STATEMENT 3: ECONOMIC OUTLOOK

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STATEMENT 3: ECONOMIC OUTLOOK

The Australian economy is expected to record solid growth in real GDP in 2005-06 after passing through a soft patch in 2004-05. Strong world demand for commodities will benefit Australia through increasing export volumes and higher terms of trade, both of which will support strong growth in national income. Gross national expenditure is forecast to grow at more moderate rates in 2004-05 and 2005-06 after a period of exceptionally strong growth in recent years. Employment growth is forecast to ease towards trend in 2005-06, while inflation is expected to remain moderate.

OVERVIEW

The rebalancing of **economic growth** in Australia from domestic to external sources that was foreshadowed in the 2004-05 Budget is occurring slowly. Real GDP growth is forecast to be 2 per cent in 2004-05, lower than the forecast presented in the *Mid-Year Economic and Fiscal Outlook 2004-05* (MYEFO). Dwelling investment and consumption growth slowed in the second half of 2004, after having experienced rapid growth in recent years. Export growth has also been slower than expected given the strength of world economic conditions. This largely reflects a continued high exchange rate, and the long lead times required to increase production in the mining sector and to expand export capacity. Despite slow growth in export volumes, high commodity prices provided a substantial boost to domestic income in 2004-05.

In 2005-06, the rebalancing of growth from domestic to external sources is expected to continue, with economic growth forecast to strengthen to 3 per cent. Gross national expenditure is expected to grow solidly, albeit slower than the very high average rate seen since 2001-02. Growth in household consumption and dwelling investment is expected to moderate, while business investment and public demand are forecast to grow at around trend rates.

Exports are expected to be an important contributor to growth in 2005-06. The mining sector invested around A$20 billion over 2003 and 2004 to boost capacity, which should be reflected in significant growth in non-rural commodity exports over the coming year. Rural exports are forecast to grow modestly in 2005-06, with growth restrained by a smaller grain harvest. Solid growth is expected in other categories of exports, supported by a strong world economy, but still affected by the high exchange rate.

The current account deficit (CAD) is forecast to narrow in 2005-06. The combination of increased export volumes and prices should lead to a markedly smaller trade deficit. The reduction in the CAD will be somewhat smaller than the reduction in the trade deficit because part of the additional income from higher commodity prices will accrue to foreigners. Payment of additional income abroad will increase Australia’s net income deficit.

Employment growth is forecast to ease towards trend in 2005-06, following the period of slower GDP growth in 2004. Unemployment is expected to remain around its current rate through 2005-06. Wage growth is forecast to remain moderate although, with the unemployment rate at a 28-year low, some localised wage pressures have begun to appear in particular industries and geographic areas. Inflation is expected to remain moderate in 2005-06.

The **world economy** is forecast to remain strong over the next two years. World economic growth is forecast to be 4¼ per cent in 2005 and 4 per cent in 2006. This is a little below the very brisk growth rate of 5.1 per cent in 2004. High oil prices and the effects of tighter macroeconomic policies, particularly in the United States and China, are contributing to the modest slowing. World inflationary pressures are expected to remain contained. There is little evidence yet that higher commodity prices are leading to significant second-round price increases in the major industrialised countries.

In the domestic economy, **household consumption** growth is expected to moderate to 3¼ per cent in 2005-06, supporting a modest rebuilding of household saving. A substantial slowdown in the accumulation of housing wealth, following several years of very strong growth, and the recent increase in official interest rates will restrain consumption. High petrol prices are also expected to continue to retard consumption growth. Partly offsetting these factors, consumption will be supported by the effects of past increases in non-housing wealth, particularly share prices, and continued solid growth in household incomes. Household incomes will benefit from continued employment growth and income tax cuts, although some portion of the tax cuts is likely to be saved.

Dwelling investment fell in the second half of 2004 after growing by almost 50 per cent in the three years to 2003-04. Dwelling investment is expected to fall by 2 per cent in 2005-06 as the recent increase in official interest rates and falls in house prices combine to dampen activity, particularly in the investor sector. However, the current housing downturn is expected to be muted compared with past cycles, with dwelling investment supported by a strong labour market and solid underlying demand for new dwellings.

Business investment is expected to again grow solidly in 2005-06. The growth in business investment in recent years has been broadly based, with the mining sector a particularly important contributor. The investment environment remains favourable, with high capacity utilisation, a relatively low cost of capital and very strong corporate balance sheets.

Public final demand should grow at a solid rate of 3¾ per cent in 2005-06, with strong growth in public investment and slowing growth in public consumption.

Australia's **net export** position is expected to strengthen in 2005-06, reflecting a rebalancing of growth from domestic to external sources. Exports are forecast to grow by 7 per cent in 2005-06, after a period of sluggish growth since 2001-02. Modest

growth in exports through this period has reflected the various economic shocks buffeting the Australian economy, a slow investment response to rising terms of trade and the high exchange rate since late 2003. Growth in **imports** is expected to ease to 8 per cent in 2005-06, in line with moderating growth in gross national expenditure.

The increase in world demand for raw materials, and limited world supply response, has resulted in markedly higher commodity prices (see Box 1). As a result, Australia's **terms of trade** are forecast to increase by 12¼ per cent in 2005-06, building on the 9¾ per cent increase expected for 2004-05. With an increase in the terms of trade and stronger export growth, the **current account deficit** is expected to narrow to 5¼ per cent of GDP in 2005-06.

Higher export prices are likely to result in very strong **nominal GDP** growth. Nominal GDP is forecast to grow by 7½ per cent in 2005-06. Corporate profits are likely to increase significantly in 2005-06 as mining companies benefit from higher export prices.

Employment growth is expected to moderate to 1¾ per cent in 2005-06, in line with recent slower GDP growth. The unemployment rate fell to 5.1 per cent in December 2004, the lowest rate in close to three decades. The unemployment rate is forecast to remain around 5 per cent, on average, over 2005-06. Rates of workforce participation are expected to remain broadly unchanged, albeit at high levels.

Inflation is expected to remain within the target band, with the Consumer Price Index forecast to increase by 2¾ per cent in 2005-06 as petrol prices remain high in the near term. This pressure is expected to moderate through 2005-06, with inflation forecast to be 2½ per cent through the year to the June quarter 2006. The cyclical slowing in labour productivity in 2004-05 is expected to have only a modest flow-through to consumer prices. There is no evidence that higher oil and other commodity prices are leading to significant second-round increases in consumer prices, although this remains a risk.

Wage growth is expected to increase modestly in 2005-06, with the Wage Price Index forecast to grow by 4 per cent. With the unemployment rate at a 28-year low, some localised wage pressures have appeared in particular regions and occupations. However, relative wage adjustment is an important signalling mechanism in a high employment economy and there is little evidence of generalised wage pressures or skill shortages. This is likely to remain the case as the economy passes through a period of more moderate employment growth.

A key **risk** to the economic outlook is the effect of the significant rise in Australia's export prices, which is forecast to take the terms of trade to their highest level since the early 1950s. The way in which mining companies respond to this additional income — by investing it, saving it or returning it to shareholders — will be important for the outlook.

Higher export prices are expected to have only a limited effect on household finances, primarily through equity holdings in mining companies. It is unlikely that higher export prices will result in significant growth in wages outside the mining sector itself, or have a major impact on aggregate employment growth across the economy. However, if these effects are greater than anticipated, then it is possible that resulting higher household incomes would lead to higher household consumption than currently forecast.

Higher export prices are not expected to result in a significant increase in investment by mining companies in 2005-06 over that which has already been announced. While it is possible that companies might invest more quickly than anticipated in response to high commodity prices, this upside risk is offset somewhat by the likelihood that commodity prices will fall beyond the present forecast period. As a substantial increase in supply is forthcoming from more recent investment in many countries, it is likely that commodity prices will retrace significantly in the medium term. This raises some issues for the projections of nominal GDP in 2006-07 and beyond. These issues are discussed in more detail in Box 7.

High commodity prices, particularly high oil prices, also present a downside risk for economic growth. Oil prices directly affect petrol prices and indirectly affect the prices of many other goods and services. High prices for iron ore affect steel prices and the cost of engineering and building construction. If oil prices increase further, this would present a downside risk to the forecasts for GDP growth in the near term. In the medium term, Australia would benefit from higher commodity prices as a net energy and mineral exporter and this would most likely boost economic growth.

Previous budget discussions of the economic outlook have identified a risk to consumption growth from the increasing level of household debt. In aggregate, there is no evidence that households are having difficulties servicing their current debt and, with consumption and dwelling investment both expected to slow, it is likely that households will take on debt at a slower rate through 2005-06. Nevertheless, there remains a possibility that households will seek to rebuild their saving to a greater extent than anticipated, leading to lower consumption growth than forecast.

While the risks around developments in the housing sector appear to have abated somewhat since the 2004-05 Budget, there remain concerns in particular market segments. Overall, it appears that house prices fell modestly over 2004. The likely outcome is that house prices will remain broadly flat in 2005-06 as the housing market continues to adjust to lower rates of turnover. While this adjustment is expected to be orderly, if house prices were to fall further then this would put downward pressure on consumption growth.

With the unemployment rate at its lowest level in a generation, there is a risk that the tight labour market could lead to wage increases across the economy that are greater than is justified by productivity growth. This would put upward pressure on unit

labour costs and inflation. Measures to increase workforce participation outlined in this Budget should help to reduce this risk over the medium term.

As is normal practice, the forecasts for the rural sector are predicated on an assumption that average seasonal conditions will prevail in 2005-06. The actual timing and distribution of rainfall through 2005 will have an important influence on rural production and exports in 2005-06, as will the lingering effects of dry weather in recent years.

The near-term risks for the world economic outlook appear to be balanced. But some medium-term downside risks remain, largely centred on different growth profiles across major economies, and associated fiscal and current account imbalances. While these imbalances may persist for some time without significant adverse consequences, they increase the vulnerability of the world economy to destabilising changes in financing flows.

Table 1: Domestic economy forecasts[(a)]

	Outcomes(b)	Estimates	Forecasts	
	2003-04 year average	2004-05 year average	2005-06 year average	Four quarters to June 2006
Panel A - Demand and output(c)				
Household consumption	5.6	4	3 1/4	3 1/2
Private investment				
Dwellings	7.3	-2	-2	1
Total business investment(d)	9.4	8	6	6
Non-dwelling construction(d)	12.5	2	2	2
Machinery and equipment(d)	7.8	11	7	7
Private final demand(d)	6.2	3 3/4	3 1/2	3 3/4
Public final demand(d)	3.8	6	3 3/4	1 1/4
Total final demand	5.7	4 1/4	3 1/2	3 1/4
Change in inventories(e)				
Private non-farm	0.0	- 1/4	1/4	1/4
Farm and public authorities(f)	0.6	- 1/4	0	0
Gross national expenditure	6.2	3 1/2	3 3/4	3 1/2
Exports of goods and services	1.6	2	7	7
Imports of goods and services	12.4	10	8	8
Net exports(e)	-2.4	-2	-1	- 3/4
Gross domestic product	4.1	2	3	3 1/4
Non-farm product	3.3	2 1/4	3	2 3/4
Farm product	35.8	-8	5	17
Panel B - Other selected economic measures				
External accounts				
Terms of trade	7.0	9 3/4	12 1/4	6
Current account balance				
$billion	-47.4	-56 1/4	-48	
Percentage of GDP	-5.8	-6 1/2	-5 1/4	
Labour market				
Employment (labour force survey basis)	1.8	2 3/4	1 3/4	1 1/2
Unemployment rate (per cent)(g)	5.8	5 1/4	5	5
Participation rate (per cent)(g)	63.5	63 3/4	63 3/4	63 3/4
Prices and wages				
Consumer Price Index	2.4	2 1/2	2 3/4	2 1/2
Gross non-farm product deflator	3.6	4	4 1/2	3 1/2
Wage Price Index	3.6	3 3/4	4	4

(a) Percentage change on previous year unless otherwise indicated.
(b) Calculated using original data.
(c) Chain volume measures.
(d) Excluding transfers of second-hand assets from the public sector to the private sector.
(e) Percentage point contribution to growth in GDP.
(f) For presentational purposes, inventories held by privatised marketing authorities are included with the inventories of the farm sector and public marketing authorities.
(g) The estimate in the final column is the forecast rate in the June quarter 2006.
Source: Australian Bureau of Statistics (ABS) Cat. No. 5206.0, 5302.0, 6202.0, 6345.0, 6401.0, unpublished ABS data and Treasury.

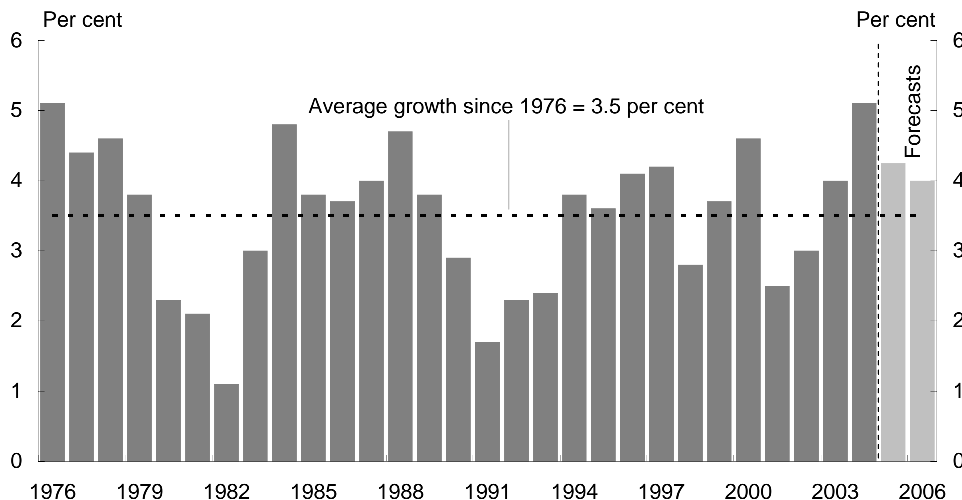
THE OUTLOOK FOR THE INTERNATIONAL ECONOMY

The world economy grew by 5.1 per cent in 2004, its fastest rate in close to 30 years and around ½ of a percentage point higher than expected at MYEFO. Strong growth was recorded across most regions, with emerging markets, in particular, benefiting from low world interest rates combined with strong demand and high prices for their commodity exports.

After peaking in the early part of 2004, world growth eased over the remainder of the year and into 2005 as the effects of high oil prices and tighter policy, particularly in the United States and China, took hold. However, with conditions in the world economy expected to remain favourable, growth is expected to stabilise at the still-solid rates recorded in the latter part of 2004, although the pattern of growth across countries is likely to be more unbalanced than previously anticipated.

World GDP growth is forecast to ease to 4¼ per cent in 2005 and 4 per cent in 2006 (see Chart 1). Growth in Australia's major trading partners is expected to ease from 4.9 per cent in 2004 to around trend rates of 3¾ per cent in 2005 and 2006.

Chart 1: World GDP growth(a)



(a) World GDP growth rates are calculated using GDP weights based on purchasing power parity.
Source: International Monetary Fund and Treasury.

World inflationary pressures are expected to remain muted. To date there has been little evidence of significant second-round effects from higher oil and other commodity prices in the major industrialised economies. In part, this reflects competitive product and labour markets and the success of macroeconomic policy in establishing well-anchored inflation expectations.

Risks to the outlook appear broadly balanced in the near term, although the persistence of global imbalances — reflected in current account positions — has increased the underlying vulnerability of the world economy over the medium term.

A downside risk to world growth stems from the increasingly unbalanced nature of the current expansion. The easing of world growth in the second half of 2004 was particularly evident in Japan and the euro area, while other major regions continued to grow strongly. This heightens the world economy's exposure to developments in a few key economies, particularly the United States and China.

Unbalanced growth, if sustained, is likely to exacerbate already large current account imbalances around the world, increasing the risk of a disorderly adjustment in financial markets. The US current account deficit was a record US$666 billion in 2004, equivalent to two-thirds of the aggregate current account surpluses in the rest of the world. These imbalances are attributable to a number of factors, including insufficient saving in the United States (particularly by the public sector), disappointing growth in Japan and the euro area (reducing their attractiveness relative to the United States as a destination for global capital), and a degree of under-investment in some East Asian countries (resulting in large and continuing current account surpluses in that region).

A gradual and orderly unwinding of these imbalances remains the most likely path of adjustment in the medium term. This would require a combination of fiscal consolidation in the United States, further US dollar depreciation and an improvement in the growth performance of Japan and the euro area. The depreciation of the dollar to date has been relatively steady and the normalisation of interest rates in the United States should also provide impetus for increased private saving, particularly if house price growth slows.

While the policy prescriptions required to rebalance the world economy are understood, little progress has been made in implementing them, suggesting that imbalances will continue to deepen in the near term. The longer policy action is deferred, the more exposed the United States and the world economy will be to a sudden change in sentiment regarding the relative risk and reward from holding US dollar assets. Such a change in investor sentiment could result in an abrupt and disruptive adjustment to exchange rates and interest rates.

Of more immediate concern are continued high and volatile oil prices. While the benchmark West Texas Intermediate price has moderated from the record nominal high of over US$57 per barrel in early April, it remains high by historical standards. To date, high oil prices have had a limited impact on world economic growth and core inflation. However, with oil prices expected to remain high in the medium to longer term, there remains the possibility that they will feed into inflation expectations more than currently expected. This risk is greater given that excess capacity in some major economies, including the United States, has been largely unwound over 2004. A sharp increase in inflation expectations could be particularly damaging for world growth

given the unusually low level of US long-term interest rates and historically low risk premia on corporate and emerging market debt.

On the upside, world growth over the past few years has consistently been stronger than anticipated. The factors that have underpinned this — accommodative monetary policy, healthy corporate balance sheets and benign financial market conditions — remain in place. As a result, the current economic expansion could prove more resilient than currently envisaged.

Table 2: International GDP growth forecasts[a]

	2003	2004	2005	2006
	Actual	Estimate	Forecast	Forecast
United States	3.0	4.4	3 1/2	3 1/2
Euro area[b]	0.5	1.8	1 1/2	2
Japan	1.4	2.6	1 1/4	2
China	9.3	9.5	8 1/2	8
Other East Asia[c]	3.6	6.1	4 3/4	5
Major trading partners	3.4	4.9	3 3/4	3 3/4
OECD	2.2	3.4	2 3/4	2 3/4
World	4.0	5.1	4 1/4	4

(a) World, OECD and euro area growth rates are calculated using GDP weights based on purchasing power parity. Calculations for major trading partners and other East Asia use export trade weights.
(b) 2004 estimate adjusted for the number of working days.
(c) Other East Asia consists of Korea, Singapore, Taiwan, Hong Kong, Indonesia, Malaysia, Thailand, and the Philippines.
Source: Various national statistical authorities, International Monetary Fund and Treasury.

Economic growth in the **United States** evolved largely as expected through 2004. Growth remained solid, but moderated as excess capacity in the economy narrowed and policy settings moved toward more neutral levels. Concerns about the labour market, which had been slow to recover from the 2001 recession, abated somewhat, with solid, albeit intermittent, gains in employment.

Domestic demand in the United States is expected to rebalance progressively away from household consumption toward business investment in 2005. The business sector, which has rebuilt its financial position in recent years, is expected to continue to invest strongly in 2005 and 2006. Conversely, households, which have spent well ahead of growth in income, driving the household saving rate to record lows, are expected to consolidate their finances. While household income will be supported by the ongoing recovery in the labour market, the high level of household debt makes consumption sensitive to increases in interest rates and fluctuations in income. A risk remains that US households may move abruptly to consolidate their financial position, particularly if financial market conditions tighten sharply.

Inflationary pressures in the United States are expected to remain in check over the forecast period, with inflation expectations well-anchored and the monetary tightening cycle now well underway. However, with the labour market expected to tighten

further, productivity growth slowing from cyclical peaks, and higher oil and other commodity prices, growth in unit labour costs could be stronger than expected.

After growing strongly toward the end of 2003 and in the early part of 2004, **Japan's** economy contracted in the middle of 2004 and posted only moderate growth in the December quarter. However, there are concerns about the quality of national accounts data, which have been subject to frequent and large revisions. Partial data indicate a more moderate easing in growth over the course of 2004.

Fundamentals in the Japanese economy have improved significantly in recent years, suggesting a continuation of growth in the period ahead. Structural reforms have improved business sentiment and corporate profits and the unemployment rate has fallen to near six-year lows. Deflation, which has weighed on consumer and business confidence in recent years, eased in 2004 and is expected by the Bank of Japan to end in early 2006.

China's economy grew at its fastest rate in almost a decade in 2004, contributing strongly to world growth and demand for commodities (see Box 1). However, concerns remain about the sustainability of the expansion, and the efficiency of the investment underpinning it. Authorities continued to use a combination of market instruments and administrative controls to tighten monetary conditions over the course of 2004 and there are signs that these measures are having an effect. While investment remains unsustainably high as a share of GDP, it has moderated somewhat. Growth in other key indicators, including industrial production, money supply and credit, eased in 2004. These data suggest that economic growth will slow to a more sustainable rate of around 8 per cent, although there remains considerable uncertainty about the timing and extent of the slowing.

The strength of the Chinese economy has led to external calls for greater flexibility in its exchange rate, particularly from the United States. However, a more flexible Chinese exchange rate is likely to have only a limited impact on global imbalances. Broader liberalisation of the capital account should be approached cautiously and coincide with a further strengthening in the Chinese financial system. These reforms, if complemented by ongoing structural reforms elsewhere in the economy, would provide a sound footing for balanced growth in the long term.

The **rest of East Asia** also grew strongly in 2004, underpinned by strong external and domestic demand. However, growth appears to have peaked, with regional economies (except Indonesia) expected to grow at a slower pace in 2005 and 2006. This reflects easing export growth due to more moderate world demand and a slowing in the global information and communication technology cycle. That said, the outlook for domestic demand remains positive, and should support still-solid growth in the region. The notable exception is Korea, where domestic demand remains weak following the bursting of the household credit bubble in 2003, although more recently, there have been signs of a pick-up in consumer and business confidence.

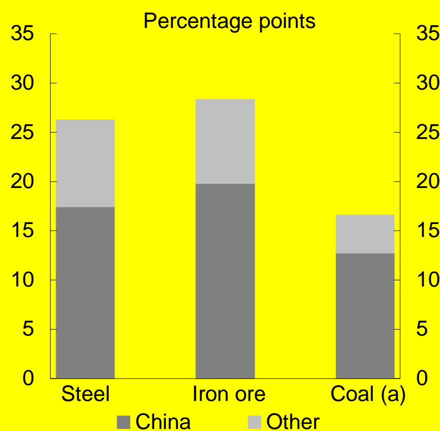
Box 1: World demand and commodity prices

The world economy grew rapidly in 2004. The composition of growth was weighted heavily towards the United States and China. Together these two countries contributed 2.2 percentage points to world growth of 5.1 per cent in 2004.

The United States and China are major commodity users. Their strong output growth saw a significant increase in demand for commodities such as oil, iron ore and coal.

In particular, China's emergence as a major commodity importer has had a significant impact. For example, over the period 2001 to 2004, China was responsible for 70 per cent of the world increase in iron ore consumption (Chart A).

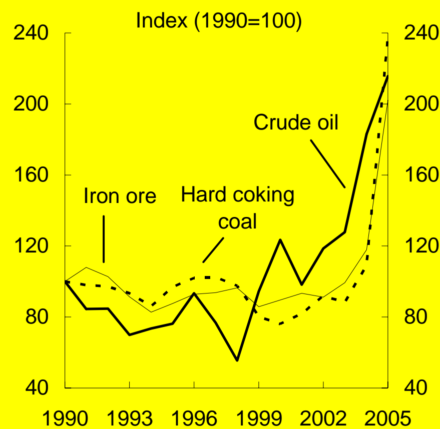
Chart A: Growth in world commodity consumption, 2001 to 2004



(a) Coal consumption growth from 2001 to 2003.
Source: AME Mineral Economics and BP Statistical Review of World Energy.

The rapid rise in commodity prices (Chart B) has generated significant benefits for commodity exporters like Australia, Canada, the Middle East, Russia and South Africa.

Chart B: Commodity prices (US$)[(a)]



(a) Year from April to March.
Source: ABARE, Thomson Financial and Treasury.

Investment in exploration and production has increased in response to the sustained commodity price rise. As a consequence, despite continued strong demand, commodity prices are likely to ease somewhat as additional world production comes on stream. However, if world demand were to falter, there is a risk that commodity prices could fall further than anticipated.

Growth in the **euro area** slowed sharply in the second half of 2004, with the combination of euro appreciation and high oil prices undermining the modest recovery that had taken place since the middle of 2003. Looking forward, growth is forecast to pick-up from recent levels, albeit at a more moderate pace than previously expected. The favourable world economic outlook will continue to underpin exports, despite the appreciation of the euro. Solid corporate profitability should see an improvement in the labour market, supporting a rebound in consumer spending.

The risks to this outlook, however, are skewed to the downside and reflect long-standing structural weaknesses. While some progress has been made on pension, health care and labour market reform in Germany and France, and on pension reform in Italy, more needs to be done. Reforms to lift labour force participation and productivity are particularly important in the face of rapidly ageing populations.

The **United Kingdom** economy grew strongly over the course of 2004, although recent data suggest that monetary policy tightening during that year is beginning to have an effect. The outlook is for growth to remain steady at recent, more moderate, rates.

THE OUTLOOK FOR THE DOMESTIC ECONOMY

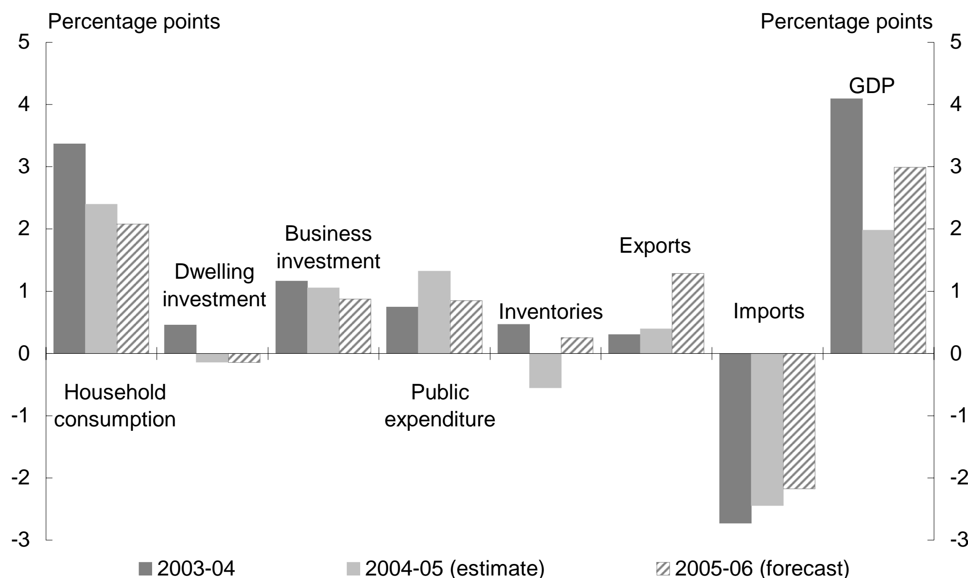
Key assumptions

The forecasts for the domestic economy are underpinned by several key technical assumptions. The exchange rate is assumed to remain around the average level of recent months (a trade weighted index of around 64). Interest rates are assumed to remain at current levels. World oil prices (West Texas Intermediate) are assumed to remain broadly unchanged through 2005-06, consistent with market expectations. The farm sector forecasts are based on an assumption of average seasonal conditions in 2005-06.

Demand and output

The rebalancing of growth from domestic to external sources that was foreshadowed in the 2004-05 Budget is occurring slowly and remains the most likely path for the economy in the period ahead. In the second half of 2004, gross national expenditure growth slowed, but export growth failed to pick up significantly, leading to a slowing in GDP growth from the very strong rates of recent years. GDP growth is expected to be 2 per cent in 2004-05 (see Chart 2). In contrast with moderate GDP growth, national income is expected to grow strongly, reflecting increased export prices.

Chart 2: Contributions to GDP growth[(a)(b)]



(a) Excluding transfers of second-hand assets from the public sector to the private sector.
(b) All charts in the domestic economy outlook section use seasonally adjusted data unless otherwise specified.
Source: ABS Cat. No. 5206.0 and Treasury.

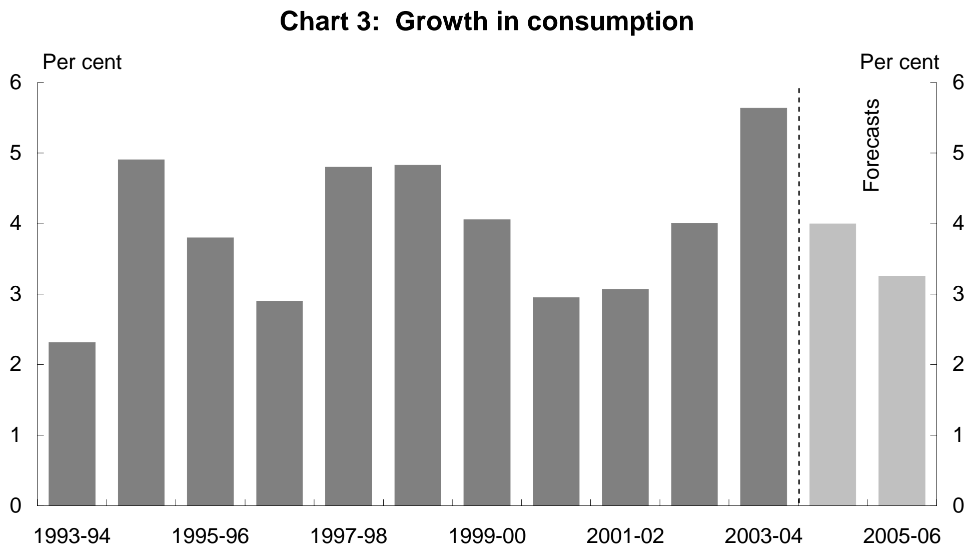
GDP growth is forecast to strengthen to 3 per cent in 2005-06. Household consumption is expected to make a smaller contribution to growth, while dwelling investment is again expected to detract from growth after the high level of construction activity in recent years. The contribution to growth from business investment is expected to remain solid. Public expenditure will contribute solidly across the forecast period. Imports are expected to detract less from growth, broadly in line with the developments in the domestic economy. Exports are forecast to make a larger contribution to growth in 2005-06, particularly as additional capacity comes on stream in the resources sector.

Non-farm GDP is forecast to grow by 2¼ per cent in 2004-05, strengthening to 3 per cent in 2005-06. Farm GDP is expected to fall by 8 per cent in 2004-05, largely reflecting generally dry conditions and the late arrival of spring rains in some areas, before increasing by 5 per cent in 2005-06 on the assumption of average seasonal conditions.

Household consumption

Household consumption is forecast to grow by 3¼ per cent in 2005-06, down from the 4 per cent growth expected for 2004-05 and below the rapid rates of growth recorded in recent years (see Chart 3).

Chart 3: Growth in consumption



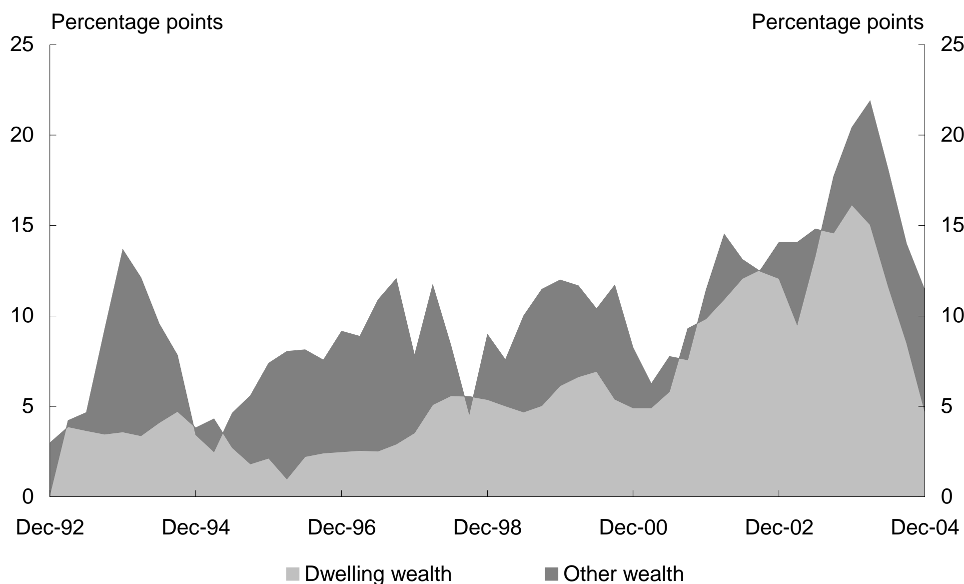
Source: ABS Cat. No. 5206.0 and Treasury.

Household income has grown steadily over the past decade, supported by increases in employment and real wages. However, the growth in income over the past decade has been insufficient to explain all of the increase in consumption. The other major contributing factor has been an increase in household wealth. Through the 1990s, higher wealth generally took the form of higher equity prices, although higher house

prices have been the more important factor in recent years (see Chart 4). These increases in wealth have seen consumption grow by more than income on average and, as a result, the household saving ratio has fallen. Australia's changing demographic profile, and the lower demand for precautionary savings in a stable and prosperous economic environment, may also have affected saving behaviour in the past decade (see Box 4).

Households are expected to increase their consumption by less than the increase in their income over 2004-05 and 2005-06. Accordingly, the rate of household saving is expected to increase, albeit by a modest amount. Recent data provide evidence that a rebuilding of household saving may have already commenced. Household nominal net disposable income increased by 6.9 per cent through the year to the December quarter 2004, while nominal consumption expenditure increased by a more moderate 5.4 per cent. It appears that some households saved the additional income from the 2004-05 Budget measures that reduced income taxes and increased the financial assistance to families with children. This trend is likely to continue with further income tax cuts and measures to support saving in the 2005-06 Budget.

Chart 4: Contributions to growth in nominal household wealth(a)



(a) Percentage point contribution to through-the-year growth.
Source: Treasury.

The expected easing in household consumption, and the consequent increase in saving, is partly the result of the substantial slowdown in house price growth over the past year. Although there can be large differences between the various measures of house prices, this slowdown was evident across all of the major data sources. For example, the Australian Bureau of Statistics' measure of established house prices grew by 18.9 per cent over 2003, but only by 2.7 per cent over 2004. If households seek to

rebuild their saving more quickly in response to these developments, then household consumption growth would be lower.

One factor that has offset the lower growth in housing wealth is the large growth in non-dwelling wealth over the past few years. The ASX200 share price index increased by more than 30 per cent in the two years to April 2005. This increase partly reflects the improved prospects of resource companies following substantial increases in world commodity prices — the resources component of the ASX200 increased by more than 80 per cent over the same two-year period.

Aside from lower growth in housing wealth, other factors that are likely to slow household consumption over the forecast period are the increase in official interest rates in March 2005 and high petrol prices. The forecasts assume that oil prices remain broadly unchanged over 2005-06 and, therefore, that petrol prices stabilise. But there is a risk that oil prices increase and put further pressure on consumption spending.

Dwelling investment

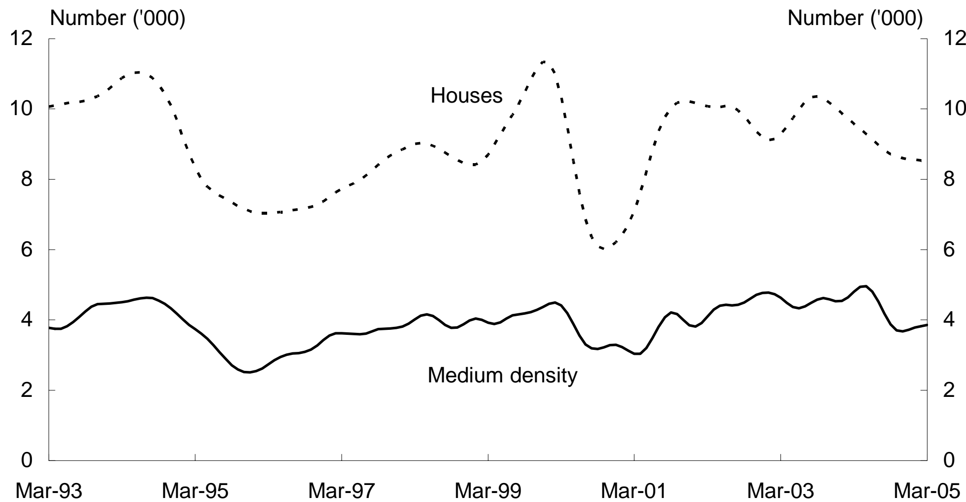
Dwelling investment is forecast to fall by 2 per cent in both 2004-05 and 2005-06, after very strong growth over the previous three years. Dwelling investment fell in the second half of 2004 and forward indicators of activity in the housing sector, such as dwelling approvals, suggest that this modest downward trend will continue in coming months (see Chart 5).

Other partial housing sector indicators point to lower activity. In late 2004 and early 2005, the number of monthly finance commitments for the construction or purchase of new dwellings by owner-occupiers was running around 15 per cent below its most recent peak in October 2003. Much of the speculative activity in the investor market also appears to have passed, with the value of investor finance falling significantly over the same period.

Thus far, the current housing cycle is unwinding in an orderly manner, with a gradual fall in housing activity levels across much of the country and house prices stabilising or falling a little. The risk of a sharp fall in house prices appears to have abated since the 2004-05 Budget. However, the rental yields on investment properties are still very low, suggesting that house prices may fall further in real terms. It seems likely that this adjustment will continue to occur gradually, without causing significant disruption to household finances. However, there remains a risk that a prolonged period of falling or flat house prices may lead households to rein in consumption expenditure more than expected.

There is no evidence of a widespread oversupply of new housing. Consistent with favourable economic conditions, the current downturn in housing activity is expected to be relatively shallow, although it is likely that medium density construction activity in the larger cities will continue to fall through 2005-06.

Chart 5: Private dwelling approvals



Source: ABS Cat. No. 8731.0 (trend data).

Business investment

Businesses are in a good position to undertake additional investment expenditure. Business profits have been strong across most sectors (especially in mining), capacity utilisation is at high levels and the Australian dollar prices of many investment goods have been falling over recent years.

New business investment is forecast to grow by 6 per cent in 2005-06, and remain at a very high level in real terms, having increased by almost 40 per cent in the three years to 2003-04 (see Chart 6). However, falling prices for business investment, particularly for imported machinery and equipment, have meant that nominal business investment has remained broadly constant as a share of nominal GDP.

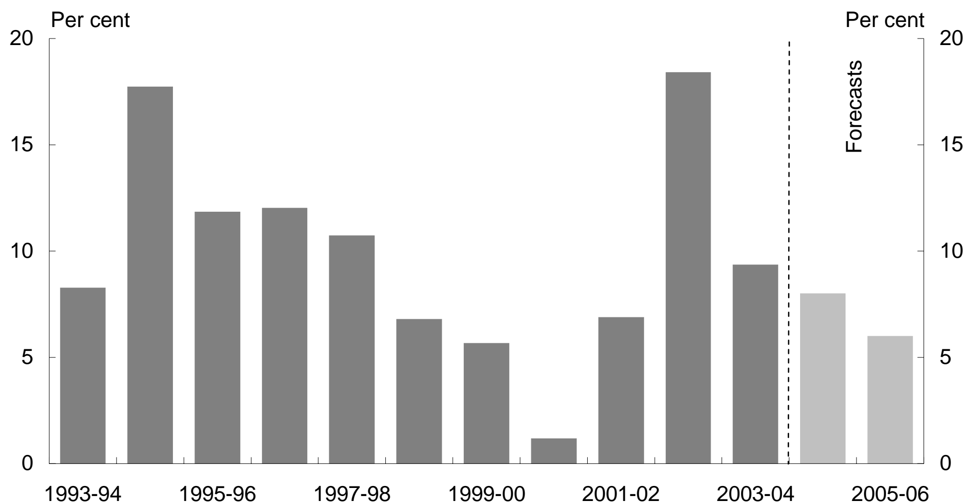
The mining sector has been an important contributor to business investment over recent years. Data from the Australian Bureau of Statistics' *Survey of New Capital Expenditure and Expected Expenditure* (CAPEX) shows that mining sector investment has been running above A$2 billion a quarter for more than two years, compared with a little above A$1 billion a quarter at the beginning of the decade. Mining sector investment should remain high for some time yet, given strong world demand for commodities.

Investment in non-dwelling construction is expected to grow by around 2 per cent in both 2004-05 and 2005-06. These forecast growth rates represent a moderation from the very strong growth in this category in recent years. Increasing commercial office vacancy rates, a slower rate of commencement of new infrastructure projects and increasing prices for steel and cement will restrain growth in non-dwelling construction. Nevertheless, continuing work on a number of large projects, and

supportive conditions for business investment more generally, will help to hold non-dwelling construction at its current high levels.

New machinery and equipment investment is also forecast to remain at high levels in 2005-06 with forecast growth of 7 per cent. The first estimate of investment intentions for equipment, plant and machinery in 2005-06 from the CAPEX survey was 5.2 per cent higher (in nominal terms) than the equivalent estimate for 2004-05. Initial estimates of investment intentions can provide only a broad indication of likely outcomes. Nevertheless, the CAPEX expectations provide early support for continued strong growth in 2005-06.

Chart 6: Growth in new business investment



Source: ABS Cat. No. 5206.0 and Treasury.

Inventories

Changes in inventories are forecast to contribute ¼ of a percentage point to GDP growth in 2005-06, primarily through growth in private non-farm inventories. Despite a positive contribution to growth from inventories, the inventories to sales ratio is expected to fall further in 2005-06 as strengthening export growth boosts overall sales.

Farm and public authority inventories (including the inventories of privatised marketing authorities) are expected to fall in 2004-05, following lower grain production in 2004, and then remain broadly unchanged at this level in 2005-06.

Public final demand

Public final demand is forecast to increase by 3¾ per cent in 2005-06, after expected strong growth of 6 per cent in 2004-05. Public investment expenditure has grown strongly over 2004. In 2005-06, growth in public investment expenditure is expected to slow, as is growth in public consumption.

Net exports and the current account

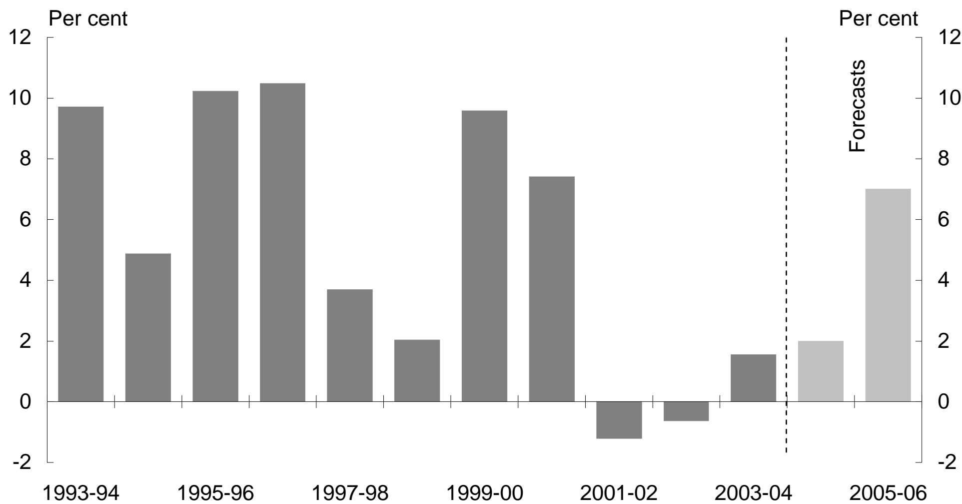
Net exports

Net exports have made a significant detraction from GDP growth over the past three years. Strong growth in gross national expenditure and a high exchange rate have supported import growth in recent years, while export growth has been subdued (see Chart 7). Net exports are expected to detract a further 1 percentage point from GDP growth in 2005-06, an improvement from previous years.

A number of shocks to the economy in the first half of this decade have acted to constrain export growth. The 2002-03 drought and subsequent dry weather conditions affected rural exports, the slowdown in the world economy in 2001 and 2002 weighed on manufactured and service exports, and various health and security concerns have affected international travel and business. The increase in the exchange rate since 2002 has also reduced the price competitiveness of Australian exports.

In volume terms, export growth still remains below what could be expected for this stage of the world economic cycle. An important part of the explanation for this relatively weak growth in export volumes is the long lead times on investment in the mining sector (see Box 2). Around A$20 billion has been invested in new production and transportation capacity in the mining sector over the past two years alone, but non-rural commodity export volumes have remained broadly flat.

Chart 7: Growth in exports

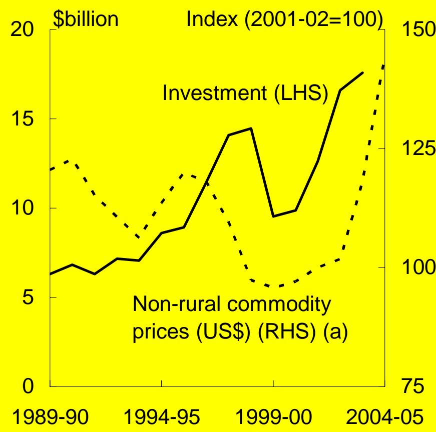


Source: ABS Cat. No. 5206.0 and Treasury.

Box 2: Mining capacity constraints

Global demand for commodities has increased more than expected over recent years, while resource production has increased only modestly. As a result, commodity prices have increased dramatically.

Chart A: Commodity prices and Australian mining investment

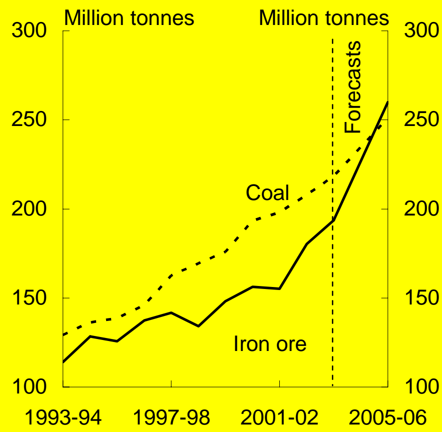


(a) Data for 2004-05 are year-average to April.
Source: ABS Cat. No. 5204.0 and RBA (original data).

The limited initial supply response reflects the large fixed costs inherent in mining projects. These costs mean that mining operations and supply chains are most profitable when operating close to capacity. Hence, there is often little spare capacity to meet an unexpected increase in demand.

Australian mining investment has surged following the increase in commodity prices since 2000 (Chart A). The resulting increase in output has already begun to lift export volumes (Chart B). There is still further productive capacity to come on stream, with resource exports expected to increase by a further 15 per cent by June 2006.

Chart B: Iron ore and coal export volumes



Source: Unpublished ABS data and Treasury (original data).

Some infrastructure constraints emerged as mining output increased. In vertically-integrated production and transport chains, such as in the iron ore and liquefied natural gas industries, these constraints are being addressed in tandem with increases in output. In cases where ownership of the production and transport chain is more fragmented, such as in the coal industry, infrastructure investment has tended to lag increases in production, leading to some bottlenecks.

Strong global demand and sustained high prices will encourage an increased supply of resources from Australia and the rest of the world. The interplay between rising global demand and supply makes predicting the future course of commodity prices particularly difficult. However, the mining sector is likely to be a significant contributor to national income in coming years.

The additional production flowing from new investment in parts of the mining sector has so far been outweighed by falling production for other commodities. Production in some of Australia's mature oil fields off Western Australia and in Bass Strait, for example, has fallen sharply over the past two years. This situation is expected to be redressed to some degree in 2005-06 as a significant expansion of capacity in areas such as liquefied natural gas and iron ore is brought into production.

After growing strongly in the late 1990s, export volumes for rural goods have not grown over the first half of this decade. The 2002-03 drought had a major impact on rural production. Grain production recovered strongly in 2003, but fell slightly in 2004. The production of livestock and some water-intensive crops has still not fully recovered from the drought. On the assumption of average seasonal conditions, rural exports are forecast to grow modestly in 2005-06.

Manufactured exports have grown more strongly, on average, than commodity exports in recent years. However, manufactured export growth has still been considerably below the average rate recorded through the 1990s. The maturing of some of Australia's manufactured export industries and the upward movement in the exchange rate since late 2001 explain some of this slowdown. The increasing quality and diversity of the goods produced by some newly industrialising countries, such as China, is also leading to increased competition and significant movements in the prices of some internationally-traded manufactured goods. It is difficult to predict precisely how Australia's exporters of manufactured goods will respond to these challenges, but a modest strengthening in manufactured export growth is expected in 2005-06.

Service exports have been broadly flat in recent years, partly reflecting the impact of a rising exchange rate and health and security concerns for international travel. Growth in service exports is expected to strengthen in 2005-06 in response to favourable world economic conditions.

Growth in imports is forecast to be 8 per cent in 2005-06, marginally slower than in 2004-05. Falling import prices and strong growth in all of the components of gross national expenditure have supported import growth in recent years. Slower growth in gross national expenditure over the forecast period will contribute to slower import growth.

The terms of trade

The terms of trade are expected to increase substantially in 2005-06, largely reflecting the convergence of strong world demand for commodities and relatively low growth in commodity supply. The exchange rate is broadly unchanged from the start of 2004, so the recent prices received for commodities in Australian dollars have generally tracked the price movements on world markets (usually expressed in US dollars). Continuing falls in import prices are also expected to support growth in the terms of trade.

In 2005-06, the terms of trade are forecast to increase by 12¼ per cent, after growth of 7.0 per cent in 2003-04 and expected growth of 9¾ per cent in 2004-05. This exceptional period of growth will take Australia's terms of trade to their highest level in 50 years.

In the late 1990s, the world supply of commodities grew strongly. Uncertainty around world economic developments, particularly following the Asian financial crisis in 1997, saw commodity prices fall to their lowest level in more than two decades in US dollar terms. This led commodity producers to reduce their investment in new capacity, notwithstanding the structural increase in global demand associated with the rapid growth in China and elsewhere. The sentiment of the time was reflected in the very strong interest in 'new economy' industries at the expense of 'old economy' industries such as mining.

Demand for commodities was relatively subdued in the following years, with most of the world's economies entering a period of subdued growth in 2001 and 2002. But some economies, most notably that of China, continued to grow strongly and increase their demand for commodities throughout these years. As the United States and, to a lesser extent, the rest of the world entered a period of stronger economic growth in 2003 and 2004, the demand for commodities quickly outstripped supply. As a result, commodity prices began to increase sharply.

Australia has benefited from these strong increases in world commodity prices and this is evident in the higher terms of trade. The prices for coal and iron ore, in particular, have increased substantially in recent rounds of contract negotiations with Japanese and Chinese buyers (see Box 3).

It seems unlikely that world commodity prices will be sustained at these levels indefinitely because the present high prices substantially exceed the cost of new production. Consequently, a large amount of investment in mining projects is already underway around the world, including in Australia. Continuing high commodity prices will encourage more investment. While the planning and construction lead times on mining projects are typically very long, meaning that supply responses typically lag demand changes, it is likely that the world supply of commodities will increase in 2005-06 and future years. For example, over the next three years, world production of iron ore is expected to increase by around 20 per cent.

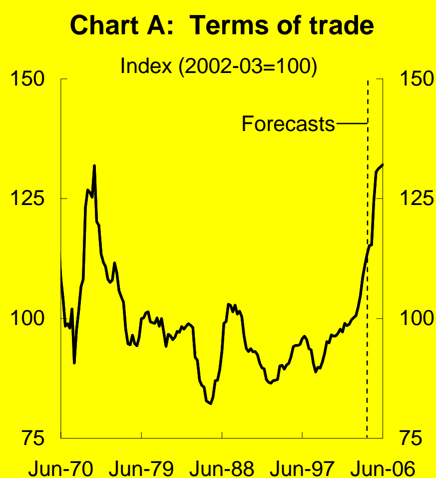
An increasing world supply of commodities should place downward pressure on commodity prices over time. The timing and extent of any such price adjustment is very difficult to predict. Since contract prices are typically struck before the beginning of the Japanese financial year on 1 April, any substantial adjustment is unlikely to occur before the June quarter 2006. However, there is a risk that Australia's terms of trade will fall over the medium term from their historical highs in 2005-06. This, in turn, carries significant implications for the budget projections for 2006-07 and beyond, particularly with respect to company tax collections from the mining sector. See Box 7 for a discussion of commodity prices and the budget projections.

Box 3: Booming commodity prices

Recent contract negotiations have locked in strong US dollar price increases in 2005 for some of Australia's key bulk commodity exports. In particular, hard coking coal prices are up by 120 per cent, iron ore prices are up by 70 per cent and steaming coal prices are up by 20 per cent.

Largely because of these export price increases, the terms of trade are expected to increase by 12¼ per cent in 2005-06, to be at their highest level in 50 years (Chart A).

Chart A: Terms of trade



Source: ABS Cat. No. 5302.0 and Treasury.

Assuming no change in the exchange rate, these commodity price increases will add approximately 2 per cent to nominal GDP in 2005-06. This additional income will benefit a number of sectors in the economy.

Mining companies will receive higher revenue, boosting their profits. Mining company shareholders (including superannuation funds) will also benefit, either from higher dividend payments or, if companies retain their earnings, stronger capital gains.

Higher prices, if sustained, will also support higher capacity utilisation and stronger investment in the mining industry with the effect of boosting production and exports. As a result, suppliers of goods and services to the mining industry will also benefit from stronger earnings. Although the mining sector is not labour intensive, employment may also increase modestly.

Governments will also benefit from higher royalties and company taxation.

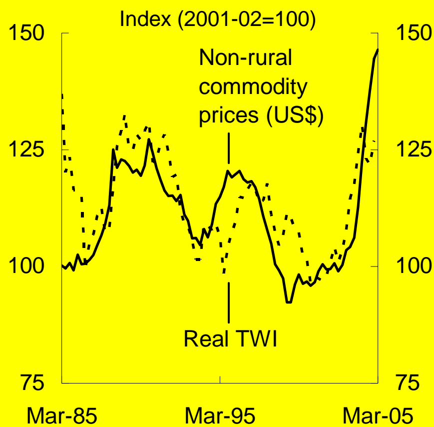
Higher commodity prices are expected to reduce the trade deficit by around 2 per cent of GDP. However, foreign investors in the Australian mining sector will receive some of the income generated by the higher commodity prices. Higher dividend payments and repatriated earnings of foreign investors are expected to widen the net income deficit component of the current account by around 1 per cent of GDP.

Thus, the increase in the net income deficit will partially offset the reduction in the trade deficit, with the overall current account deficit reduced by around 1 per cent of GDP.

Box 3: Booming commodity prices (continued)

This analysis is based on the technical assumption of an unchanged exchange rate. However, since the float of the Australian dollar in 1983, an appreciation of the exchange rate has generally accompanied an increase in world commodity prices (Chart B).

Chart B: Commodity prices and the real exchange rate



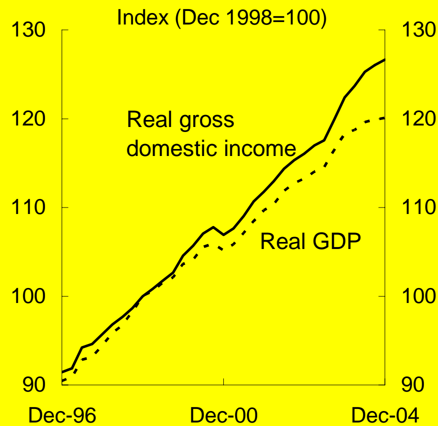
Source: RBA (original data).

If the exchange rate was to appreciate further in response to higher commodity prices, the benefits of stronger world demand for Australian exports would pass through the economy in a different way. The terms of trade and real incomes would still be higher. But, for resource exporters, the higher exchange rate would dampen the effect of the price increase on revenue. And for exporters of manufactures and services, and import-competing industries, a higher exchange rate would make it more difficult to compete.

Consumers and domestic producers would still benefit directly from improved purchasing power as import prices fall.

The increase in purchasing power is captured in the real gross domestic income (GDI) measure (Chart C). Real GDI is estimated as the volume of GDP plus the terms of trade effect.

Chart C: Terms of trade effect on purchasing power



Source: ABS Cat. No. 5206.0.

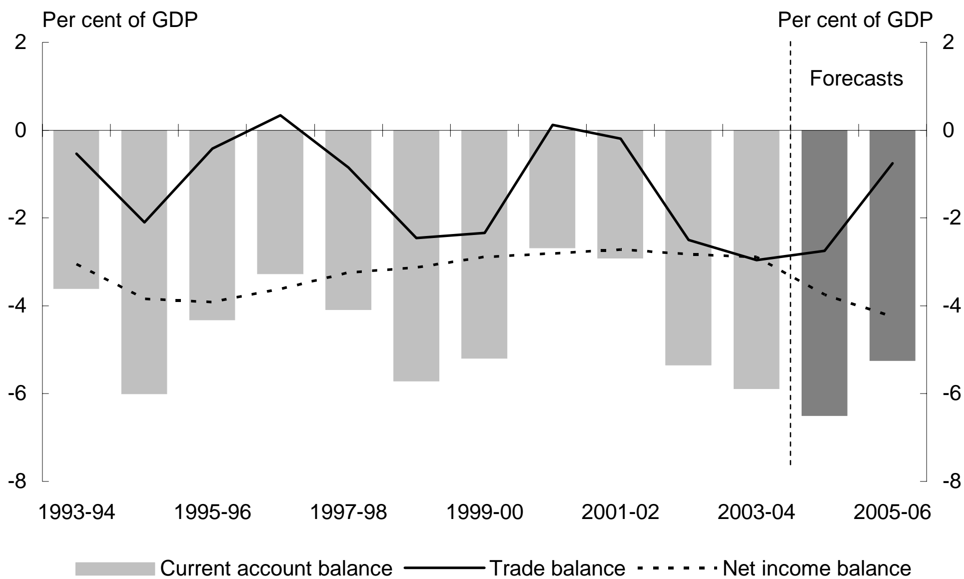
Regardless of how the benefits flow through the economy, the current high demand for Australia's commodity exports is generating considerable real income gains.

The current account

The current account deficit (CAD) has remained relatively high as a proportion of GDP in recent years, largely reflecting an increase in the trade deficit since 2001-02 (see Chart 8). As discussed in the net export section, export growth has been subdued in recent years, while import growth has remained robust, in line with strong growth in gross national expenditure. Australia's CAD is financed by an offsetting capital account surplus, the components of which are examined in Box 4.

An important influence on movements in the CAD over the forecast period will be the boom in commodity export prices. The net income deficit will increase as higher export prices result in higher profits being paid to foreign investors in the Australian mining sector, but this will be offset by the positive impact of higher prices on the trade deficit.

Chart 8: Current account balance



Source: ABS Cat. No. 5302.0, 5206.0 and Treasury.

The CAD is forecast to narrow to 5¼ per cent of GDP in 2005-06 from an expected 6½ per cent of GDP in 2004-05. Higher commodity prices will contribute to this improvement in the CAD (see Box 3).

Box 4: The balance of payments and net lending

The balance of payments consists of the current account (goods, services and income transactions between Australia and the rest of the world) and the capital account (flows of funds between Australia and the rest of the world that are required to finance current account transactions).

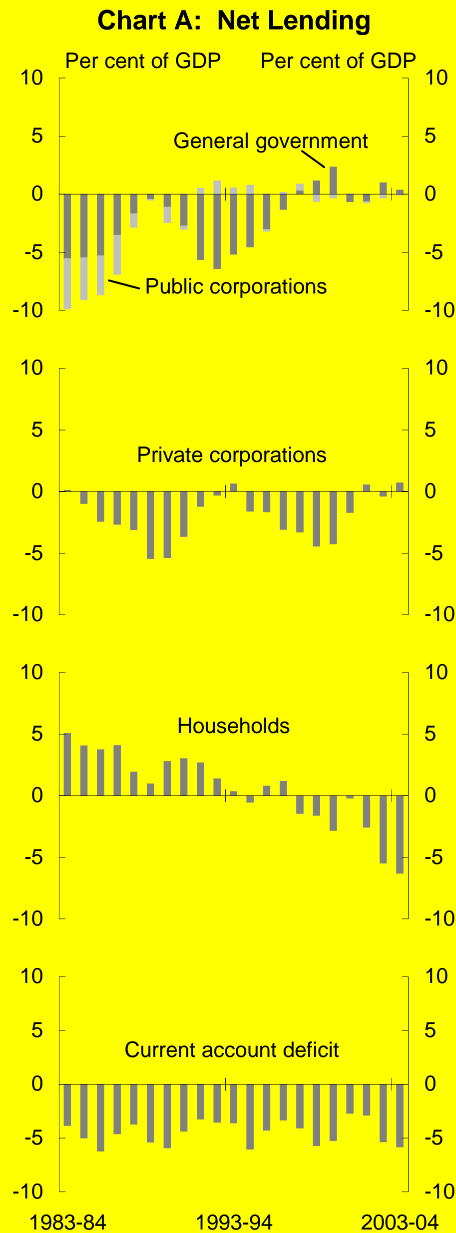
A country that invests more than it saves records a current account deficit (CAD). This is financed by an inflow of funds from the rest of the world, which is recorded as a capital account surplus.

The net lending framework decomposes the economy's financing requirements between the household, corporate and public sectors. The net lending framework for Australia is presented in Chart A. Negative figures indicate a requirement to borrow from other sectors or from the rest of the world.

Since 1996-97, the government sector has become a small net lender on average, making a positive direct contribution to the current account balance.

Private corporations have also become small net lenders in recent years, as companies have funded investment from profits rather than borrowings.

Almost all of the recent increase in the CAD is attributable to the household sector. In other words, households have been borrowing from other sectors and, ultimately, from the rest of the world, via the banking system.



Source: ABS Cat. No. 5204.0, 5302.0 and Treasury (original data).

Box 4: The balance of payments and net lending (continued)

The increase in households' net borrowing is partly a result of higher household wealth (from higher house prices), leading households to invest more and save less.

Higher investment and lower saving is also a response to a more stable and resilient economy with sustained employment growth and low inflation. In a stable economy, households may choose to hold a lower level of precautionary savings than in a volatile economy.

In addition, deregulation of financial markets, combined with low inflation, has lowered borrowing costs. This has allowed households greater flexibility to spread their consumption and investment decisions over time.

The outlook for 2005-06 is for GDP growth to rebalance away from domestic to external sources. Accordingly, while the corporate and government sectors are expected to remain net lenders, the household sector's net borrowing is expected to decrease in line with easing dwelling investment and consumption.

Labour market, wages and prices

Labour market

Employment has continued to grow rapidly through 2004-05, with the unemployment rate falling to a 28-year low of 5.1 per cent in December 2004. Construction employment has increased strongly over the past year, reflecting the high levels of economic activity in that sector.

Forward indicators of employment, such as measures of job vacancies, point to further solid employment growth in coming months. For example, the Australian Bureau of Statistics' job vacancy series increased by around 40 per cent through the year to February 2005.

Employment growth is expected to moderate to 1¾ per cent in 2005-06 as the effects of recent slower GDP growth feed through to the labour market. In particular, employment growth in the construction sector is expected to slow, reflecting the flattening of growth in residential and commercial construction.

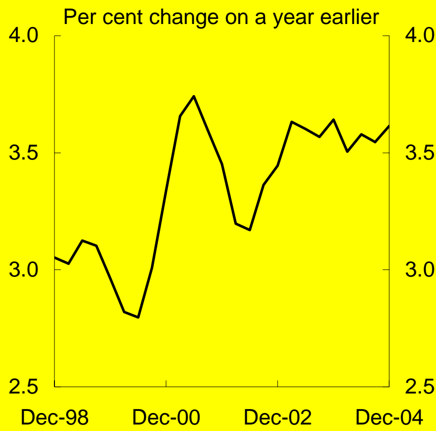
The unemployment rate is forecast to remain near 5 per cent through 2005-06 after averaging around 5¼ per cent in 2004-05. Workforce participation is forecast to remain high by historical standards at 63¾ per cent on average in 2005-06. This is a little below its level of recent months. This Budget contains measures to increase workforce participation over the medium term. In the short term these measures will place upwards pressure on measured unemployment as new entrants to the labour market take time to find jobs.

Box 5: Labour market flexibility

The labour market has performed very strongly over the past 12 months, with the unemployment rate falling to a 28-year low.

Given this historically low outcome, it is not surprising that some business surveys are indicating that suitable labour is becoming more difficult to find. However, there is currently no evidence of widespread labour shortages or generalised wage pressure (Chart A).

Chart A: Wage price index



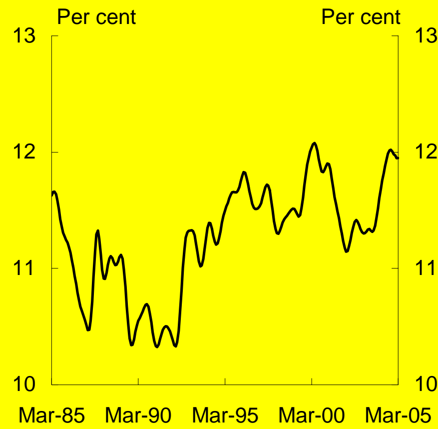
Source: ABS Cat. No. 6345.0.

This combination of low unemployment and moderate wage growth reflects past labour market reforms which have created more flexible working arrangements. This has led to a more efficient allocation of labour, higher productivity and increased real wages without triggering inflationary pressure.

These reforms have also encouraged more people to participate in the labour force, with greater flexibility in the degree to which they participate. For example, part-time employment now accounts for around 28 per cent of total employment.

Given the right circumstances, around a quarter of these workers have indicated they would like to work more hours, increasing the available pool of labour. Employers have been drawing on this pool, with the flows of workers from part-time to full-time employment around record highs (Chart B).

Chart B: Proportion of part-time workers gaining full-time employment



Source: ABS Cat. No. 6203.0, 6291.0.55.001 (trend data).

The ability to utilise existing workers more effectively should lessen the impact of tighter labour market conditions on economic activity and inflation.

While the unemployment rate is at a 28-year low, there is further scope to increase labour inputs to production through the better use of under-utilised labour and by encouraging greater workforce participation (see Box 5).

Wages

Moderate wage growth in recent years has provided a good foundation for sustained economic growth. The Wage Price Index has averaged growth of around 3½ per cent for the past two years. These moderate outcomes are welcome in the light of a steadily falling unemployment rate.

Reforms in recent years to boost the economy's productive potential, particularly those in the area of workplace relations, have supported this healthy combination of strong employment and moderate nominal wage growth (see Box 5). Statement 4 in the 2004-05 Budget discussed labour market flexibility issues in more detail.

Wage growth is expected to increase over 2005-06, with the Wage Price Index forecast to grow by 4 per cent. Some localised wage pressure has appeared in specific industries and occupations, particularly in those areas affected by conditions in the mining sector. With the unemployment rate at a 28-year low, it is likely that some localised wage pressures will remain. Such relative wage adjustment is an important signalling mechanism in a high employment economy, helping to direct workers to the areas of their highest productive value.

At this stage, there is no evidence of more generalised wage pressure, and the expected more modest employment growth in the period ahead should help to contain overall wage pressure. However, it will remain important that wage growth is backed by increases in productivity on average — particularly with the current very low levels of unemployment — to support further sustainable economic growth.

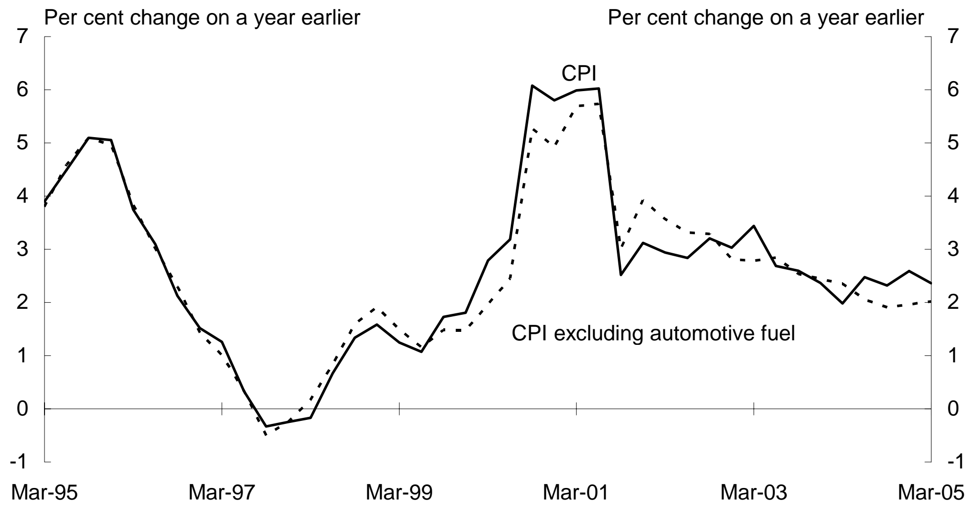
Prices

Inflation has been contained in recent years (see Chart 9), reflecting moderate growth in unit labour costs, the effects of a higher exchange rate and vigorous competition in the retail sector. The Consumer Price Index (CPI) increased by 2.4 per cent through the year to the March quarter 2005. Although petrol prices are expected to place some further upward pressure on consumer prices in the near term, inflation is expected to remain moderate, with the CPI forecast to grow by 2½ per cent through the year to the June quarter 2006.

Unit labour costs are forecast to increase in 2004-05, reflecting a cyclical slowing in productivity growth and a slight increase in wage growth. While this will put some upward pressure on inflation, businesses are expected to look through some of the cyclical slowing in productivity growth in order to ameliorate volatility in retail prices.

Oil prices have continued to exert some upward pressure on the CPI in recent quarters. The direct impact of oil prices has been through higher petrol prices, although the prices of some other goods and services — air fares for example — have also been affected. Oil prices are assumed to remain broadly unchanged over 2005-06 and, therefore, petrol prices are expected to stabilise.

Chart 9: Inflation



Source: ABS Cat. No. 6401.0 (original data).

Box 6: Real GDP projections

The economic outlook includes projections for real GDP growth beyond the immediate two forecast years. From the 2005-06 Budget, this assumption is amended from 3½ per cent to 3¼ per cent per annum for 2008-09 and beyond.

The Intergenerational Report (IGR) notes that falling labour market participation due to an ageing population is expected to lower potential GDP growth in the coming decades.

Projections of GDP growth for 2008-09 will begin to reflect the IGR projections of declining participation rates and hence employment growth. Specifically, projections for employment growth have been adjusted down to 1¼ per cent in 2008-09, bringing projected GDP growth down to 3¼ per cent (Table A).

Table A: Economic projections(a)

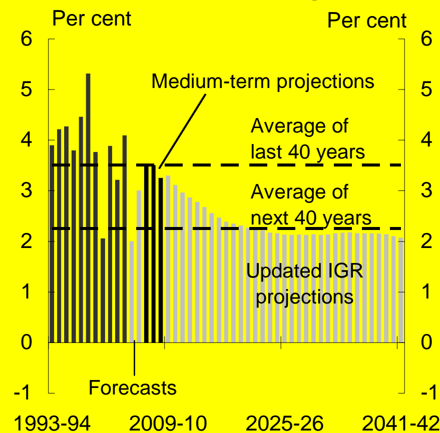
	2006-07	2007-08	2008-09
Employment(b)	1 1/2	1 1/2	1 1/4
Productivity	2	2	2
Real GDP	3 1/2	3 1/2	3 1/4
Wages(c)	3 3/4	3 3/4	4
CPI	2 1/2	2 1/2	2 1/2

(a) Percentage change on previous year.
(b) Labour Force Survey.
(c) Wage Price Index.
Source: Treasury.

The projections for 2006-07 and 2007-08 assume that the wage share of GDP continues to fall. From 2008-09, compensation of employees and corporate profits are assumed to grow at the same rate as nominal GDP, keeping the wage share constant. As a result, wages are projected to grow by 4 per cent in 2008-09.

The long run implications for GDP growth of adopting the IGR projections for declining aggregate participation and hence employment growth are shown in Chart A.

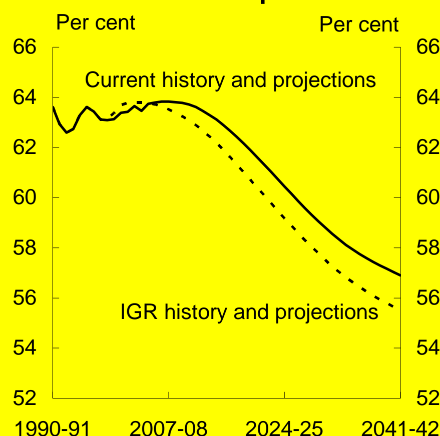
Chart A: Real GDP growth



Source: ABS Cat. No. 5206.0 and Treasury.

These projections are based on new population and participation data available since the 2002-03 IGR. With these new data, the peak in participation is now projected to occur in 2006-07 (Chart B).

Chart B: Participation rate



Source: ABS Cat. No. 6202.0 and Treasury (original data).

Box 7: Nominal GDP projections

Nominal GDP is forecast to grow by 7½ per cent in 2005-06, largely reflecting increases in Australia's commodity export prices.

Nominal GDP has grown very strongly for a number of years. In 2003-04, nominal GDP grew by 7.3 per cent, largely reflecting the impact of housing demand on both real GDP and domestic prices. Strong growth in the terms of trade and the effects of higher oil prices are expected to result in nominal GDP growth of 6 per cent in 2004-05.

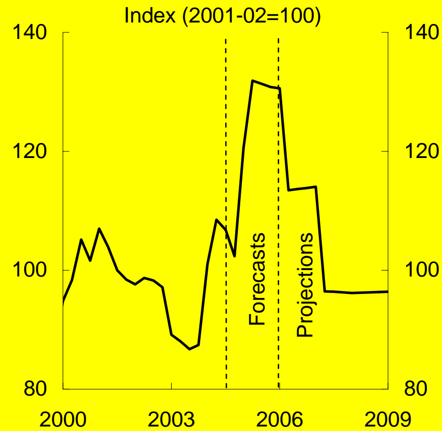
Nominal GDP projections, for the period 2006-07 to 2008-09, are typically based on underlying trends for real GDP and the GDP deflator – they are not forecasts. However, if the GDP deflator is projected at its historically-based trend growth rate, it would imply that commodity prices would remain at historically high levels over the entire projection period.

Beyond the forecast period, world supply for commodities that Australia exports is expected to increase in response to the recent surge in demand. This is likely to place downward pressure on Australia's export prices. As a result, not all of the recent boost to Australia's nominal income will be permanent.

How much of recent nominal income gains will be unwound in the projection period is a matter for judgement.

The approach, adopted in this Budget's fiscal projections, is to assume that commodity prices return to their long-run average level over the first two years of the projection period (Chart A). As a result, nominal GDP growth in 2006-07 and 2007-08 is not projected to grow as strongly. Projected real GDP growth is unaffected by the technical assumption for commodity prices.

Chart A: Commodity prices



Source: ABS Cat. No. 5302.0 and Treasury.

The interplay between rising global demand and supply makes predicting the future course of resource prices particularly difficult. Therefore, there is considerable uncertainty around the technical assumption for commodity prices.