expected to grow at a slightly stronger pace than forecast at Budget. Non-mining business investment is forecast to grow solidly, with a strengthening in business conditions and non-mining capital expenditure intentions over the past year.

Household consumption is forecast to grow by 2¼ per cent in 2017-18 and 2¾ per cent in 2018-19. Growth in household consumption has been relatively modest in recent years compared with long-run historical growth rates, reflecting subdued growth in household incomes. Growth in consumption is expected to pick up over the forecast period in response to strengthening labour market conditions. Household incomes are also expected to rise over the forecast period, with a pick-up in wage growth. Consumption growth is expected to continue to outpace growth in disposable incomes and the household saving rate is expected to fall further.

Dwelling investment is expected to decline moderately over the forecast period, falling by 1½ per cent in both 2017-18 and 2018-19. Recent data are consistent with a softening in dwelling investment occurring slightly earlier than expected at the time of Budget. Dwelling investment has now declined for the past three quarters. In addition, house price growth has slowed and auction clearance rates have fallen since the beginning of the year. This is most evident in the Sydney market. Building approvals have fallen below their record levels recorded in mid-2016 but remain above their historical average. The pipeline of construction work remains elevated and is expected to support activity for some time.

Business investment is expected to grow at a stronger pace than forecast at Budget. It is forecast to grow by 2 per cent in 2017-18 and 3 per cent in 2018-19. Mining investment is expected to continue to fall over the forecast horizon as large resource projects are finalised, but the drag on economic growth is near complete. Since its peak in the December quarter 2012, mining investment has fallen by around 60 per cent. Growth in non-mining business investment was stronger than expected in 2016-17 and is forecast to remain solid at 5 per cent in both 2017-18 and 2018-19. There has been a significant strengthening in business conditions and non-mining capital expenditure intentions over the past year.

Chart 2.1: Mining and non-mining business investment

Source: ABS cat. no. 5204.0 and Treasury.

Public final demand is forecast to grow by 4 per cent in 2017-18 and 3 per cent in 2018-19. Public final demand is expected to be supported by both investment and consumption expenditure, with the National Broadband Network, National Disability Insurance Scheme and strong investment by the States and Territories all expected to contribute to growth.

Exports are forecast to grow by 3 per cent in 2017-18 and 4 per cent in 2018-19. This growth continues to be supported by resource exports, which are forecast to grow by 4½ per cent and 6 per cent respectively as the last of the major liquefied natural gas (LNG) and iron ore projects come online and ramp up capacity. While delays in the start-up of some LNG projects have softened the pace of growth over the forecast period, projects remain on track to reach expected capacity over the next few years.

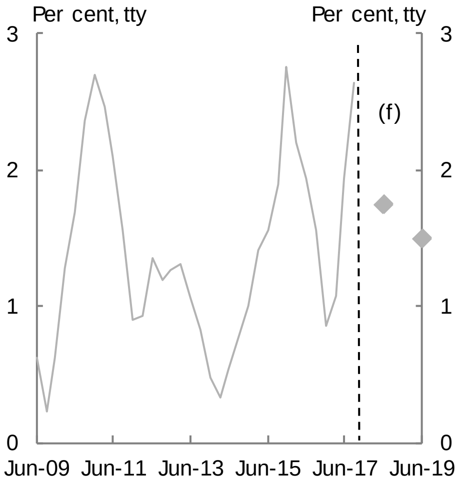
Services exports are also expected to continue to make a strong contribution to export growth. They are forecast to grow by 5 per cent in 2017-18 and 4 per cent in 2018-19. Growth in services exports continues to be driven by strong demand from Asia for Australia's tourism and education services, with sustained growth in short-term visitor arrivals and international student enrolments.

Rural exports are expected to decline in 2017-18, as crop production falls from the record levels achieved in 2016-17. The decline in rural exports is stronger than forecast at Budget as a result of drier-than-expected seasonal conditions during winter.

Imports are forecast to grow by 3 per cent in 2017-18 and 2½ per cent in 2018-19, broadly in line with growth across the economy.

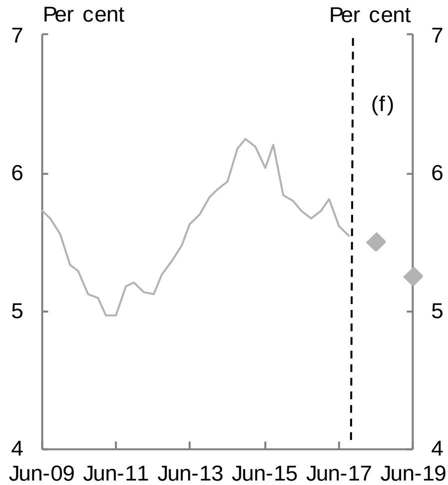
Labour market conditions have been stronger than expected at Budget. Over 380,000 jobs have been created in the past year, with the vast majority of these being full-time. The underemployment rate has not fallen by as much as the unemployment rate, indicating some ongoing spare capacity in the labour market. The unemployment rate has fallen to 5.4 per cent for three consecutive months, the lowest rate in over four years. The participation rate has increased, including a notable increase in the female participation rate.

Chart 2.2: Employment growth



Note: Quarterly employment actuals reflect three month averages. Forecasts reflect the seasonally adjusted, through the year growth rate to the June quarter.
Source: ABS cat. no. 6202.0 and Treasury.

Chart 2.3: Unemployment rate



Note: Quarterly unemployment actuals reflect three month averages. Forecasts reflect the seasonally adjusted June quarter rate.

Employment is forecast to grow by 1¾ per cent through the year to the June quarter 2018 and 1½ per cent through the year to the June quarter 2019. The unemployment rate is forecast to be 5½ per cent in the June quarter 2018 and 5¼ per cent in the June quarter 2019 – lower than forecast at Budget as a result of recent strong labour market outcomes. The participation rate is forecast to be 65 per cent in the June quarter 2018 and 64¾ per cent in the June quarter 2019.

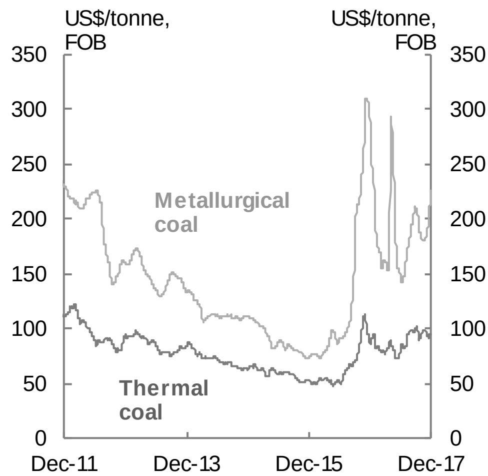
Wage growth remains low by historical standards in both the public and private sectors and has been more subdued than expected since Budget. Wages, as measured by the Wage Price Index, are forecast to grow by 2¼ per cent through the year to the June quarter 2018 and 2¾ per cent through the year to the June quarter 2019. This is a ¼ of a percentage point lower in both years compared with Budget. Wage growth is forecast to lift as the economy strengthens, inflation picks up and excess capacity in the labour market is reduced.

Growth in **consumer prices** also remains subdued, with the Consumer Price Index (CPI) increasing by 1.8 per cent through the year to the September quarter 2017. A combination of factors including heightened competition in the retail sector and subdued rental price growth are expected to contain inflation in the short term. The updating of the weights of the expenditure classes in the CPI in the December quarter 2017 release is also likely to reduce measured inflation. Petrol and electricity prices are expected to add some short-term upward pressure. Consumer prices are forecast to increase by 2 per cent through the year to the June quarter 2018, before accelerating to 2¼ per cent through the year to the June quarter 2019.

Commodity prices remain sensitive to global developments, including Chinese policy interventions and supply disruptions both domestically and abroad. This volatility remains a key uncertainty in the outlook for the terms of trade and nominal GDP. Iron ore prices are assumed to remain flat at US$55 per tonne free-on-board (FOB) over the forecast period. This is broadly consistent with the Budget assumption that iron ore prices would fall to US$55 per tonne by the beginning of 2018. By contrast, metallurgical coal prices are assumed to decline later than assumed at Budget, falling over the March and June quarters of 2018 to reach US$120 per tonne in the September quarter 2018. Thermal coal prices are assumed to be flat at US$85 per tonne, consistent with the Budget assumption and the current Japanese fiscal year annual contract price.

Chart 2.4: Iron ore prices

Chart 2.5: Coal prices



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.

Iron ore prices are being affected by significant government-enforced shutdowns in China's key steelmaking regions in an effort to combat seasonal pollution during winter. Meanwhile, significant supply disruptions and Chinese policy interventions have resulted in substantial rises in coal prices over the past year. Liaison with a range of industry contacts continues to suggest that current prices for metallurgical coal are unlikely to be sustained. While the prudent assumption for a reduction in prices has been maintained, determining the precise timing around commodity price movements poses significant uncertainty to the economic forecasts. Sensitivity around the timing of this assumption is presented in Box A.

The **terms of trade** are forecast to fall by 2 per cent in 2017-18 and by 5 per cent in 2018-19, after growing by 14.5 per cent in 2016-17 as a result of strong increases in commodity prices. The slightly stronger forecast in 2017-18 and the slightly weaker forecast in 2018-19 compared with Budget partly reflects the shift in the phase-down assumption for metallurgical coal prices.

Nominal GDP is forecast to grow by 3½ per cent in 2017-18 and 4 per cent in 2018-19. The 2017-18 forecast is lower compared with Budget, largely reflecting recent subdued outcomes for wage growth and domestic prices. Reflecting the softer outlook for wage growth, forecast growth in compensation of employees has eased while growth in corporate profits has been upgraded compared with Budget. Growth in unincorporated business income has also eased consistent with weaker domestic prices.

There are a number of **uncertainties** around the forecasts. While global growth has strengthened over the course of the year, there is uncertainty around the inflation outlook and the extent to which financial conditions in advanced economies might adjust, with spill-overs to emerging economies. In China, the main challenge will be progressing structural reforms needed to sustain growth while managing the risks associated with continued debt accumulation and excess capacity in parts of the economy. More broadly, geopolitical risks remain elevated.

There are also uncertainties around the forecasts for the domestic economy, with both upside and downside risks. The outlook for business investment appears to be firming and the risks around the forecasts are more balanced than they have been for some time. A more significant pick-up in the momentum of non-mining business investment is an upside risk to the forecasts, but it is still the case that growth in non-mining business investment has not broadened across all industries. Such a broadening would ensure that the outlook for business investment was on a more sustainable path.

Uncertainties around the forecast for household consumption remain. Household consumption growth has slowed over the past year and there is a risk that continued subdued income growth may result in slower consumption growth than forecast. A change in households' attitudes towards saving could also lead to household consumption growth being weaker than forecast. Stronger labour market conditions than forecast could provide an upside risk to consumption growth.

Commodity prices are also an uncertainty for the forecasts. A permanent 10 per cent rise (fall) in non-rural commodity prices could increase (reduce) the level of nominal GDP by 1 per cent by 2018-19 compared with forecast. This, in turn, would be expected to affect tax receipts and payments, increasing (reducing) the underlying cash balance by around $1.8 billion in 2017-18 and $5.6 billion in 2018-19. See Attachment A of Part 3 for further information on the estimated impact of a movement in the terms of trade.

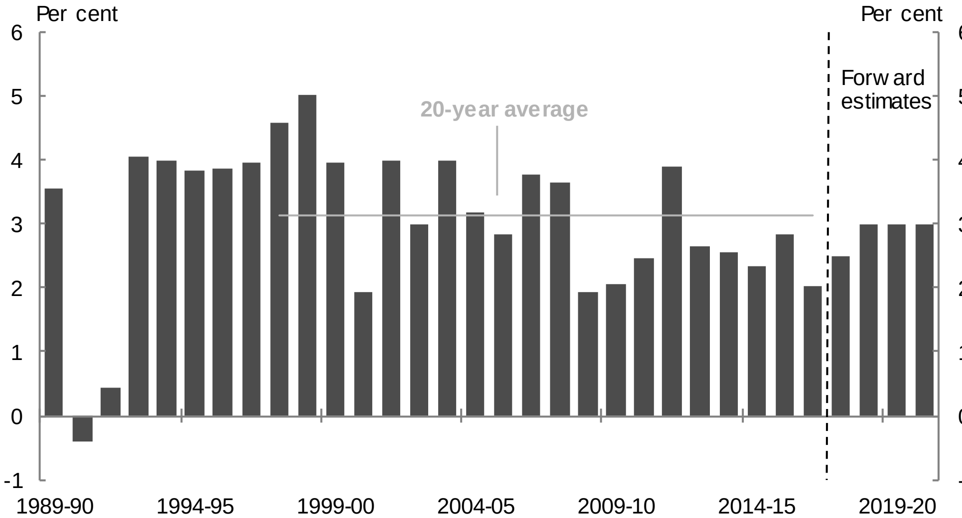
Medium-term projections

The fiscal aggregates in the MYEFO 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 medium-term projection methodology, as outlined in the 2014-15 Budget, assumes that spare capacity is absorbed over five years following the forecast period. The sensitivity of the projections to a different adjustment period was presented in 2017-18 Budget Paper No. 1 Statement 8: Forecasting Performance and Scenario Analysis.

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

Chart 2.6: 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. Australia's potential GDP growth is estimated to be 2¾ per cent over the next few years. The unemployment rate is projected to converge 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 mid-point of the RBA's medium-term target band. The terms of trade are projected to remain flat at around their 2005 level from 2020-21.

Box A — Sensitivity analysis: Metallurgical coal

Extraordinary movements in metallurgical coal prices have occurred over the past year. In late 2016, Chinese authorities imposed restrictions on domestic coal production, contributing to a surge in prices to levels last experienced during the peak of the commodity price boom in 2011.

While prices readjusted as some of these measures were unwound, a temporary resurgence occurred in 2017 as Tropical Cyclone Debbie caused significant supply disruptions to Australia's coal sector, which accounts for more than half of global seaborne metallurgical coal trade.

The sensitivity of coal markets to supply factors creates considerable uncertainty around the outlook for metallurgical coal prices. While prices are assumed to decline over a six-month period from currently elevated levels, the below analysis outlines the impacts from altering the timing of this assumption.

If metallurgical coal prices were to remain elevated for two quarters longer than currently assumed, before falling immediately to US$120 per tonne FOB, nominal GDP could be around $1.8 billion higher than forecast in 2017-18 and $2.5 billion higher in 2018-19. This would result in an increase in tax receipts of around $0.1 billion in 2017-18 and $0.9 billion in 2018-19 (Table A).

By contrast, if metallurgical coal prices were to fall immediately to US$120 per tonne FOB, two quarters earlier than assumed, nominal GDP could be around $3.1 billion lower than forecast in 2017-18 and $1.2 billion lower in 2018-19. This would result in a decrease in tax receipts of around $0.2 billion in 2017-18 and $0.8 billion in 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)	1.8	2.5	-3.1	-1.2
Tax receipts ($billion)	0.1	0.9	-0.2	-0.8

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