

PART 2: ECONOMIC OUTLOOK

OVERVIEW

The Australian economy continues to transition from the investment phase to the production phase of the mining boom. Economic growth is expected to increase over the forecast period as the drag from the decline in mining investment dissipates and the economy transitions to broader-based growth, supported by historically low interest rates and a lower Australian dollar.

Real GDP is forecast to grow by 2 per cent in 2016-17, partly reflecting the decline in GDP in the September quarter 2016. Economic growth is expected to pick up to 2¾ per cent in 2017-18 as the detraction from mining investment eases. Exports and household consumption are expected to support growth, with dwelling investment higher in the near term. A modest recovery in non-mining business investment is expected over coming years.

Nominal GDP growth is expected to be 5¾ per cent in 2016-17, stronger than at PEFO. This largely reflects the recent strong gains in commodity prices.

The strength and volatility of commodity prices have presented a particular challenge in framing the forecasts and projections. After broad and deep industry and market consultation, Treasury judged it prudent to suspend the practice of using a recent average of some commodity prices to underpin the forecasts. An alternative assumption of a phased reduction in prices from recent levels has been adopted for metallurgical coal and iron ore.

Coal prices have increased significantly since PEFO as a result of global supply disruptions and changes in Chinese policy that have reduced coal production. Iron ore prices are also higher. Some of the factors driving iron ore and coal prices are likely to be temporary and prices are widely expected to retrace some of their recent gains. In line with this assessment, nominal GDP growth is expected to moderate to 3¾ per cent in 2017-18. Commodity prices remain a key uncertainty to the outlook for the terms of trade and nominal GDP.

Wage growth and consumer price inflation remain weak. With spare capacity in the labour market expected to persist, growth in household incomes and domestic prices are forecast to remain subdued.

INTERNATIONAL ECONOMIC OUTLOOK

The outlook for global growth remains uncertain. While there have been weaker than expected outcomes since the 2016 PEFO in advanced and emerging market economies, there are some very preliminary signs that are encouraging. Global growth is forecast

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to pick up from 3 per cent in 2016 to 3¼ per cent in 2017 and 3½ per cent in 2018. This is in part due to higher forecast growth in the United States and Other East Asia economies in 2017 and 2018.

Australia’s major trading partners are forecast to continue to grow at a stronger pace than the global economy, at a rate of 3¾ per cent in 2016 and 4 per cent in 2017 and 2018. This is a slight downward revision from the 2016 PEFO, largely reflecting weaker than expected outcomes in the first half of 2016, including below average growth in the Other East Asia economies.

The global economic environment continues to be characterised by bouts of financial market volatility. The Australian economy has proved resilient during these periods of volatility and remains well placed to manage the economic and financial market uncertainty linked to risks in the global economy.

Global economic growth has been below expectations for some time. The global economy has been characterised by low productivity growth and weak trade growth but relatively low unemployment rates. Inflation has been very subdued. Against this backdrop, major advanced economies’ monetary policies remain accommodative. Uncertainty about the outlook remains elevated and business investment remains weak. The recent support for protectionist sentiments and measures could place further pressure on global growth.

Table 2.1: International GDP growth forecasts

	Outcomes	Forecasts		
	2015	2016	2017	2018
China	6.9	6 1/2	6 1/4	6
India	7.2	7 1/2	7 1/2	7 3/4
Japan	1.2	1	1/2	1/2
United States	2.6	1 1/2	2	2
Euro area	1.9	1 1/2	1 1/4	1 1/4
Other East Asia(a)	3.7	3 3/4	4	4 1/4
Major trading partners	4.2	3 3/4	4	4
World	3.2	3	3 1/4	3 1/2

(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 2016, Thomson Reuters and Treasury.

Growth in the **United States** is forecast to be modest in 2016 following weaker than expected GDP outcomes in the first half of the year. However, momentum in the US economy has improved recently, in part due to businesses restocking inventories. Strong consumption growth and a robust labour market, with falling unemployment and strong jobs growth, should also continue to underpin activity. That said, business investment has been subdued partly due to the ongoing effects of lower oil prices on

energy sector investment. Growth in the US is expected to pick up in 2017 and 2018. The US Federal Reserve resumed raising its policy rate in December 2016 following a rate rise in December 2015, which was the first in more than nine years.

The recovery in the **euro area** is forecast to remain modest. The outcome of the June 2016 'Brexit' referendum resulted in a period of heightened financial market volatility and uncertainty. This volatility has since receded but the economic effects of Brexit can only be judged over a longer timeframe. Banking sector fragility – including high levels of non-performing loans in several countries – remains a risk for the euro area.

The outlook for **China** is particularly important for Australia. The Chinese economy is on track to meet its 2016 annual growth target of between 6.5 and 7 per cent, supported by policy stimulus and strong credit growth. The Chinese authorities continue to seek a balance between providing support to short-term demand, while also progressing longer-term structural reforms aimed at addressing industrial overcapacity and rising risks in the financial system.

Economic activity in the **ASEAN 5** has remained relatively resilient despite subdued global demand. The Indonesian economy has continued to expand, driven by private consumption and public investment. Economic growth in the Philippines and Vietnam has remained strong but has been more moderate in Malaysia and Thailand.

India is expected to remain the world's fastest growing major economy over the forecast period, despite some volatility in the near term associated with the withdrawal and exchange of high-denomination currency from circulation. The Indian Government is implementing important reforms to support growth in the medium-term, including a national goods and services tax in 2017 and measures to reduce corruption and formalise the financial sector.

Economic growth in **Japan** is expected to remain subdued through to 2018. The postponement of a consumption tax increase and further stimulus measures announced this year by the Japanese Government and the Bank of Japan are expected to boost growth modestly in the near term. But demographic pressures, persistent low inflation and significant government debt will constrain longer-term growth prospects.

DOMESTIC ECONOMIC OUTLOOK

Australia's real GDP is forecast to grow by 2 per cent in 2016-17. This is weaker than forecast at PEFO, partly reflecting the decline in GDP in the September quarter. Economic growth is forecast to strengthen to 2¾ per cent in 2017-18 as the detraction from mining investment eases. The transition underway in the economy from the investment phase to the production phase of the mining boom is expected to continue. Exports and household consumption are expected to support growth, with dwelling investment higher in the near term. A modest recovery in non-mining business investment is expected over coming years.

Table 2.2: Domestic economy forecasts^(a)

	Outcomes(b)	Forecasts				
		2015-16	2016-17		2017-18	
			PEFO	MYEFO	PEFO	MYEFO
Real gross domestic product	2.7	2 1/2	2	3	2 3/4	
Household consumption	2.9	3	2 3/4	3	3	
Dwelling investment	10.8	2	4 1/2	1	1/2	
Total business investment(c)	-10.4	-5	-6	0	0	
<i>By industry</i>						
Mining investment	-27.5	-25 1/2	-21	-14	-12	
Non-mining investment	1.2	3 1/2	1 1/2	4 1/2	4 1/2	
Private final demand(c)	0.8	1 1/2	1	2 1/2	2 1/2	
Public final demand(c)	3.4	2 1/4	3	2	2 1/4	
Change in inventories(d)	-0.1	0	0	0	0	
Gross national expenditure	1.3	1 3/4	1 3/4	2 1/2	2 1/4	
Exports of goods and services	6.7	5	5 1/2	5 1/2	5	
Imports of goods and services	-0.3	2 1/2	2	3	3	
Net exports(d)	1.4	3/4	3/4	3/4	1/2	
Nominal gross domestic product	2.3	4 1/4	5 3/4	5	3 3/4	
Prices and wages						
Consumer price index(e)	1.0	2	1 3/4	2 1/4	2	
Wage price index(f)	2.1	2 1/2	2 1/4	2 3/4	2 1/2	
GDP deflator	-0.3	1 3/4	3 3/4	1 3/4	3/4	
Labour market						
Participation rate (per cent)(g)	64.8	65	64 1/2	65	64 1/2	
Employment(f)	1.9	1 3/4	1 1/4	1 3/4	1 1/2	
Unemployment rate (per cent)(g)	5.7	5 1/2	5 1/2	5 1/2	5 1/2	
Balance of payments						
Terms of trade(h)	-10.2	1 1/4	14	0	-3 3/4	
Current account balance (per cent of GDP)	-4.5	-4	-1 1/4	-3 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 A).

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 75 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\$49 per barrel.

Source: ABS cat. no. 5204.0, 5206.0, 5302.0, 6202.0, 6345.0, 6401.0, unpublished ABS data, Treasury.

Household consumption is expected to continue to grow at a moderate rate, supported by further employment growth and low interest rates. The household saving rate is expected to continue to decline over the forecast period as consumption growth outpaces the modest growth in disposable incomes. Household consumption is forecast to grow by 2¾ per cent in 2016-17 and 3 per cent in 2017-18.

Dwelling investment has been robust in recent years, driven by investment in medium-to-high density dwellings. Dwelling investment is forecast to grow by

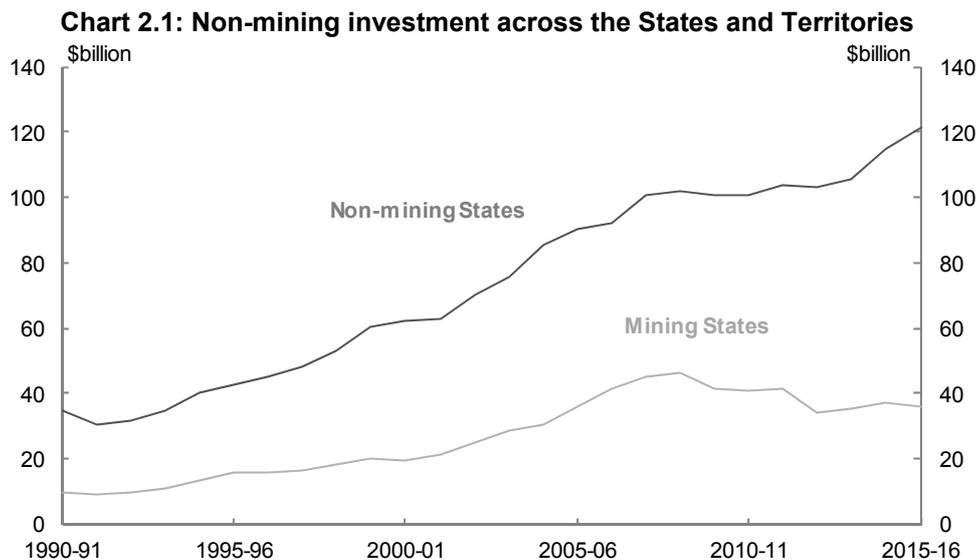
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4½ per cent in 2016-17 before easing to ½ per cent in 2017-18, as the current pipeline of construction – which is evident in the data on building approvals and commencements – is completed.

Business investment is forecast to fall by 6 per cent in 2016-17 and to be flat in 2017-18. This reflects further large forecast falls for mining investment of 21 per cent in 2016-17 and 12 per cent in 2017-18. The impact of this decline in mining investment on the economy is expected to diminish over the forecast period.

In line with the transition in the Australian economy, non-mining business investment is expected to rise moderately over coming years. Business conditions in the non-mining sector remain above average and borrowing costs remain low. These factors provide a supportive backdrop for an improvement in non-mining investment.

The transition is playing out differently across the States and Territories. Economic conditions in the mining States remain subdued as mining investment continues to wind down and increased resource exports only partially offset soft domestic demand. In the non-mining States, conditions are generally stronger, with some evidence of a pick-up in non-mining business investment (Chart 2.1).



Note: Investment is in nominal dollars. Mining States comprise Western Australia, Queensland and the Northern Territory. Given data limitations, figures have been interpolated between industries and States using relevant benchmarks to capture estimated activity.

Source: ABS cat. no. 5204.0, 5206.0, 5625.0, 8412.0 and Treasury.

Exports are forecast to grow by 5½ per cent in 2016-17 and 5 per cent in 2017-18. Exports are expected to be supported by non-rural commodity exports – LNG and iron ore in particular – and services exports. Services export volumes, including tourism and education services, continue to be supported by a lower exchange rate and rising demand from Asia.

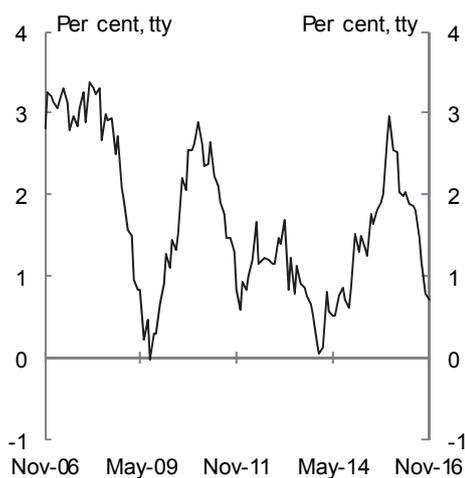
Rural exports are now expected to grow by 1½ per cent in 2016-17 compared to the modest fall forecast at the 2016 PEFO. Rural export volumes in 2016-17 are being supported by high rainfall and other favourable weather conditions. Rural export volumes are expected to grow by 3 per cent in 2017-18.

Imports are forecast to grow by 2 per cent in 2016-17 and 3 per cent in 2017-18. Growth in import volumes has been relatively subdued in recent years, reflecting both a lower exchange rate and weakness in capital goods imports as the economy transitions from the investment phase of the mining boom.

Employment growth is expected to be supported by continued economic growth and subdued wage growth. Employment is forecast to grow at a slightly more moderate pace of 1¼ per cent through the year to the June quarter 2017, reflecting more subdued employment growth over recent months (Chart 2.2) and slower output growth. Following the recent highs, which saw almost 300,000 jobs created in 2015, employment growth has been slower in 2016. Employment growth is expected to increase to 1½ per cent through the year to the June quarter 2018 as economic growth strengthens.

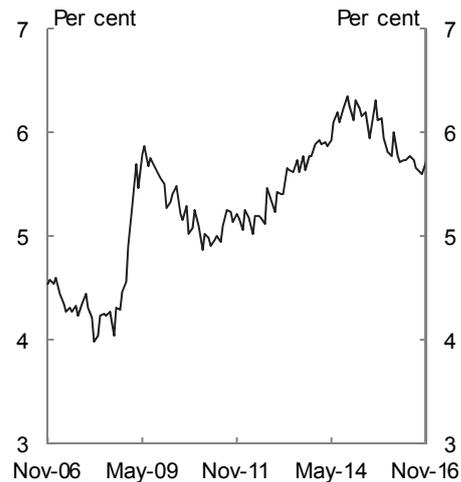
The **unemployment rate** has declined since its recent peak of 6.3 per cent in July 2015 (Chart 2.3). The unemployment rate is forecast to remain around 5½ per cent in the June quarters of 2017 and 2018. While the unemployment rate has fallen, the underemployment rate has remained elevated. These developments suggest that spare capacity remains in the labour market. The forecast for the **participation rate** has been revised down since the 2016 PEFO and it is expected to be 64½ per cent in the June quarters of 2017 and 2018.

Chart 2.2: Employment growth



Source: ABS cat. no. 6202.0.

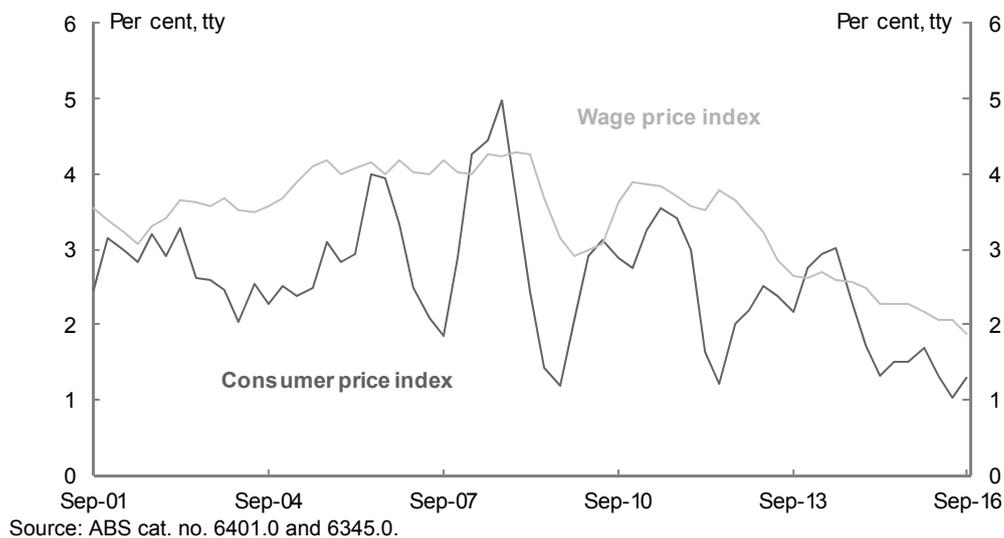
Chart 2.3: Unemployment rate



Consumer price inflation is low reflecting subdued wage growth and other factors such as heightened competition in the retail sector, slower growth in rents and lower import and petrol prices. There is also a subdued inflationary environment globally. Consumer prices are expected to grow by 1¾ per cent through the year to the June quarter 2017, before picking up to 2 per cent through the year to the June quarter 2018. This is lower than forecast at the 2016 PEFO.

Wage growth has also softened since the 2016 PEFO, in line with weaker consumer price outcomes and other factors such as spare capacity in the labour market (Chart 2.4). As with consumer prices, wage growth is expected to increase gradually over the forecast period to be 2¼ per cent through the year to the June quarter 2017 and 2½ per cent through the year to the June quarter 2018.

Chart 2.4: Consumer price inflation and wage growth



Commodity prices are volatile and remain a key uncertainty to the outlook for the terms of trade and nominal GDP. After reaching multi-year lows over 2015-16, bulk commodity prices have strengthened since the 2016 PEFO (Charts 2.5 and 2.6). In recent years, Budget and MYEFO forecasts have used an assumption that commodity prices would remain around a recent average over the forecast period. In light of the current exceptional circumstances for bulk commodities, this assumption is not considered prudent at this time. An alternative assumption of a phased reduction in prices from recent levels has been adopted for metallurgical coal and iron ore.

Chart 2.5: Coal price developments

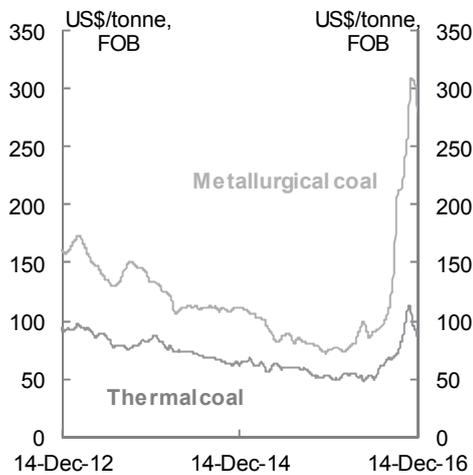
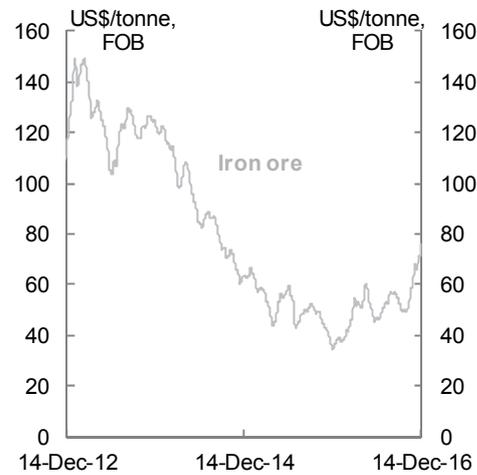


Chart 2.6: Iron ore price developments



Note: Spot price data presented as a seven day moving average.

Source: S&P Global Platts.

Since the 2016 PEFO, metallurgical coal prices have increased sharply. Liaison with a range of industry contacts revealed a widespread expectation that current price levels will not be sustained. There is considerable uncertainty around the pace and timing of possible price falls. The metallurgical coal price is assumed to be US\$200 per tonne Free on Board (FOB) in line with the December 2016 quarterly contract price, before declining through the September and December quarters of 2017 to reach a level of US\$120 per tonne FOB in the March quarter 2018. This price is consistent with recent industry liaison.

It is difficult to judge when some of the temporary factors boosting metallurgical coal prices may fade. Sensitivity around the impact of this timing assumption is presented in Box A.

Iron ore prices are also higher than the 2016 PEFO and have been volatile. Liaison with industry indicates that there is very considerable uncertainty around the drivers of the recent price movements, with the only consensus being that current elevated prices are unlikely to be sustained. That said, there is no consensus as to when prices may fall and by how far. In this MYEFO, the iron ore price is assumed to decline from its recent average of US\$68 per tonne FOB through the March and June quarters of 2017 to reach a level of US\$55 per tonne FOB in the September quarter 2017. This is the average price that has prevailed since PEFO. As with metallurgical coal prices, sensitivity analysis around changing the timing assumption for iron ore is also presented in Box A.

Thermal coal is typically sold under different contract arrangements than the other bulk commodities. Prices are also significantly higher since the 2016 PEFO. The MYEFO assumption is for thermal coal spot prices to remain at US\$62 per tonne FOB. This is consistent with recent averages before the recent sharp price increases. It is also consistent with the current Japanese fiscal year annual contract price of

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US\$62 per tonne FOB. Prices are assumed to remain at this level over the forecast period reflecting the typically longer duration of contracts in the thermal coal market.

In line with these judgments, the **terms of trade** are forecast to rise by 14 per cent in 2016-17 and then fall by 3¾ per cent in 2017-18 as commodity prices retrace some of their recent gains.

Nominal GDP growth is forecast to be 5¾ per cent in 2016-17 and 3¾ per cent in 2017-18. The forecast for 2016-17 is stronger than the 2016 PEFO forecast, with higher commodity prices providing an offset to weaker wage growth and domestic price pressures.

Key risks

The global economy continues to pose risks for the domestic outlook, with uncertainty across both advanced and emerging market economies. In China, the main challenge will be around progressing structural reforms needed to sustain growth while managing the risks associated with debt accumulation and excess capacity in parts of the economy. In addition, there are uncertainties regarding the impact of monetary policy normalisation in the United States. Risks also remain in Europe, including banking sector fragility in the euro area and uncertainty around the impact of Brexit.

Large changes in commodity prices can have a significant impact on nominal GDP growth. A permanent ten per cent fall in non-rural commodity prices could reduce nominal GDP by 1 per cent by 2017-18 compared with levels forecast. This, in turn, would be expected to affect tax receipts and payments, reducing the underlying cash balance by around \$1.3 billion in 2016-17 and \$4.6 billion in 2017-18. See Attachment A of Part 3 for further information on the estimated fiscal impact of a fall in the terms of trade.

Notwithstanding the recent improvement in the terms of trade, nominal GDP growth continues to be constrained by weak inflation and wage growth. If inflation and wage growth remain low, this would slow nominal GDP growth and in turn have adverse consequences for tax receipts, somewhat offset by a reduction in payments. For example, if inflation outcomes were consistent with the lower bound of the range presented in the Reserve Bank of Australia (RBA) November 2016 Statement on Monetary Policy, nominal GDP could be around 0.6 per cent lower than forecast by 2017-18, resulting in a deterioration in the underlying cash balance of around \$1.9 billion by 2017-18.

The Australian economy contracted in the September quarter 2016 following modest growth in the June quarter 2016. It is forecast that this period of weaker growth is temporary and that the economy will accelerate over the forecast period. Smaller declines in mining investment coupled with low interest rates and a lower exchange rate are expected to support this acceleration. However, slower growth in household

consumption and uncertainty about dwelling and business investment are risks to this forecast.

Household consumption growth has been relatively steady in recent years and has decelerated a little in the past few quarters. It is forecast to increase over the forecast period. However, factors such as sustained subdued income growth may result in slower growth in consumer spending.

There is also some uncertainty around the outlook for dwelling investment over the forecast horizon, given increasing concerns of oversupply in the high-rise apartment market in some areas, and weak demand in some mining-dependent regions.

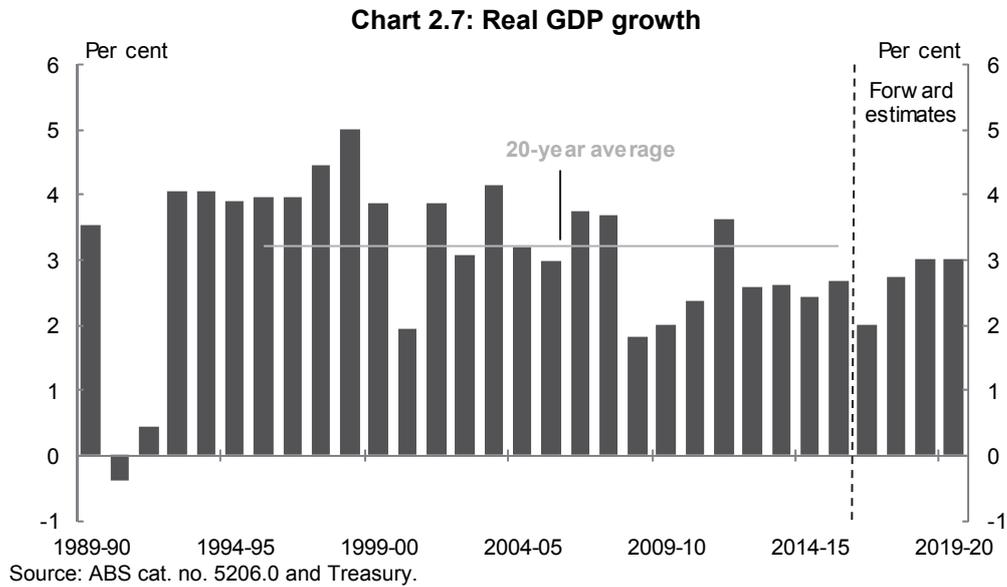
As the economy transitions from the investment phase to the production phase of the mining boom, the pace and timing of a pick-up in non-mining business investment also remains a key source of uncertainty in the forecasts.

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.

Crucially, 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 2016-17 Budget Paper No. 1 Statement 7: Forecasting Performance and Scenario Analysis.

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 2018-19 real GDP is projected to grow faster than potential at 3 per cent. By the end of 2022-23 spare capacity is absorbed and real GDP is projected to grow at its potential rate thereafter.



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 its 2005 level from 2019-20.

Box A — Sensitivity analysis: Commodity prices

Since the 2016 PEFO, bulk commodity prices have risen sharply. Metallurgical coal, thermal coal and iron ore have seen significant price increases.

Coal prices have increased sharply as a result of global supply disruptions and changes in Chinese policy that have reduced coal production. It is expected that higher spot prices will be reflected in the prices that Australian exporters receive, although there is some uncertainty around this relationship.

The metallurgical coal spot price is sharply higher than at PEFO. The outlook for metallurgical coal prices is highly uncertain, with some of the factors driving recent price increases likely to be temporary. Prices are widely expected by industry to retrace some of their recent gains. The timing and pace of the expected price falls is uncertain. The metallurgical coal price is assumed to be US\$200 per tonne Free on Board (FOB) in line with the December 2016 quarterly contract price, before declining through the September and December quarters of 2017 to reach a level of US\$120 per tonne FOB in the March quarter 2018. This latter price is in line with industry liaison.

If metallurgical coal prices remain elevated at US\$200 per tonne FOB for two quarters longer and then step down to US\$120 per tonne FOB, nominal GDP could be around \$4.5 billion higher than forecast in 2017-18, resulting in an increase in tax receipts of around \$0.5 billion in 2017-18 and a similar amount in 2018-19 (Table A.1).

In contrast, if metallurgical coal prices step down two quarters earlier to US\$120 per tonne FOB, nominal GDP could be around \$4.5 billion lower than forecast in 2017-18, resulting in a decrease in tax receipts of around \$0.6 billion in 2017-18 and a smaller amount in 2018-19.

Table A.1: Sensitivity analysis of an earlier and later step down in metallurgical coal spot prices

	Later fall to US\$120/tonne FOB ^(a) spot price		Earlier fall to US\$120/tonne FOB spot price	
	2016-17	2017-18	2016-17	2017-18
Nominal GDP (\$billion)	0	4.5	0	-4.5
Tax Receipts (\$billion)	0	0.5	0	-0.6

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

Box A — Sensitivity analysis: Commodity prices (continued)

Iron ore prices are also higher than at the 2016 PEFO and have also been volatile. Liaison with industry indicates there is significant uncertainty around the drivers of the recent price movements, with the current elevated prices not considered likely to be sustained. There is uncertainty as to when prices could fall and by how far. It is assumed that the iron ore price will decline from its recent average of US\$68 per tonne FOB through the March and June quarters of 2017 to reach a level US\$55 per tonne FOB in the September quarter 2017. This is the average price that has prevailed since PEFO.

If iron ore prices remain elevated at US\$68 per tonne for two quarters longer and then step down to US\$55 per tonne, nominal GDP could be around \$3.3 billion higher than forecast in 2016-17 and around \$0.6 billion higher than forecast in 2017-18, resulting in an increase in tax receipts of around \$0.2 billion in 2016-17 and around \$0.6 billion in 2017-18 (Table A.2).

In contrast, if iron ore prices step down to US\$55 per tonne two quarters earlier, nominal GDP could be around \$3.5 billion lower than forecast in 2016-17 and \$0.2 billion lower than forecast in 2017-18, resulting in a decrease in tax receipts of around \$0.2 billion in 2016-17 and \$0.6 billion in 2017-18.

Table A.2: Sensitivity analysis of an earlier and later step down in iron ore spot prices

	Later fall to US\$55/tonne FOB ^(a) spot price		Earlier fall to US\$55/tonne FOB spot price	
	2016-17	2017-18	2016-17	2017-18
Nominal GDP (\$billion)	3.3	0.6	-3.5	-0.2
Tax Receipts (\$billion)	0.2	0.6	-0.2	-0.6

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