STATEMENT 2: ECONOMIC OUTLOOK

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

CONTENTS

STATEMENT 2: ECONOMIC OUTLOOK

OVERVIEW

The Australian economy is entering its 25^{th} consecutive year of growth and is forecast to strengthen further over the next few years. This is the second longest continuous period of growth of any advanced economy in the world.

Conditions globally are expected to improve somewhat over the forecast period. Growth in Australia's major trading partners is expected to outpace world GDP growth, as activity in major advanced economies rises and growth remains strong in our faster growing Asian trading partners.

The recovery in the United States is becoming increasingly broad-based and will provide support for world growth more broadly. Growth in China will continue to make a strong contribution to global output as authorities look to rebalance the economy towards consumption-led drivers of growth. In India, growth has accelerated and is expected to exceed growth in all other major economies.

The lower exchange rate, lower oil and electricity prices and macroeconomic policy settings are all working together to underpin stronger growth in Australia.

Dwelling investment continues to grow strongly and household consumption grew at its fastest rate in almost three years in the December quarter 2014. Exports are also expanding rapidly as resource production ramps up and the lower exchange rate supports services sectors, such as tourism.

The outlook for growth remains positive even in the face of the adjustment underway as the resources investment boom unwinds. Mining investment is expected to fall by around 25 per cent in 2015-16 and 30 per cent in 2016-17. [1]

Real GDP is expected to grow by 2¾ per cent in 2015-16. This is one quarter of a percentage point slower than expected 12 months ago in the 2014-15 Budget, as a sustained recovery in non-mining business investment is taking longer than expected. However, stronger non-mining business investment is expected to drive an increase in growth to 3¼ per cent in 2016-17.

The labour market has proven more resilient than expected in recent months. Employment growth has picked up, supported by wage restraint across the economy. This has led to a downward revision to the forecast for the unemployment rate for the

1 All data are in chain volume measures and percentage change on previous year unless otherwise stated.

June quarter 2015 to 6¼ per cent. This is in the face of an improvement in the participation rate which is now expected to be 64¾ per cent in the June quarter 2015.

Going forward, the unemployment rate is expected to edge a little higher in 2015-16 before falling in 2016-17. The participation rate is forecast to be slightly higher than it was in the 2014-15 Budget as improved job prospects encourage additional people back into the workforce.

Iron ore and metallurgical coal prices have fallen sharply as a substantial increase in global supply coincides with some easing in steel demand from China. The forecasts are underpinned by an iron ore price of US$48 per tonne FOB (free on board). By comparison, the spot price forecast in the 2014-15 Budget averaged US$96 per tonne FOB, which itself was well below the peak price of US$185 per tonne FOB in 2011.

The fall in commodity prices has had a significant impact on both business profits and wages with material implications for nominal GDP.

As a result, nominal GDP is now expected to grow by 3¼ per cent in 2015-16 before picking-up to 5½ per cent in 2016-17. This has driven a substantial downgrade to government taxation receipts of $52 billion since the 2014-15 Budget (see Budget Statement 4).

Momentum in the recovery in the US, Japan and euro area and stronger growth in India will support stronger global growth. While risks have somewhat abated for the global economic outlook, risks remain, notably with China's transition to a more sustainable growth model.

In Australia, the pace and timing of the pick-up in economic growth is subject to some uncertainty. A lower exchange rate, historically low interest rates and lower oil prices should stimulate faster growth in household spending and business investment than forecast. However, there remain some risks. The headwinds from the reduction in mining investment are significant and it is also possible that the pick-up in non-mining investment may not be as strong as expected. There is also a risk that momentum in consumer spending could dissipate.

Table 1: Domestic economy forecasts[(a)]

	Outcomes(b)	Forecasts		
	2013-14	2014-15	2015-16	2016-17
Real gross domestic product	**2.5**	**2 1/2**	**2 3/4**	**3 1/4**
Household consumption	2.2	2 3/4	3	3 1/4
Dwelling investment	5.1	6 1/2	6 1/2	4 1/2
Total business investment(c)	-5.1	-5 1/2	-7	-3 1/2
By industry				
Mining investment	-7.0	-15 1/2	-25 1/2	-30 1/2
Non-mining investment	-3.7	2	4	7 1/2
Private final demand(c)	0.9	1 1/4	1 1/4	2 1/4
Public final demand(c)	1.6	1 1/4	1 1/2	1 1/2
Change in inventories(d)	-0.3	0	0	0
Gross national expenditure	0.7	1 1/4	1 1/2	2 1/4
Exports of goods and services	5.8	6 1/2	5	6 1/2
Imports of goods and services	-1.9	-3	-1 1/2	2 1/2
Net exports(d)	1.6	2	1 1/4	1
Nominal gross domestic product	4.0	1 1/2	3 1/4	5 1/2
Prices and wages				
Consumer price index(e)	3.0	1 3/4	2 1/2	2 1/2
Wage price index(f)	2.5	2 1/2	2 1/2	2 3/4
GDP deflator	1.5	-1	1/2	2 1/4
Labour market				
Participation rate (per cent)(g)	64.6	64 3/4	64 3/4	64 3/4
Employment(f)	0.7	1 1/2	1 1/2	2
Unemployment rate (per cent)(g)	5.9	6 1/4	6 1/2	6 1/4
Balance of payments				
Terms of trade(h)	-3.7	-12 1/4	-8 1/2	3/4
Current account balance (per cent of GDP)	-3.1	-3	-3 1/2	-2 3/4

(a) Percentage change on preceding year unless otherwise indicated.
(b) Calculated using original data unless otherwise indicated.
(c) Excluding second-hand asset sales from the public sector to the private sector.
(d) Percentage point contribution to growth in GDP.
(e) Through-the-year growth rate to the June quarter.
(f) Seasonally adjusted, through-the-year growth rate to the June quarter.
(g) Seasonally adjusted rate for the June quarter.
(h) The forecasts are underpinned by spot prices of $48 ($US/t, FOB) for iron ore; $90 ($US/t, FOB) for metallurgical coal and $60 ($US/t, FOB) for thermal coal.

Note: The forecasts for the domestic economy are based on several technical assumptions. The exchange rate is assumed to remain around its recent average level — a trade-weighted index of around 64 and a $US exchange rate of around 77 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$64 per barrel.

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

OUTLOOK FOR THE INTERNATIONAL ECONOMY

Global economic conditions have continued to improve and are expected to strengthen somewhat over the forecast period. Australia's major trading partner growth is expected to outpace world growth. This reflects both the improved outlook in advanced economies and the increasing importance of our faster growing Asian partners. It also highlights the opportunity available to Australian businesses and consumers with the world's engine room of growth being in Asia.

Lower oil prices are a net positive for global growth, while central banks in the major advanced economies maintain supportive monetary policy settings. Compared with a year ago, a number of downside risks have abated.

Australia's major trading partners are expected to grow by 4½ per cent in 2015 and 2016. Reflecting the ongoing move to a more sustainable growth rate within the Chinese economy, major trading partner growth is expected to ease a little to 4¼ per cent in 2017.

Table 2: International GDP growth forecasts(a)

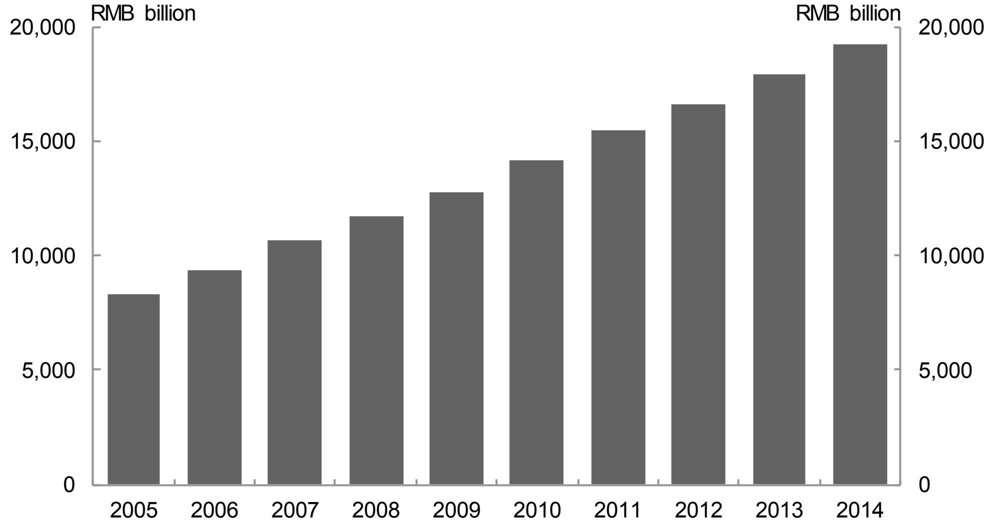
	Actuals	Forecasts		
	2014	2015	2016	2017
China	7.4	6 3/4	6 1/2	6 1/4
India	7.2	7 1/2	7 1/2	7 1/2
Japan	0.0	1	1	1/2
United States	2.4	3 1/4	3 1/4	3
Euro area	0.9	1 3/4	1 3/4	1 3/4
Other East Asia(b)	4.1	4 3/4	4 3/4	5
Major trading partners	4.2	4 1/2	4 1/2	4 1/4
World	3.4	3 1/2	3 3/4	3 3/4

(a) World, euro area and other East Asia growth rates are calculated using GDP weights based on purchasing power parity (PPP), while growth rates for major trading partners are calculated using export trade weights.
(b) Other East Asia comprises the newly industrialised economies (NIEs) of Hong Kong, South Korea, Singapore and Taiwan and the Association of Southeast Asian Nations group of five (ASEAN 5), which comprises Indonesia, Malaysia, the Philippines, Thailand and Vietnam.
Source: National Statistical Agencies, IMF World Economic Outlook April 2015, Thomson Reuters and Treasury.

A period of extraordinary growth rates has made **China** one of the largest economies in the world. The Chinese economy is now more than double the size that it was a decade ago (Chart 1).

The growth rate is now moderating to a more sustainable pace. Authorities are navigating the dual challenges of transitioning the economy to a more balanced growth model and managing a significant downturn in the property sector. In response to concerns about the pace of the slowdown, monetary policy has been eased and other pro-growth measures have been introduced in China. Alongside increased infrastructure investment, these measures are expected to support growth.

Chart 1: Chinese real GDP



Note: 1990 prices.
Source: IMF April 2015 World Economic Outlook.

Looking forward, solid and sustained growth in China will be underpinned by the transition to a pattern of growth that is more reliant on consumption. A broader-based model of growth will enhance the resilience of the Chinese economy as the market plays a more decisive role and institutional settings are reformed. This will also strengthen the economy as it faces long-term challenges, including an ageing population. A key risk, however, is that China's transition to a more sustainable growth model may not be smooth, presenting changing demand patterns for Australian exports.

Despite the recent impact on commodity prices, China's transition provides opportunities for Australia's economy. China's middle class is projected to increase from around 12 per cent of the population in 2009 to around 70 per cent by 2030.[2] Combined with the economy's shift towards consumption-led growth this will provide significant new markets for our services exports. In 2009, there were 356,400 Chinese visitor arrivals into Australia. By 2013-14 there were over 760,000 Chinese visitor arrivals to Australia, spending around $6.5 billion or $8,600 per visitor.

India is expected to be the fastest growing major economy in the world in 2015. Growth is forecast to be 7½ per cent in 2015, 2016 and 2017. India's improved prospects reflect the Indian Government's economic reform agenda (Box 1). In addition, ongoing low energy prices have reduced businesses' operating costs and

2 Kharas and Gertz (2010).

Box 1: India's growing potential as a trading partner

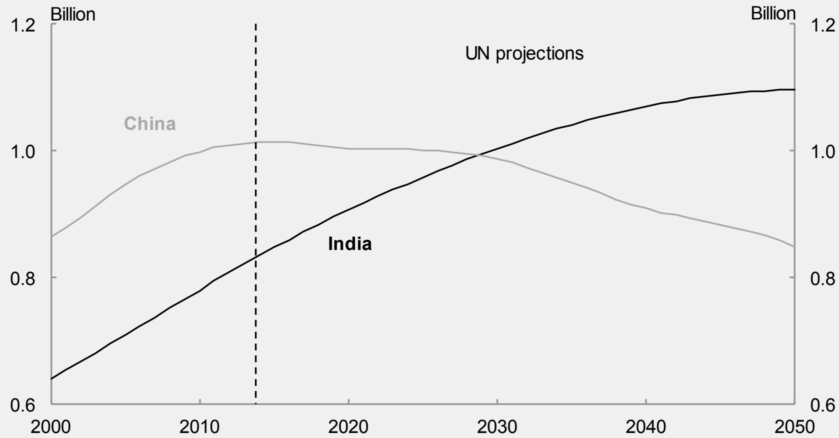
India has the potential to become a major trading partner for Australia. At more than 1.2 billion people, it is the second most populous country, with the third largest economy on a PPP basis. India is expected to overtake China as the world's most populous country by 2030, with the working age population expected to reach around 1 billion by 2030 (Chart A).

Following moderate economic activity in recent years, Indian growth has accelerated and is expected to outpace all other major economies in 2015, exceeding that of China for the first time in over a decade. Growth is being led by strong gains in the manufacturing, service and utilities sectors.

The economic outlook for India has been bolstered by policy reforms including a proposed staged reduction in the rate of company tax, measures to make doing business easier and more predictable, and a commitment to stable macroeconomic policy settings. Increased infrastructure expenditure (including the equivalent of $4 billion for a new National Infrastructure and Investment Fund) and lower energy prices have also enhanced India's growth prospects.

Australian exports to India were worth $10.5 billion in 2013-14, with commodities (primarily energy) and education services contributing a large share. India and Australia are currently negotiating a Comprehensive Economic Cooperation Agreement, with India being only our twelfth largest trading partner. With trade worth only one-tenth of our trade with China there is scope to further broaden trade and investment linkages with India.

Chart A: India and China working age population (15-64)



Source: UN Population Statistics.

benefited private consumers. They have also contributed to lower-than-expected inflation, enabling authorities to ease monetary policy to support growth. If stronger growth is sustained, India could become a much more important trading partner for Australia and the region, which is why the Government is prioritising the negotiation of a Comprehensive Economic Cooperation Agreement with India.

The **United States** economy is poised to strengthen over the forecast period and provide an impetus to world growth. Low oil prices are contributing to increased household disposable income and, coupled with a strengthening labour market, are supporting private consumption. Along with the pick-up in domestic demand, business investment is also robust. The recent loss of momentum reflects temporary weather-related factors, which are now dissipating, and the strength of the US dollar weighing on exports.

The United States is expected to grow at 3¼ per cent in 2015 and 2016 — above its trend growth. Consistent with the strengthening outlook, the US Federal Reserve expects to start normalising monetary policy settings and raising interest rates in the second half of 2015. The pace and timing of rate increases may result in bouts of financial market volatility. Growth is expected to moderate a little to 3 per cent in 2017.

On the back of the stronger outlook, the US dollar continues to appreciate. This strengthening of the US dollar has contributed to a depreciation of the Australian dollar, having positive flow-on impacts for our economy.

Expectations of a **euro area** recovery are stronger than they were at 2014-15 Budget, reflecting a weaker euro and lower commodity prices providing a much needed boost to growth. Given the significant policy impulse to growth, we expect euro area growth to strengthen to 1¾ per cent over the forecast horizon. The recent decline in the euro is expected to raise inflation via higher import prices and support growth by boosting exports.

Nevertheless, recent developments with regard to Greece highlight the continued structural challenges faced by the euro area. Fiscal and structural reforms remain crucial to ensure a sustained recovery.

Economic growth in **Japan** is also expected to strengthen to 1 per cent in both 2015 and 2016. While activity has been weaker than expected following the increase of the consumption tax rate in April 2014, December quarter 2014 GDP suggests that activity has turned the corner. This improved outlook is underpinned by accommodative monetary and fiscal policy settings, coupled with the depreciation of the yen and lower oil prices. Over the medium to longer term Japan continues to face structural challenges and the ongoing success of the 'Abenomics' reform package will be critical in boosting growth.

Economic growth for the **ASEAN 5 economies** is expected to accelerate, reflecting falls in commodity prices and improved growth prospects of their trading partners.

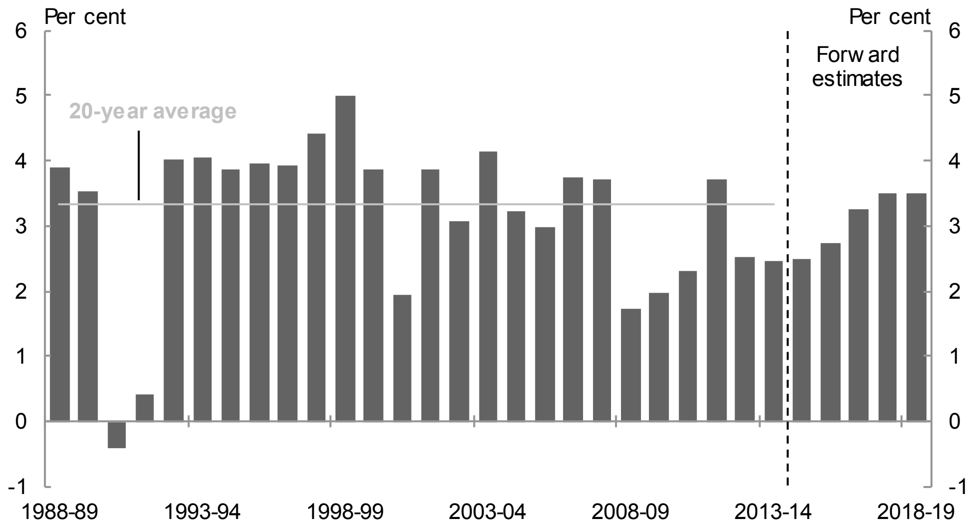
OUTLOOK FOR THE DOMESTIC ECONOMY

Outlook for Real GDP growth

The outlook for the Australian economy remains positive. It is one of the fastest growing economies in the advanced world. The fundamentals are solid with a lower exchange rate, lower petrol and electricity prices, rising household wealth and macroeconomic policy settings working together.

The Australian economy is weathering one of the largest falls in commodity prices in its history, and is still expected to grow by 2¾ per cent in 2015-16 before increasing further to 3¼ per cent in 2016-17 (Chart 2). The transition to broader-based growth is well underway. Household consumption, dwelling investment and exports are all lifting. On the other hand, a sustained recovery in non-mining business investment is taking longer than expected.

Chart 2: Real GDP growth



Source: ABS cat. no. 5206.0 and Treasury.

Fundamentals are underpinning this transition to broader-based growth. Interest rates are at historic lows with the official cash rate reduced by 275 basis points since the peak in the terms of trade in the September quarter 2011. However, they remain above near zero interest rates in most of the major advanced economies, consistent with the relative strength of the Australian economy (Table 3). This is in contrast to the Reserve Bank of Australia's emergency response to the global financial crisis, when Australia's official cash rate was reduced by 425 basis points over a period of 8 months to avoid Australia following other major advanced economies into recession.

Table 3: Global interest rates

	Policy rate
Australia	2.00
United States	0.13
Canada	0.75
Switzerland	-0.75
United Kingdom	0.50
Sweden	-0.25
Euro area	0.05
Japan	0.10

Note: Switzerland policy rate is the midpoint of the 3-month LIBOR target band.
Source: Central Banks and Bloomberg.

The Australian dollar has declined since September last year, providing support for export-oriented and import-competing firms. Oil prices have also fallen since the 2014-15 Budget, boosting households' spending power and reducing costs for businesses. Electricity prices are down on average 3.9 per cent compared with one year ago, after a record fall of 5.1 per cent in the September quarter 2014 following the abolition of the carbon tax.

Low interest rates are supporting households

Low interest rates are supporting the Australian economy's transition to broader-based growth at a time when household demand is strengthening. The dwellings sector has contributed strongly to recent growth. Housing construction is responding positively to accommodative monetary policy, strong growth in house prices as well as solid population growth. A significant pipeline of approvals suggests that the upswing in **dwelling investment** still has some way to run and growth is forecast to be 6½ per cent in 2015-16 and 4½ per cent in 2016-17.

Buoyant conditions in the housing market are also supporting **household consumption,** increasing both household wealth and spending on household furnishings. Weaker oil prices have also improved household budgets with recent retail fuel prices down by over 14 per cent or 22 cents per litre since the 2014-15 Budget. These factors, along with rising equity prices and lower electricity prices, helped household consumption to grow at its fastest rate in nearly three years in the December quarter 2014.

Household consumption has also been supported by a modest fall in the household saving ratio. Savings rose strongly during the period of rapid household income growth that accompanied the terms of trade boom and following the financial crisis. There are signs that households are now smoothing their consumption as the terms of trade decline. The household saving ratio is forecast to continue to fall but only by a modest amount, and is expected to remain well above pre-crisis lows.

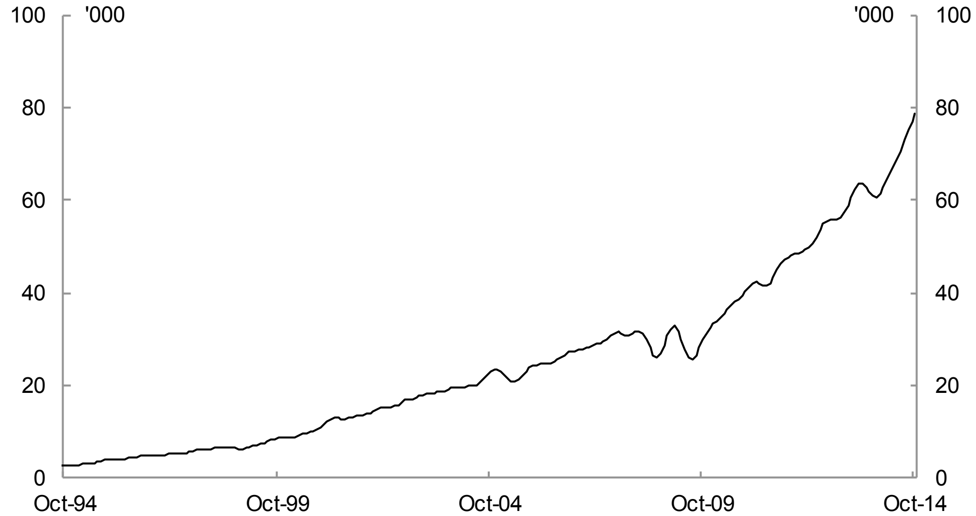
Household consumption is forecast to rise by 3 per cent in 2015-16 and 3¼ per cent in 2016-17. The extent to which the household saving ratio will fall to support consumption growth is a key risk surrounding this outlook.

A lower exchange rate is making Australian businesses more competitive

As commodity prices have fallen sharply, the exchange rate has also started to fall (see Box 2). The fall in the exchange rate combined with subdued wage growth will facilitate the economy's adjustment to the fall in commodity prices and is encouraging export growth in sectors such as tourism and education.

Growth in our region is also expected to support tourism. Tourists from China accounted for over one quarter of the growth in travel services spending in 2013-14. There were over 760,000 Chinese visitor arrivals in that year alone spending around $6.5 billion or $8,600 per visitor, providing support for businesses in sectors such as retail and accommodation and food services (Chart 3).

Chart 3: China overseas visitor arrivals (persons monthly)



Source: ABS cat no. 3401.0.

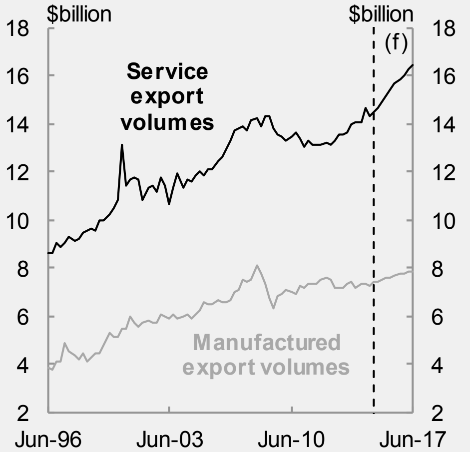
Total **exports** are expected to increase by 5 per cent in 2015-16 and 6½ per cent in 2016-17. Exports of non-rural commodities continue to grow strongly as the investment phase of the mining boom nears completion and production increases. The volume of iron ore exports has doubled over the past 5 years and is expected to increase by a further 8 per cent by the end of 2016-17 as mine expansions already underway are completed (Chart 4).

Significant investments in LNG are still under development and will make a strong contribution to export growth in coming years. Exports of LNG are set to nearly double over the forecast period as major projects in Western Australia, Queensland and the Northern Territory enter into their production phases. By the end of the decade, Australia is set to overtake Qatar as the largest exporter of LNG in the world.

Box 2: The export benefits of a lower exchange rate

The exchange rate depreciation is providing opportunities for export growth in industries that struggled under the weight of the high Australian dollar during the resources boom. Services and manufacturing exports are, in particular, forecast to increase at a solid rate over the next couple of years (Chart A).

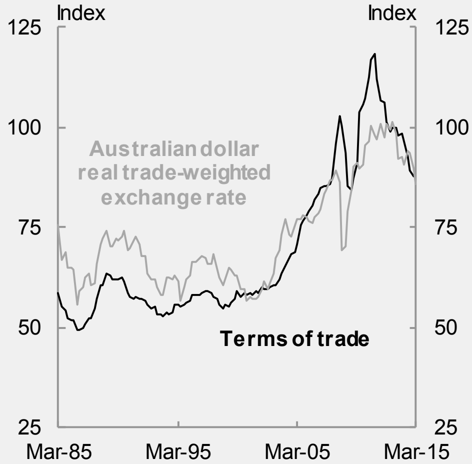
Chart A: Service and Manufactured Export Volumes



Note: 2012-13 prices; forecast period is from March 2015 to June 2017.
Source: ABS cat. no. 5302.0 and Treasury.

Australia's real exchange rate appreciated by around 30 per cent during the terms of trade boom, and has subsequently depreciated by 13 per cent since the peak in the terms of trade in September quarter 2011 (Chart B).[3] The exchange rate has played an important role in smoothing the adjustment of the real economy to the terms of trade shock and keeping inflation contained.

Chart B: Exchange Rate and Terms of Trade



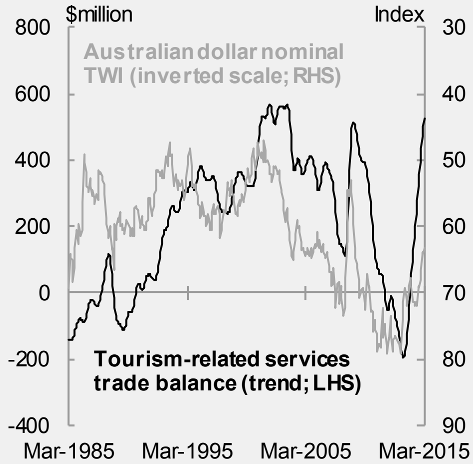
Note: Index 2012-13 average = 100.
Source: ABS cat. no. 5206.0 and RBA.

One industry that is already benefiting from a lower dollar is tourism. Real travel expenditure by international visitors to Australia has increased by 11 per cent since the start of 2012, whereas real travel expenditure by Australian residents travelling abroad has decreased by 11 per cent. Overall, this has contributed to a sharp improvement in the trade balance of tourism-related services (Chart C). The recent strength in travel service exports has been broad-based across all states and territories.

The depreciation of the exchange rate is also expected to boost manufactured exports. Australia's manufacturing sector has been facing increased competition from lower cost producers in Asia for some time now.

3 The real exchange rate adjusts nominal exchange rates for differences in relative price levels across countries.

Chart C: Tourism-related services trade balance



Note: Tourism-related services include travel services and passenger transportation services; exchange rate index March 1970 = 100.
Sources: ABS cat. no. 5368.0 and RBA.

Chart D: Manufacturing export volumes

Note: 2012-13 prices; manufacturing classifications are based on UNCTADstat definitions; excludes food, beverage, iron and steel manufacturing exports.
Sources: ABS cat. no. 5302.0, Treasury and UNCTADstat.

Even during this period of strong competition and the high Australian dollar, some manufacturing industry sectors performed relatively well, namely producers of medium-to-high skilled and technology-intensive goods such as pharmaceuticals, professional and scientific equipment, and machinery and transport equipment (Chart D). The depreciation of the exchange rate and a recovery in global demand should support growth in these industries.

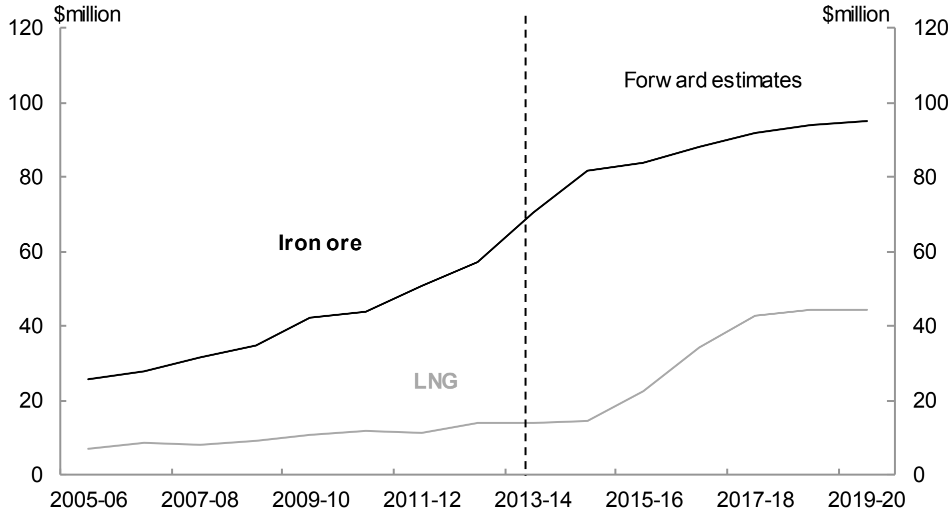
Recent domestic policy changes and the expanding middle class in Asia will also reinforce the benefit of the lower Australian dollar for other exports such as rural goods and education services.

Education exports will be boosted by changes to student visa policy arrangements. The Department of Immigration and Border Protection is forecasting net international student migration to increase from 88,200 in 2014 to 139,300 in 2017-18, following the introduction of new visa streamlining measures and post-study work arrangements.

Free Trade Agreements with Korea, Japan and China will also improve Australia's competitiveness across a range of agricultural exports. Australian services exporters will also gain improved access to Chinese markets, for example, for financial, legal, education and tourism services.

Following strong growth in recent years, rural exports are expected to moderate in 2015-16. Wheat exports are expected to fall after record highs in crop production over the past two years which were underpinned by favourable weather conditions. Beef exports are also expected to be lower, in part due to farmers rebuilding their herds following past drought conditions.

Chart 4: Export volumes



Note: 2012-13 prices.
Source: Department of Industry.

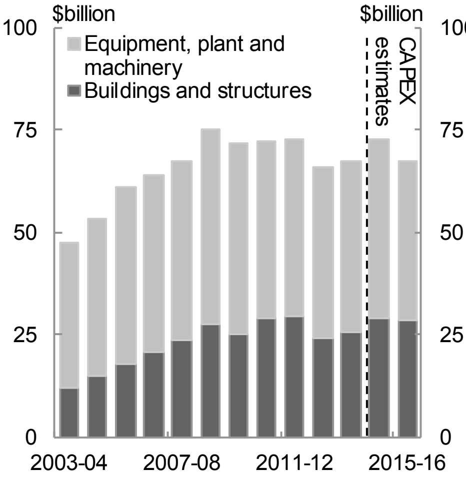
The transition underway in the economy is also having an impact on **imports**. The fall in the Australian dollar is expected to encourage consumers and businesses to switch from imported goods and services to domestically produced ones. The end of the investment phase of the resources boom will also lead to a reduction in capital imports in coming years. Imports are forecast to fall by 1½ per cent in 2015-16 but grow by 2½ per cent in 2016-17 as GDP growth returns to trend.

Investment is still rebalancing from mining to non-mining

The most significant revision to real GDP growth in 2015-16 since the 2014-15 Budget is **business investment**. Non-mining business investment grew solidly in 2014, particularly in the services sector. Despite this, business liaison, the latest ABS Private New Capital Expenditure and Expected Expenditure (CAPEX) and non-residential building approvals data all suggest that firms in the non-mining sectors of the economy are yet to commit to significant additional investment in 2015-16 (Chart 5).

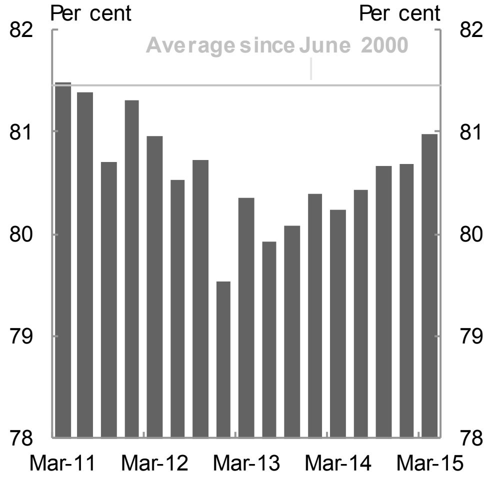
However, conditions are expected to support a lift in non-mining business investment. Healthy corporate balance sheets along with the lower interest rates, the lower Australian dollar and lower fuel costs should encourage investment plans going forward as firms rebuild and modernise their capital stocks. Reflecting this, real non-mining business investment is expected to grow by 4 per cent in 2015-16 and strengthen further to 7½ per cent in 2016-17.

Chart 5: Nominal non-mining CAPEX



Note: Estimates for 2014-15 and 2015-16 are based on survey respondents' expectations and have been adjusted using long-run realisation ratios.
Source: ABS cat. no. 5625.0 and Treasury.

Chart 6: Non-mining capacity utilisation



Source: NAB.

The pace and timing of the recovery in non-mining business investment remains a major source of uncertainty. Bearing that in mind, the Budget forecasts suggest that household and overseas demand will encourage a lift in business confidence and investment, and recognise that the CAPEX survey is a less reliable guide of investment in the non-mining economy.

It is possible that conditions could improve more rapidly than expected if households increase their spending more rapidly, with businesses responding by ramping up investment. With interest rates at historic lows and rising capacity utilisation, there is some upside risk to the forecasts, particularly in 2016-17, if a stronger bounce-back were to materialise (Chart 6). However, if demand and confidence fail to lift, there is a risk that the recovery in non-mining business investment could be further delayed.

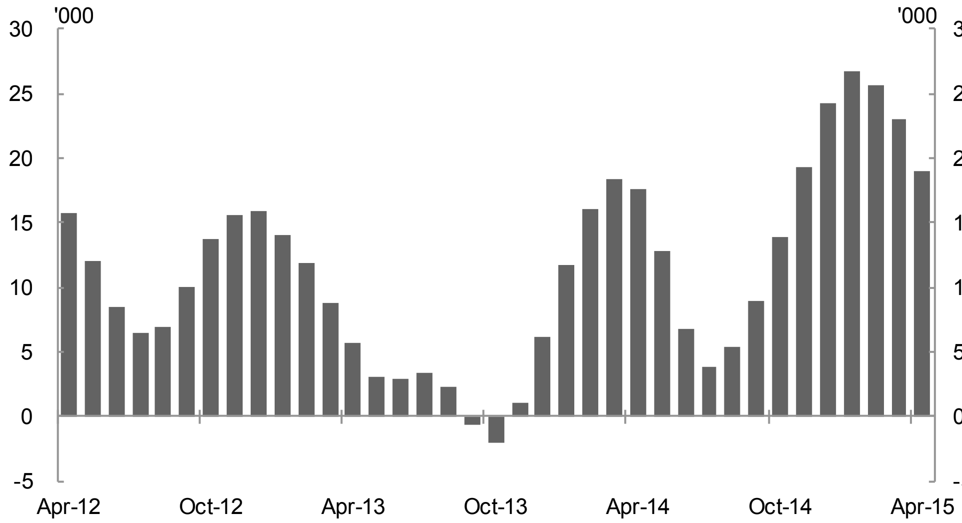
Mining investment is expected to decline further as current projects are completed and few new projects are commissioned. Resources companies are also continuing with their productivity drives to use their capital more efficiently which along with a decline in exploration expenditure is expected to weigh further on mining investment. Mining investment is forecast to fall by 25½ per cent in 2015-16 and 30½ per cent in 2016-17, detracting around 4 percentage points from GDP growth over the three years to 2016-17.

Public final demand, which captures the direct economic impact of consumption and investment across all levels of government, is forecast to grow modestly as governments remain focused on budget consolidation. As a result, public final demand is forecast to rise by 1½ per cent in both 2015-16 and 2016-17.

Employment is growing steadily

As the economy has continued to transition to broader-based growth, the **labour market** has been resilient. Since the 2014-15 Budget, employment growth has picked up to 1.5 per cent. The unemployment rate has remained steady at around 6.2 per cent since the middle of last year. The sectors experiencing the largest employment growth over the past year include professional, scientific and technical services, construction and accommodation and food services.

Chart 7: Trend employment growth



Source: ABS cat. no. 6202.0 and Treasury.

Looking forward, indicators such as job advertisements, vacancies and business survey measures of hiring intentions suggest continued growth in employment. The forecast below-trend GDP growth means that the **unemployment rate** is still expected to drift up to 6½ per cent in 2015-16. With the economy forecast to strengthen further in 2016-17, the unemployment rate is expected to fall to 6¼ per cent.

The **participation rate** is expected to remain close to recent levels over the forecast period and the outlook has improved compared with the 2014-15 Budget. The improvement in labour market conditions should encourage some job seekers back to the labour force to resume their search for work but this will be somewhat offset by the ongoing effect of population ageing.

Wage flexibility has been key to supporting employment during a period where the economy has been growing a little below trend. Wage growth has been constrained by spare capacity in the labour market as the economy transitions to the less labour intensive production phase of the resources boom.

The Wage Price Index (WPI) grew by 2.5 per cent over 2014. Wage growth has been subdued in both the public and private sectors as governments across the country focus on expenditure restraint and businesses look to reduce costs. Within the private sector, wage growth has contracted most markedly in mining, retail trade and administrative services.

Income growth is expected to remain modest, consistent with falls in the terms of trade. Accordingly, the WPI is forecast to remain constrained, growing by 2½ per cent through-the-year to the June quarter 2015 and 2¾ per cent through-the-year to the June quarter 2016.

Consumer prices have grown by 1.3 per cent over the past year, as the removal of the carbon tax, low oil prices and modest domestic activity have kept price growth well contained. In the forecast period, forces are pulling the consumer price index (CPI) in two directions. While wage growth is moderate, the fall in the exchange rate and the increase in the tobacco excise are forecast to contribute to the CPI. Overall, CPI inflation is expected to remain around the middle of the Reserve Bank of Australia's target band at 2½ per cent through the year to the June quarter 2015 and 2016.

Outlook for nominal GDP

While real GDP has been downgraded only modestly compared with the 2014-15 Budget, there has been a more substantial downgrade to **nominal GDP** in line with weakening commodity prices and subdued growth in wages. Since the 2014-15 Budget, nominal GDP growth has been revised down by one and a half percentage points in 2015-16 to 3¼ per cent before increasing to 5½ per cent in 2016-17. This will weigh significantly on government taxation receipts with a $52 billion downgrade compared with the 2014-15 Budget (see Budget Statement 4).

Bulk commodity prices have continued to fall sharply in US dollar terms. Iron ore prices have nearly halved since the 2014-15 Budget and metallurgical coal prices have fallen by nearly a third. The lower Australian dollar has cushioned some of the fall but even in Australian dollar terms, the decline is still significant.

In part, these falls reflect a fall in costs of commodity producers expressed in US dollar terms as their currencies have fallen against the US dollar. But there are also fundamental factors at play with the global supply of major commodities accelerating at a brisk pace at the same time as resource demand in China has been weakening.

The inherent uncertainty around both supply and demand factors means the iron ore price outlook, particularly over the short run, is subject to considerable risk (Box 3).

Experience shows that prices can move sharply in short periods of time, often at odds with broader market expectations. Recognising the significant recent volatility, the bulk commodity prices used to underpin the forecasts have been based on a recent average. The prices used are US$48 per tonne FOB for iron ore (equivalent to US$53 per tonne cost and freight (CFR)), US$90 per tonne FOB for metallurgical coal and US$60 per tonne FOB for thermal coal.

The impact of iron ore prices being US$10 per tonne lower/higher, based on the sensitivity analysis presented in Budget Statement 7, is set out in Table 4. A US$10 per tonne reduction/increase in the iron ore price results in just over a 3 per cent fall/rise in the terms of trade and a 0.8 per cent reduction in nominal GDP in 2015-16. These illustrative impacts differ from the ones presented in the Mid-Year Economic and Fiscal Outlook due to movements in the exchange rate and timing issues.

Table 4: Sensitivity Analysis of Iron Price Movements[(a)]

	US$38/tonne FOB[(b)] spot price		US$58/tonne FOB spot price	
	2015-16	2016-17	2015-16	2016-17
Nominal GDP ($billion)	-9.8	-13.4	9.8	13.4
Tax Receipts ($billion)	-2.1	-4.4	2.1	4.4

(a) Key aggregates are shown relative to the 2015-16 Budget iron ore spot price forecast of US$48/tonne and based on an exchange rate assumption of 77 US cents.
(b) FOB is the free-on-board price which excludes freight costs.
Source: Treasury.

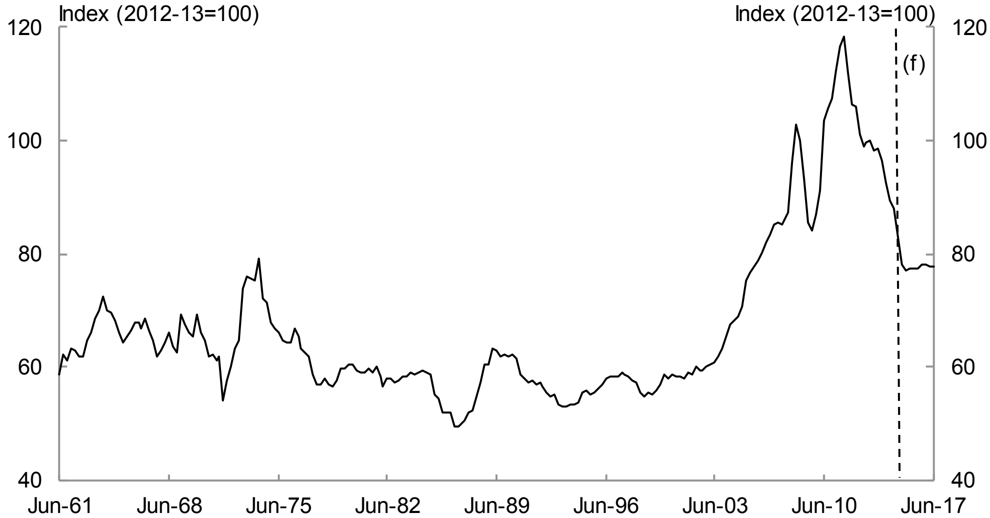
The actual impact of different assumptions about iron ore prices on nominal GDP will depend on movements in the exchange rate, changes in the Australian dollar price actually received by exporters, production decisions by companies and responses in other parts of the economy.

The prices outlook for rural goods is mixed although the depreciation in the Australian dollar will support rural producers. World wheat prices are expected to fall in 2015-16 as production recovers in the US and other wheat producing regions. Beef prices are forecast to increase in 2015-16 as strong export demand continues and herds rebuild along with improved seasonal conditions.

Overall, commodity prices are weighing on the **terms of trade** which are forecast to fall by 8½ per cent in 2015-16. A modest recovery in some commodity prices and the waning impact of the depreciation of the dollar on imports is forecast to see the terms of trade remain broadly flat in 2016-17 (Chart 8).

Lower commodity prices reduce nominal GDP through more than just weaker export prices and mining profits. Miners have responded to the new price environment by cutting costs and wage and profit growth has also softened in sectors such as construction and business services that support mining activity.

Chart 8: Terms of trade



Source: ABS cat no. 5206.0 and Treasury.

More broadly, wage flexibility is playing an important role in facilitating adjustments in the labour market. Slower wage growth is allowing firms to retain staff at a time when profit growth is modest and will encourage them to employ additional workers as demand increases, but is dragging on nominal GDP growth.

Box 3: Iron ore market developments

The iron ore spot price has nearly halved over the past year (Chart A).

The price fell as low as US$43 per tonne FOB at the start of April, but has partially recovered in recent weeks with signs that some major iron ore producers may delay elements of their expansion plans.

Chart A: Recent spot price developments

Source: Platts.

The Chinese economy now consumes about 80 per cent of Australia's iron ore exports and the cut in production by Chinese steelmakers in early 2015 was a key factor behind the price declines.

China's construction sector, which accounts for two-thirds of China's steel usage, has remained weak in early 2015, curbing steelmakers' production plans.

Further growth in low-cost supply has also continued to weigh on prices. In 2014, increased Chinese iron ore imports from Australia and Brazil (worth a combined 150 million tonnes) more than offset falls in Chinese domestic production and imports from non-major suppliers.

Despite the fall in prices over the past year, expansion of low-cost supply is set to continue for some time.

In 2015, Australia is expected to lead the way, adding another 50 million tonnes of exports.

The continued ramp-up in 2015 will see Australia confirm its position as the single largest supplier globally, with the 770 million tonnes of Australian exports accounting for around a third of global production.

Brazil is still expected to add up to 90 million tonnes of new low-cost capacity, although most of this is not expected to begin to come on line until the middle of 2016.

On the demand side, the continued weakness in China's housing sector is expected to weigh on China's demand for iron ore in the near term. This reflects the substantial stock of unsold housing that has built up over recent years, as housing starts have consistently outstripped sales (Chart B).

Chart B: Chinese property supply

Note: 12 month moving average reported.
Source: CEIC China Database and Treasury.

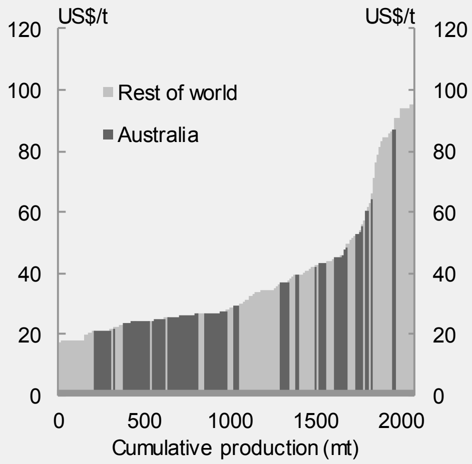
That said, macroeconomic policy easing such as the recent 100 basis point cut to the reserve ratio requirement could help support demand for steel in other parts of the Chinese economy, such as infrastructure, as could other potential policy measures targeted at supporting the steel industry.

Meanwhile, demand from other economies including Japan (which accounts for 11 per cent of Australian exports) and Korea (which accounts for 7 per cent) will also help to underpin Australian exports going forward.

As its economy continues to industrialise, India also has the potential to become a major destination for Australian iron ore and coal exports.

While iron ore prices are not expected to rise to levels that were seen during the peak of the commodities cycle, Australia's iron ore industry is generally well positioned as one of the low cost global producers (Chart C).

Chart C: 2015 Iron ore cost curve



Note: Estimated 2015 iron ore cost curves FOB basis.
Source: AME Group.

There are a number of key uncertainties. These include the future path of Chinese steel output, the potential for further reductions in mine operating costs and the possibility that companies may alter production plans.

Medium–term projections

The fiscal aggregates in the Budget are underpinned by economic forecasts for the budget year and the subsequent financial year, and by projections for the following two financial years. These projections are not forecasts, but rather are based on a set of medium-term assumptions.

The medium-term projection methodology assumes that spare capacity in the economy is absorbed over five years following the two year forecast period. As this occurs, 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 2017-18, real GDP is projected to grow above trend, at 3½ per cent, over the five years from 2017-18 to 2021-22. By then, spare capacity is absorbed and real GDP grows at trend thereafter.

Trend GDP is estimated based on analysis of underlying trends for population, productivity and participation. The unemployment rate is projected to converge back to 5 per cent over the medium term consistent with Treasury's estimate of the non-accelerating inflation rate of unemployment (NAIRU). Inflation is projected to be 2½ per cent, consistent with the Reserve Bank of Australia's medium-term target band. The terms of trade is projected to remain flat at around its 2005-06 level from 2019-20.