STATEMENT 2: ECONOMIC OUTLOOK

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

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STATEMENT 2: ECONOMIC OUTLOOK

OVERVIEW

The Australian economy is in the midst of a major transformation, moving from growth led by investment in resources projects to broader-based drivers of activity in the non-resources sectors. This is occurring at a time when the economy has generally been growing below its trend rate and the unemployment rate has been rising. During this transition, the economy is expected to continue to grow slightly below trend and the unemployment rate is expected to rise further to 6¼ per cent by mid-2015.

In this environment, the Government is focused on implementing measures to support growth and jobs while putting in place lasting structural reforms to restore the nation's finances to a sustainable footing. The timing and composition of the new policy decisions mean that the faster pace of consolidation in this Budget does not have a material impact on economic growth over the forecast period, relative to the 2013-14 Mid-Year Economic and Fiscal Outlook (MYEFO).

Since MYEFO, the near-term outlook for the household sector has improved. Leading indicators of dwelling investment are consistent with rising activity, while household consumption and retail trade outcomes have improved recently, consistent with gains in household wealth. This is partly offset by weaker business investment intentions, particularly for non-resources sectors.

The outlook for the resources sector is largely unchanged from MYEFO. Resources investment is still expected to detract significantly from growth through until at least 2015-16, as reflected in the outlook for investment in engineering construction which is forecast to decline by 13 per cent in 2014-15 and 20½ per cent in 2015-16. Rising resources exports are only expected to partially offset the impact on growth. Overall, real GDP is forecast to continue growing below trend at 2½ per cent in 2014-15, before accelerating to near-trend growth of 3 per cent in 2015-16.

The labour market has been subdued since late 2011, characterised by weak employment growth, a falling participation rate and a rising unemployment rate, although outcomes since the beginning of 2014 have been more positive. The unemployment rate is forecast to continue to edge higher, settling around 6¼ per cent, consistent with the outlook for real GDP growth. Consumer price inflation is expected to remain well contained, with moderate wage pressures and the removal of the carbon tax.

The outlook for the global economy has improved gradually since the end of 2013, led by a pickup in activity in advanced economies, most notably the United States. While activity has moderated in emerging market economies, these economies are still expected to contribute nearly three quarters of global growth over the forecast period.

Despite continued solid growth in China, prices for Australia's key commodity exports have fallen sharply since the start of the year. Coal prices are expected to remain weak while iron ore prices are expected to ease further in line with growing world supply. In light of a further expected decline in the terms of trade and subdued domestic price growth, nominal GDP is forecast to remain historically weak, growing by only 3 per cent in 2014-15 before strengthening somewhat to 4¾ per cent in 2015-16.

Sustained softness in nominal GDP growth is a recent phenomenon, emerging over the past two years. Given the importance of nominal GDP to income growth, this continuing weakness contributes to ongoing subdued growth in a number of major areas of revenue.

There are both upside and downside risks to the economic outlook. Most notably, non-resources business investment could pick up earlier and more rapidly than expected following a prolonged period of caution, while some trade-exposed sectors would benefit from a lower exchange rate, which is historically an outcome associated with a fall in the terms of trade. Conversely, the fall in resources investment is likely to be lumpy, while the associated rise in exports also has uncertain timing. International risks are more balanced than previously, though still to the downside as economies continue to deal with legacy issues from the financial crisis.

There is always a degree of uncertainty around the forecasts, which can be estimated based on past errors. Appendix B of Statement 3 provides further detail. The degree of uncertainty is also reflected in the divergent views outside government. The Budget forecasts are within the range of non-government forecasts. Appendix B provides further detail. Appendix A analyses the performance of Treasury's 2012-13 forecasts in retrospect.

Table 1: Domestic economy forecasts[a]

	Outcomes(b)	Forecasts		
	2012-13	2013-14	2014-15	2015-16
Panel A - Demand and output(c)				
Household consumption	2.0	2 1/2	3	3 1/4
Private investment				
Dwellings	-0.1	3 1/2	7 1/2	5 1/2
Total business investment(d)	6.1	-4	-5 1/2	-3 1/2
Non-dwelling construction(d)	13.9	-2 1/2	-9 1/2	-12 1/2
Machinery and equipment(d)	-4.3	-9 1/2	-2	7
Private final demand(d)	2.8	1 1/4	1 1/2	2
Public final demand(d)	-1.3	1 3/4	1 1/2	1
Total final demand	1.9	1 1/2	1 1/2	1 3/4
Change in inventories(e)	-0.3	- 1/4	1/4	0
Gross national expenditure	1.6	1 1/4	1 3/4	1 3/4
Exports of goods and services	6.0	5 1/2	5 1/2	7
Imports of goods and services	0.5	-3	2	2 1/2
Net exports(e)	1.2	1 3/4	1	1 1/4
Real gross domestic product	2.6	2 3/4	2 1/2	3
Non-farm product	2.8	2 3/4	2 3/4	3
Farm product	-3.6	5	-4	1
Nominal gross domestic product	2.5	4	3	4 3/4
Panel B - Other selected economic measures				
External accounts				
Terms of trade	-9.8	-5	-6 3/4	-1 3/4
Current account balance (per cent of GDP)	-3.6	-3 1/4	-4	-3 3/4
Labour market				
Employment(f)	1.2	3/4	1 1/2	1 1/2
Unemployment rate (per cent)(g)	5.6	6	6 1/4	6 1/4
Participation rate (per cent)(g)	65.1	64 3/4	64 1/2	64 1/2
Prices and wages				
Consumer price index(h)	2.4	3 1/4	2 1/4	2 1/2
Gross non-farm product deflator	-0.3	1 1/4	1/2	1 3/4
Wage price index(f)	2.9	2 3/4	3	3

(a) Percentage change on preceding year unless otherwise indicated.
(b) Calculated using original data unless otherwise indicated.
(c) Chain volume measures except for nominal gross domestic product which is in current prices.
(d) Excluding second-hand asset sales between the public and private sectors.
(e) Percentage point contribution to growth in GDP.
(f) Seasonally adjusted, through-the-year growth rate to the June quarter.
(g) Seasonally adjusted rate for the June quarter.
(h) Through-the-year growth rate to the June quarter.

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 71 and a United States dollar exchange rate of around 93 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$113 per barrel. The farm sector forecasts are based on an assumption of average seasonal conditions in 2014-15 and 2015-16.

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

OUTLOOK FOR THE INTERNATIONAL ECONOMY

The global economic outlook has improved gradually since the end of 2013, led by a pickup in activity in advanced economies. Over the same period, activity has moderated in emerging market economies, although they are still expected to contribute nearly three quarters of global growth over the forecast period, with growth in China remaining solid. The risks are more balanced than previously, though still to the downside. Both advanced and emerging market economies are continuing to deal with legacy issues from the financial crisis. These include adjusting to a tightening of financial conditions as the United States gradually normalises its unconventional monetary policy, and addressing continued high unemployment in many advanced economies.

In 2013, the global economy experienced its most subdued pace of growth since the financial crisis, expanding by around 3 per cent. World GDP growth is expected to gradually pick up towards trend across the forward estimates with growth of 3½ per cent in 2014, and 3¾ per cent in both 2015 and 2016, largely reflecting growing momentum in the recoveries of advanced economies. With diverging conditions across advanced and emerging market economies, a stronger global economy is not expected to be reflected in evenly robust growth across regions and countries.

Forecast growth for Australia's major trading partners has improved slightly to 4¾ per cent over the forecast period, above its trend rate of around 4 per cent. This reflects both the improved outlook in advanced economies and the increasing weight accorded to Australia's fast growing Asian partners.

Table 2: International GDP growth forecasts(a)

	Actuals	Forecasts		
	2013	2014	2015	2016
China(b)	7.7	7 1/4	7 1/4	7
India(b)	4.4	4 3/4	5 1/4	5 1/2
Japan	1.5	1 1/2	1	1
United States	1.9	2 3/4	3	3
Euro area	-0.4	1	1 1/2	1 1/2
Other East Asia(c)	4.0	4 1/2	4 1/2	4 3/4
Major trading partners	4.6	4 3/4	4 3/4	4 3/4
World	3.0	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) Production-based measure of GDP.
(c) 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 2014, Thomson Reuters and Treasury.

While growth in **China** has moderated, it is still expected to remain solid. The economy grew 7.7 per cent in 2013, slightly above the official target of 7.5 per cent.

Consistent with the recent softening in key indicators, growth is expected to moderate to 7¼ per cent in 2014 and 7 per cent by 2016, as the economy adjusts to the inevitable slowdown from the very high rates of credit growth in recent years, and becomes less dependent on investment and more on consumption.

The **United States** is poised for stronger economic growth over the year ahead, with forecasts of above trend growth. Relatively weak data in early 2014 is expected to reflect the impact of an unusually severe winter and lower inventory levels after significant stockpiling in late 2013. Household consumption has underpinned the recovery to date, with a long-awaited pickup in business investment expected to provide ongoing momentum. Fiscal headwinds from 2013 have also abated, as has short-term fiscal uncertainty with the latest budget deal and suspension of the debt ceiling. The United States Federal Reserve is widely expected to continue to reduce asset purchases as conditions strengthen. However, while inflation remains subdued, a tightening of policy (through official interest rate increases) is not expected before 2015.

In **Japan**, the economy has been boosted by short-term monetary and fiscal stimulus and a pickup in private demand and prices. Growth is forecast to moderate in the aftermath of the consumption tax hike in April this year, though partially offset by fiscal stimulus. The recovery is forecast to remain relatively subdued given a range of structural constraints on growth — such as a falling working age population and relatively low female labour force participation — and continued fiscal consolidation. A stronger recovery in Japan requires the 'third arrow' of structural reforms to lift productivity and longer-run growth potential, and the successful achievement of the Bank of Japan's inflation objectives.

Despite the welcome pickup in activity in the **euro area**, the recovery is forecast to remain weak, uneven and fragile. Euro area GDP growth is expected to strengthen to around 1 per cent supported by accommodative monetary policy, an easing of fiscal headwinds, improved external demand and a more even balance of risks. However, the outlook remains subdued, given continued financial system impairment, an ageing population and the effect of structural rigidities on productivity and employment growth. A more enduring resolution to the euro area design will require challenging reforms, including establishing an effective banking union.

Major **ASEAN** economies moderated in 2013 on the back of tighter financial conditions, lower commodity prices and structural impediments to growth. However, domestic demand remains resilient and, for the more trade-exposed economies, an improved global outlook should also support relatively solid growth. **India** is showing early signs of recovery from a consumption and investment-led slowdown, although its structural impediments are expected to constrain growth to around 5 to 6 per cent.

OUTLOOK FOR THE DOMESTIC ECONOMY

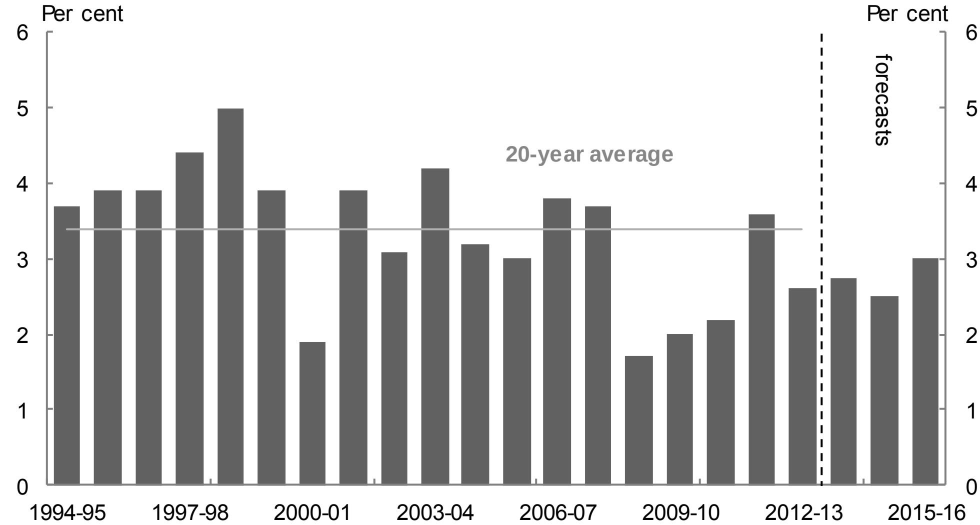
Key influences affecting the outlook

The Australian economy is going through an extraordinary period of transition, with investment in resources projects shifting from being the key driver of growth towards becoming a significant detractor from growth. The fall in investment, which is expected to happen alongside a further decline in the terms of trade, will lead to a reversal of the substantial shift of labour and capital into the resources sector that has taken place since the beginning of the investment phase.

These influences on the Australian economy are expected to persist for some time. The substantial decline in resources investment is forecast to continue through until at least 2015-16, while the decline in the terms of trade will likely last longer still. Further complicating the growth outlook is the need to pursue a prudent approach to Australia's fiscal situation over the years ahead in order to help manage the impact of the ageing population and build the capacity to respond to future global shocks.

That said, the economy is forecast to grow only slightly below trend (Chart 1). The household sector is responding to historically low interest rates and wage flexibility is supporting employment growth. The fall in the exchange rate over 2013 is also helping, although further falls would help support the necessary rebalancing of the economy.

Chart 1: Real GDP growth



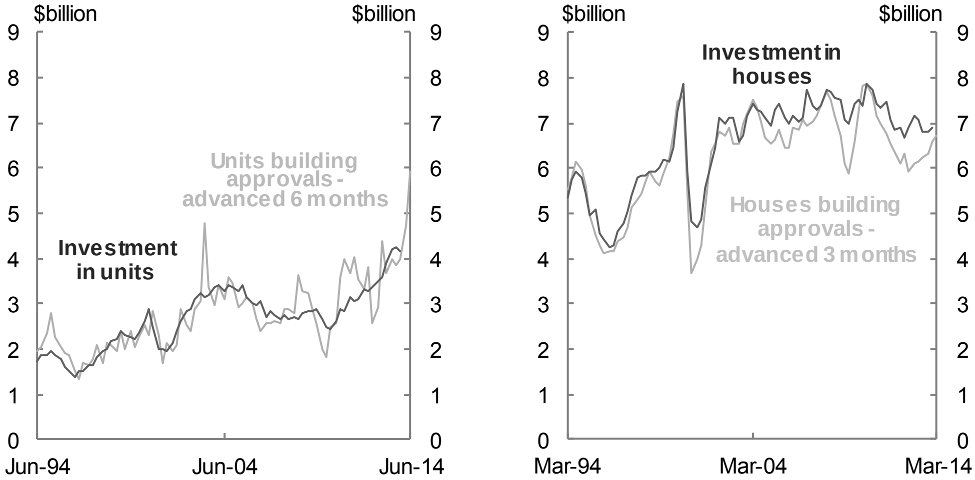
Source: ABS cat. no. 5206.0 and Treasury.

Household sector responding to low interest rates

There are clear signs that the household sector is responding to low interest rates. Dwelling sector indicators uniformly point to a pickup in activity, suggesting construction will gain momentum in the near term (Charts 2 and 3), while household consumption is being boosted by recent improvements in wealth. These developments have contributed to an improved outlook for the household sector at a time when household income is being restrained by the soft labour market.

The housing sector is beginning to respond to lower interest rates with a pickup in prices and leading indicators of construction. Rising dwelling prices in mid-2013 were one of the first signs that the dwelling sector was responding to low interest rates, while leading indicators of dwelling construction began to rise around the same time as the sector responded to the improved returns available from building.

Charts 2 and 3: Leading indicators of dwelling investment



Source: ABS cat. no. 8731.0 and unpublished ABS data.

Dwelling investment is yet to reflect the strength in leading indicators, growing by only 1.4 per cent through the year to the December quarter 2013. Liaison suggests this sluggish response is most likely due to the increasing proportion of approvals in medium- and high-density dwellings, which are more complex projects to manage and take longer to plan and complete. This suggests dwelling investment should rise strongly over the near term.

Dwelling investment is forecast to grow by 7½ per cent in 2014-15 and 5½ per cent in 2015-16.

The increase in dwelling prices since mid-2013 has coincided with higher equity prices and generated an 11 per cent rise in household wealth over the year to the December quarter 2013. Rising wealth has encouraged consumption to grow more rapidly than household income, with the (trend) household saving ratio falling from a peak in 2012 near 12 per cent to its current level of around 10 per cent.

Household income is expected to grow more slowly than average over the forecast period, reflecting moderate employment growth and subdued wage growth. However, further gains in household wealth are expected to support a further modest decline in the saving ratio, enabling consumption to grow faster than income.

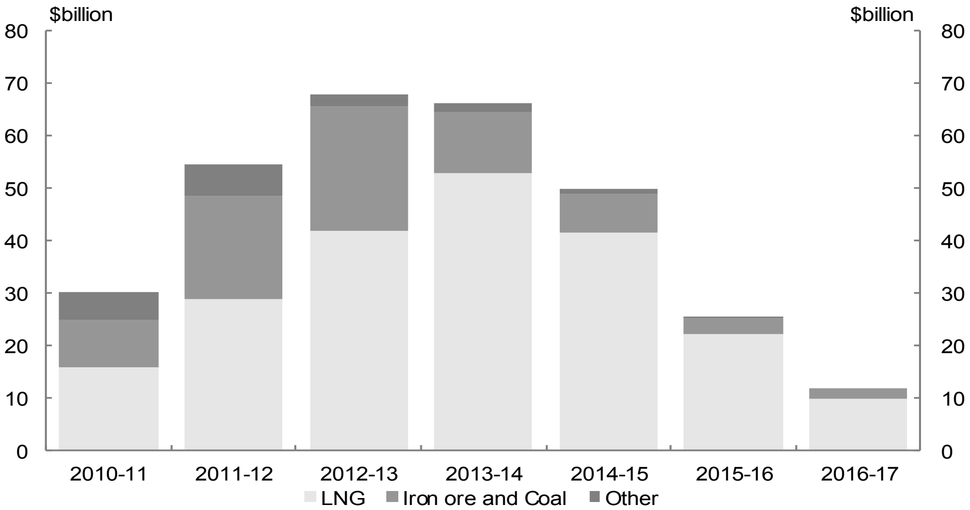
Notwithstanding this anticipated decline, the saving ratio is expected to remain well above the levels seen in the decade before the financial crisis, which were a reflection of a prolonged period of rising household borrowings. After the crisis, households reduced their demand and appetite for credit, leading to a sharp step-up in the household saving ratio and a marked slowing in household credit growth. Developments in household consumption will be heavily influenced by how these factors change during the prospective period of moderate income growth.

Household consumption is forecast to grow by 3 per cent in 2014-15 and 3¼ per cent in 2015-16.

The resources boom transitioning between phases

Investment in resources projects has passed its peak and is expected to detract significantly from growth over the next three years (Charts 4 and 5). While there is some confidence about the size of the decline in resources investment, the precise timing of the fall remains less certain. The size of the fall is more predictable because of the small number of large Liquefied Natural Gas (LNG) projects that are underpinning the current resources investment profile, and the construction lead time associated with, and the small number and size of, any other projects that might be undertaken in the near term.

Chart 4: Spending on major resources projects



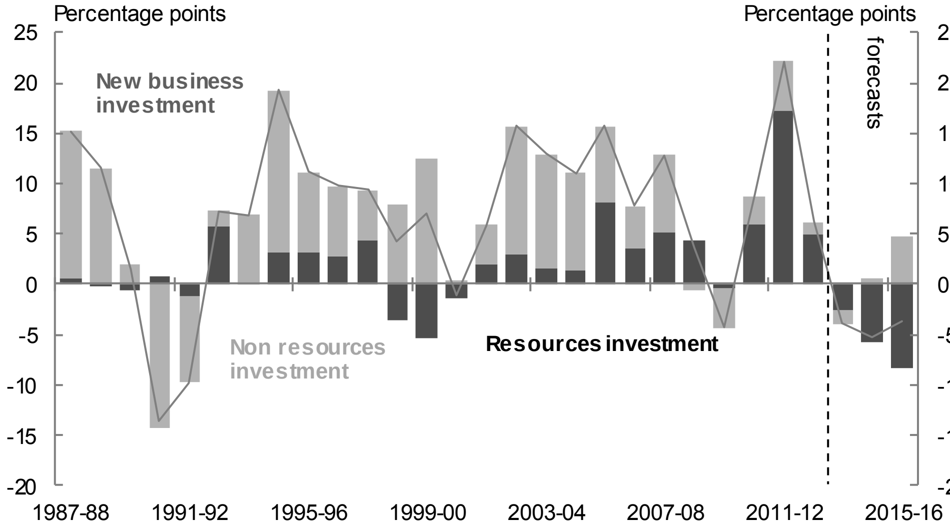
Note: Treasury's major resources projects profile is the sum of spending on existing and planned resources projects greater than $2 billion, weighted by their probability of going ahead.
Source: Treasury.

Non-resources businesses are waiting before investing

Investment by non-resources businesses remains subdued. While interest rates remain low and business confidence is higher than it was a year ago, conditions remain difficult, as reflected in low levels of capacity utilisation and business surveys. Not surprisingly, given these circumstances, the latest CAPEX data point to only a modest increase in investment in 2014-15. This is consistent with reports from Treasury's business liaison which suggests firms are reluctant to invest until they have a clearer sense that demand is improving.

The scale and timing of the anticipated recovery in non-resources business investment is the predominant source of uncertainty affecting the outlook. Consistent with the CAPEX data, the outlook for 2014-15 remains subdued, with growth likely again to be below trend. However, there are some positive signs including a rise in approvals for non-residential building over 2013. Non-resources investment is forecast to pick up in 2015-16 as firms start to respond to improving demand and existing levels of spare capacity are absorbed, with GDP growth returning towards trend (Chart 5).

Chart 5: Contributions to growth in business investment



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

Overall **new private business investment** is forecast to fall by 5½ per cent in 2014-15 and 3½ per cent in 2015-16. The fall in resources investment is reflected in the forecast for new engineering construction, which is expected to fall by 13 per cent in 2014-15 and 20½ per cent in 2015-16. The recovery in non-resources investment has influenced the forecast for new non-residential building investment, which is expected to remain flat in 2014-15 and grow by 5 per cent in 2015-16, and the forecast for new machinery and equipment investment, which is expected to fall by 2 per cent in 2014-15 and grow by 7 per cent in 2015-16.

Resources exports continue to grow

The strong rise in resources exports over recent years is expected to continue over the forecast period as capacity in the resources sector continues to come on stream. The volume of non-rural commodity exports is forecast to grow by 8 per cent in 2014-15 and 9½ per cent in 2015-16.

Large expansions in iron ore infrastructure are mainly complete and production will build up to designed capacity over the next two years. Coal export volumes are also expected to rise, although both metallurgical and thermal coal producers are under pressure from low prices and higher costs which saw Australian producers move from predominantly the bottom half of the global cost curve to the top half over the past five years. Impediments to driving down costs will exacerbate the pressure associated with weak prices and could result in mine closures and job losses.

To date, coal mine closures have been limited, with many producers bound by contractual arrangements with infrastructure providers that require some payment for transport regardless of the volume of coal actually transported. Under these arrangements, many producers are maximising their production to reduce average unit costs. This situation raises uncertainty around the outlook for coal exports, particularly if price weakness continues and as contracts with infrastructure providers expire.

Exports of LNG are expected to grow significantly by 2015-16 as the more advanced LNG projects begin production. By 2015-16, the value of LNG exports is expected to be roughly double its current level. This would see it surpass both thermal and metallurgical coal, currently Australia's second and third largest exports by value. Continued robust growth is also expected beyond the forecast years as additional projects come online, with Australia likely to overtake Qatar to become the world's largest LNG exporter before the end of the decade.

While these projects are already in the construction phase, considerable uncertainty remains over exactly when they will begin exporting, and how quickly they can ramp up to full capacity. A number of projects have already experienced cost overruns and have delayed expected start-up dates. The unique properties of individual gas fields and technological differences between conventional and unconventional gas extraction will also likely affect gas flow rates and the ability to reach the project's stated capacity.

Projects that fail to meet their production targets may need to purchase gas from established gas sources, either in Australia or overseas, to meet contractual obligations to foreign customers. Shortfalls are most likely to occur on the East Coast gas network, which will have implications for domestic gas users in the form of higher prices and more difficulty in securing long-term supply agreements. Restrictions on the spread of new gas extraction technologies are likely to make this problem more acute.

Notwithstanding significant drought in Queensland, New South Wales and parts of South Australia and Victoria, rural exports are forecast to decline only marginally in 2014-15. Exports are expected to recover in 2015-16, assuming a return to average seasonal conditions.

The depreciation of the exchange rate over 2013 has created better conditions for exporters, but the exchange rate remains high by historical standards. This strength stands in sharp contrast to the historical tendency of the exchange rate to move together with the terms of trade. Exporters will benefit from the improved outlook for growth in our major trading partners. The already lower exchange rate is likely to support modest growth in non-commodity goods exports, which are forecast to rise by 3 per cent in 2014-15 and 3½ per cent in 2015-16. Services exports improved over 2012-13, ending a period of weakness that began around the financial crisis, buoyed by higher tourism arrivals, particularly from China and South-East Asia, a trend that is expected to continue. Services exports are forecast to grow by 3 per cent in both 2014-15 and 2015-16.

Total **exports** are forecast to increase by 5½ per cent in 2014-15 and 7 per cent in 2015-16.

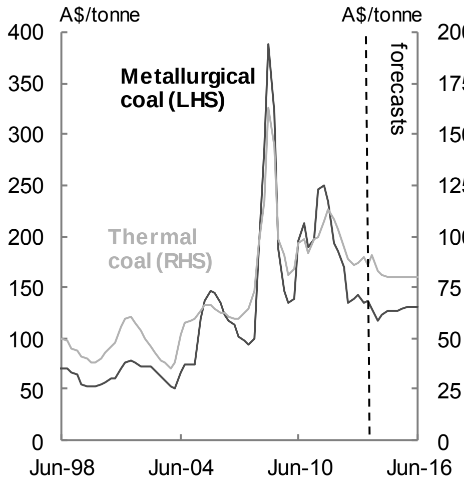
Over the forecast period, imports of capital goods are expected to decline as construction on LNG projects winds down. Imports of consumption goods are forecast to grow reflecting near trend consumption growth and the elevated exchange rate, but at more moderate rates than the average of the previous decade. Total **imports** are forecast to grow by 2 per cent in 2014-15 and 2½ per cent in 2015-16.

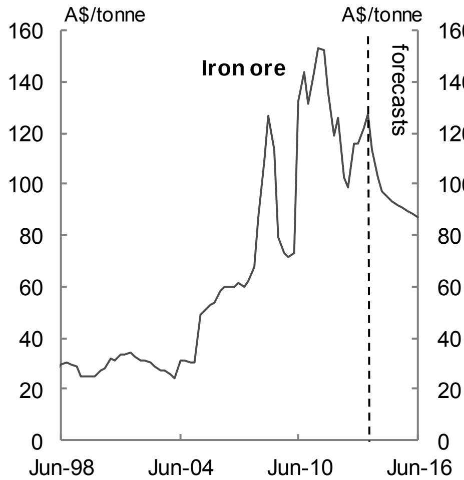
The terms of trade are expected to continue to decline

After holding up during the second half of 2013, iron ore and coal prices have fallen sharply since the beginning of 2014. The decline has been due to weaker demand for steel, a period of negative sentiment around China's economic growth prospects, as well as rising global supply, in particular due to recently built capacity coming on line from Australia.

Iron ore prices are expected to fall further in 2014-15 and 2015-16, reflecting further growth in global supply and slower growth in demand for steel. Metallurgical coal prices are expected to rise slightly over the forecast period as global supply growth slows, while thermal coal prices are forecast to remain stable (Charts 6 and 7).

Charts 6 and 7: Bulk commodity export prices





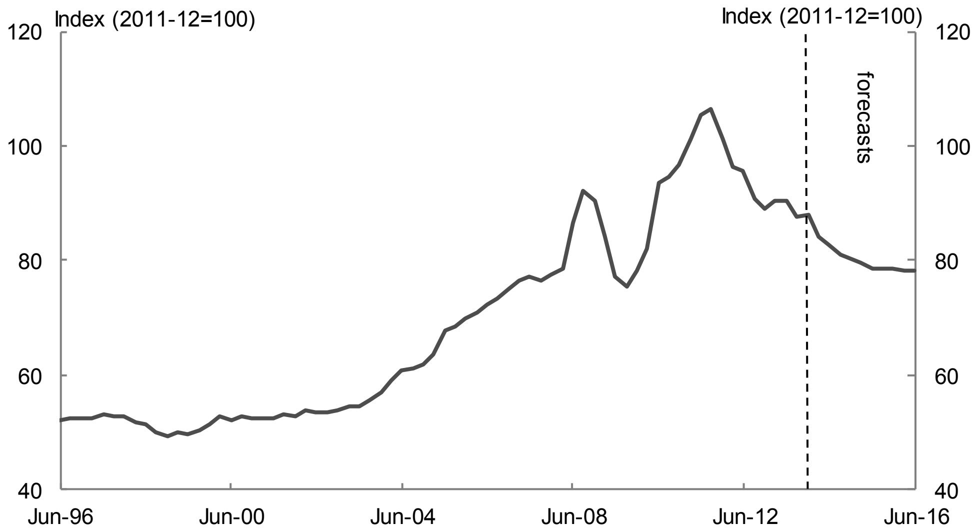
Source: Based on ABS data and Treasury. Export prices differ from the more-widely quoted spot prices. Export prices reflect the actual price foreigners pay for our exports and reflect the quality of the resource being provided (such as the iron ore content), long-term contracts and exchange rate movements.

LNG export prices are expected to increase over the forecast period as the new contracts associated with projects that are starting up come into force. As most LNG contract prices are tied to global oil prices, there is some uncertainty over future price movements. Global supply developments, particularly the potential for gas exports from the United States, will also have important implications for global gas prices. While this is unlikely to have a large impact on current LNG projects, which have long-term contractual arrangements, additional US supply to the Asia-Pacific region would affect the feasibility of new or expanded operations in Australia.

Over the longer term, it is also possible that LNG exports from the US may be directed across the Atlantic, given a renewed focus on energy security in Europe following events in Ukraine. This would reduce potential supply in the Asia-Pacific and could support prices in the region.

The weak outlook for commodity export prices is consistent with the medium-term projections based on a bottom-up framework outlined in MYEFO as described in Treasury Working Paper 2014-01,[1] which sees a falling terms of trade until 2019-20. The terms of trade are expected to fall by 6¾ per cent in 2014-15 and 1¾ per cent in 2015-16 (Chart 8).

Chart 8: Terms of trade



Source: ABS cat. no. 5206.0 and Treasury.

The **current account deficit** is forecast to widen from 3¼ per cent of GDP in 2013-14 to 4 per cent of GDP in 2014-15, before narrowing slightly to 3¾ per cent of GDP in 2015-16, driven mainly by changes in the trade balance.

While export volumes will rise, further expected weakness in export prices implies that the trade balance is likely to return to a modest deficit over the forecast horizon. Further, as the economy transitions from the investment to the exports phase of the mining boom, Australia's net income deficit is expected to widen due to the high degree of foreign ownership in Australia's resources sector.

1 http://www.treasury.gov.au/PublicationsAndMedia/Publications/2014/Long-run-forecasts-of-Australias-terms-of-trade.

Fiscal consolidation continuing

The measures in this Budget improve the budget bottom line over the forecast period and beyond. Over the forecast period, the timing and composition of the new policy decisions mean that the faster pace of consolidation in this Budget does not have a material impact on economic growth relative to the 2013-14 MYEFO, including because the fiscal multipliers associated with infrastructure spending are larger than those for the measures having a direct impact on households and businesses. Fiscal consolidation, at both Commonwealth and State levels, is one of the forces acting on the economy taken into account in the setting of interest rates by the Reserve Bank of Australia.

Public final demand, which captures the direct economic impact of public sector consumption and investment by all levels of government, is forecast to grow moderately, as governments pursue budget consolidation. **New public final demand** is forecast to grow by 1½ per cent in 2014-15 and by 1 per cent in 2015-16. These forecasts represent a significantly smaller than average contribution to overall growth from public demand.

Incentives provided through the $5 billion Asset Recycling Initiative by the Commonwealth Government for state governments to reinvest the proceeds of privatisations into new productivity-enhancing infrastructure, along with $3.7 billion of additional investment for road projects and the $2.9 billion Western Sydney Infrastructure Plan, are expected to boost construction activity from 2015-16. This will enable states to employ construction capacity that will be freed up as investment in the resources sector winds down. Governments can also fund projects beyond the finance generated by privatisation and Commonwealth assistance.

Investment in national infrastructure adds immediately to economic activity and can also lift the long-term potential output of the economy, particularly by allowing businesses to expand to exploit the better transport, communications or energy solutions available.

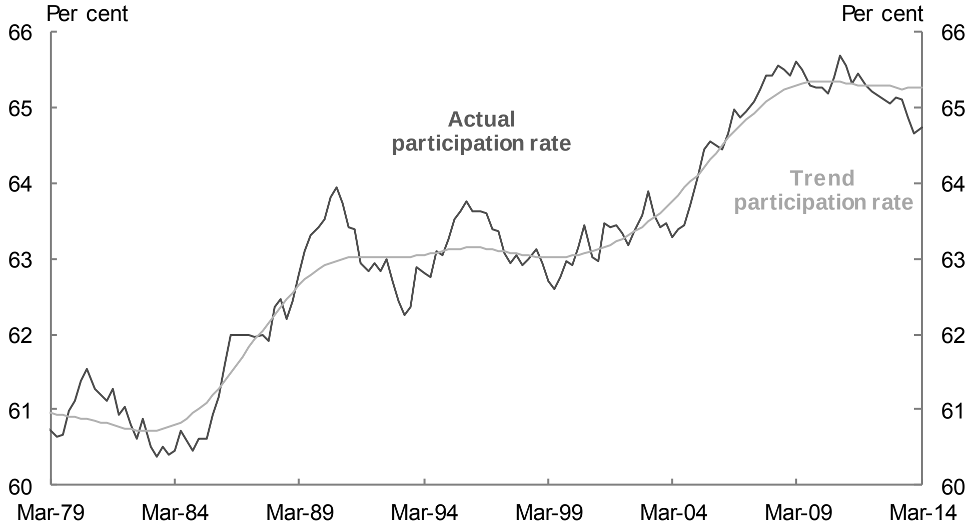
Weakness in the labour market leading to subdued wages

Participation in the labour market can be affected by structural and cyclical factors. The change in the population's age structure as the `baby boomers' reach retirement age is exerting downward pressure on participation. The downward pressure is due to the increasing proportion of the population in older age groups that have low participation. At present, this pressure is being predominately offset by other structural factors not related to ageing, including increases in the participation rate for many specific age groups, particularly over 60s. However, the negative structural effect due to ageing is expected to start dominating by the end of the decade.

The fall in the participation rate over the past three years has been driven not only by ageing but also by potential employees giving up the search for work, given weak employment demand and scarce job opportunities. This phenomenon, the discouraged worker effect, is associated with a cyclical downturn in the labour market and is consistent with sub-trend demand across the economy.

That said, there has been a significant pickup in employment growth and job vacancies have improved since the start of the year. While the turnaround is encouraging, there remains significant spare capacity in the labour market. In trend terms, the employment to population ratio continues to decline, and the unemployment rate would be markedly above its current rate of 5.8 per cent if the participation rate had not fallen significantly over the past three years.

Chart 9: Participation rate



Source ABS cat. no. 6202.0 and Treasury. Trend participation is derived from a disaggregated analysis of age and gender specific participation rates as outlined in Treasury Working Paper 2014-02[2].

Over the forecast period, the participation rate is expected to decline from its current rate of 64.7 per cent to 64½ per cent in the June quarters of both 2015 and 2016, reflecting the expectation that employment growth will not be strong enough to entice discouraged workers to resume their job search (Chart 9). However, an improvement in job vacancies and advertisements in early 2014 indicates that there are upside risks.

A number of measures in the 2014-15 Budget support participation and economic growth: the Restart initiative for over-50s; the tightened unemployment benefit arrangements for under-30s; changes to eligibility for Family Tax Benefit Part B; and the Paid Parental Leave scheme.

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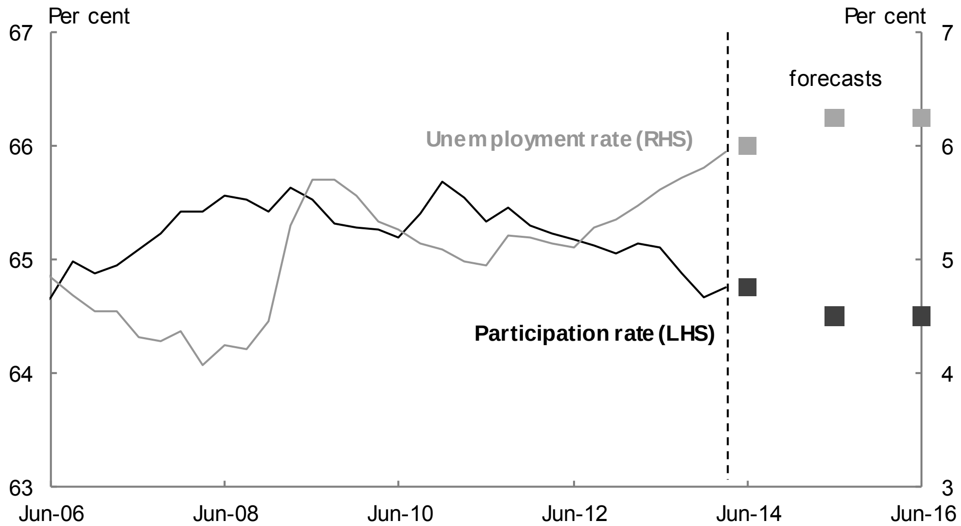
2 http://www.treasury.gov.au/PublicationsAndMedia/Publications/2014/Tsy-Medium-Term-Projection.

Employment growth is forecast to be 1½ per cent through the year to the June quarters of both 2015 and 2016 reflecting sub-trend GDP growth across the economy. This forecast is on an aggregate basis and employment will vary across industry sectors. Based on the employment and participation rate forecasts, the **unemployment rate** is forecast to be 6¼ per cent in the June quarters of both 2015 and 2016 (Chart 10), although positive labour market developments since the start of the year suggest the unemployment rate could peak at a lower level.

Chart 10: Unemployment rate and participation rate



Source ABS cat. no. 6202.0 and Treasury.

Recent wage growth has been very subdued, consistent with the current spare capacity in the labour market. The wage price index grew by 2.6 per cent through the year to the December quarter 2013, its weakest growth since the series began in 1997.

Wage flexibility is an important adjustment mechanism. As was seen during the financial crisis, slower wage growth allows employers to maintain higher staff levels, particularly at a time when business income is expected to come under pressure from the declining terms of trade. It will also encourage non-resources sectors to employ more of the labour that will be freed up as major resources projects are completed.

Subdued wage growth is expected to continue until the spare capacity in the labour market is absorbed. The **wage price index** is forecast to grow by a still subdued 3 per cent through the year to the June quarters of both 2015 and 2016.

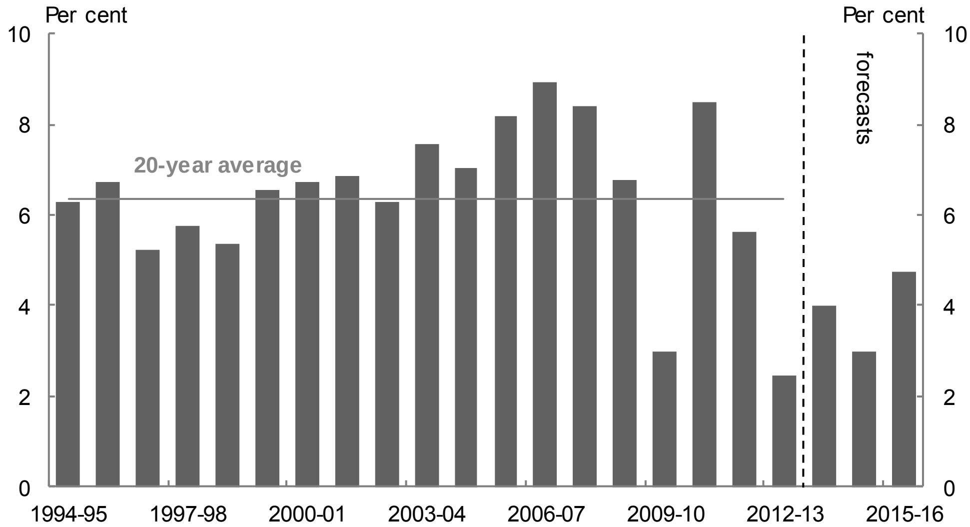
Consumer price inflation is forecast to remain contained over the forecast period. Subdued wage growth will help keep unit labour costs down and contribute to lower inflationary pressure. The removal of the carbon tax is expected to reduce the headline Consumer Price Index (CPI) by ¾ of a percentage point and the underlying CPI by ¼ of a percentage point over the year to the June quarter of 2015 compared to what it would have been with a $25.40 carbon tax. **Headline inflation** is forecast to be 2¼ per cent through the year to the June quarter of 2015 and 2½ per cent to the June quarter of 2016. **Underlying inflation** is forecast to be 2¼ per cent through the year to the June quarter of 2015 and 2½ per cent to the June quarter of 2016.

Outlook for nominal GDP remains weak

Nominal GDP growth is expected to remain well below its 20-year average over the forecast period, largely reflecting further declines in the terms of trade and subdued domestic price growth.

Below average nominal GDP growth is generating weak income growth over the forecast period. This is reflected in weak growth in company gross operating surplus, corresponding to low output prices, and weak growth in compensation of employees, corresponding to low wage growth. **Nominal GDP** is forecast to grow by 3 per cent in 2014-15 and 4¾ per cent in 2015-16 (Chart 11).

Chart 11: Nominal GDP growth



Source: ABS cat. no. 5206.0 and Treasury.

Risks

International risks are more balanced than previously, although still to the downside. Advanced and emerging market economies continue to deal with legacy issues from the financial crisis. Ongoing financial fragilities remain and the search for yield may see new risks emerge in some markets. The process of normalising US monetary policy may cause financial market volatility and may trigger a reassessment of some emerging market economies with pre-existing domestic vulnerabilities.

New risks include the resurfacing of geopolitical tensions, which may also affect vulnerable emerging market economies, and are not without the potential for wider implications.

Another emergent risk to the outlook for the euro area is the persistence of very low inflation outcomes, which may cause inflation expectations to drift down and raise the possibility of area-wide deflation. This risk adds another layer of complexity for policymakers in managing an already weak and uneven recovery. Other risks include the lingering weaknesses in the financial system, the handling of the asset quality review of euro area banks, concerns with budget sustainability, and the ongoing official assistance to some member countries.

In China, there are downside risks around managing both the economy's financial sector — including shadow banking activities and high rates of leverage in some sectors — and the reform initiatives to help rebalance the economy and move up the production chain.

In the United States, there is a risk that recent weak data could reflect more than just temporary or weather-related factors. In the other direction, with many of the factors holding back the recovery having abated, US growth could be stronger than expected. Japan will need to balance the needs of its recovery with charting a path towards budget consolidation over the medium-term. The effective implementation of structural reforms to boost Japan's growth potential presents an upside risk to the medium-term outlook.

Domestic risks are evenly balanced. The household sector is clearly responding to low interest rates. Although business investment intentions remain weak, a further improvement in domestic or external demand could provide the necessary incentive for firms to upgrade their plans. Non-resources exports have been subdued for an extended period under the influence of the strong exchange rate. A weaker exchange rate, which is historically an outcome associated with a declining terms of trade, would benefit exporters and import-competing sectors in general and result in a better balance between the exchange rate and the level of interest rates than is currently the case.

Balancing these upside risks, the fall in resources investment is likely to be lumpy, while the associated rise in exports also has uncertain timing. Together, these effects could generate short-term weakness in GDP. Many trade-exposed sectors continue to battle against a still-elevated exchange rate, while a further softening of the labour market would have repercussions for household consumption. Finally, while a further large increase in house prices would support economic activity in the near term, it would also raise concerns about whether prices could be sustained at that level and whether policy might need to respond.

MEDIUM-TERM PROJECTIONS

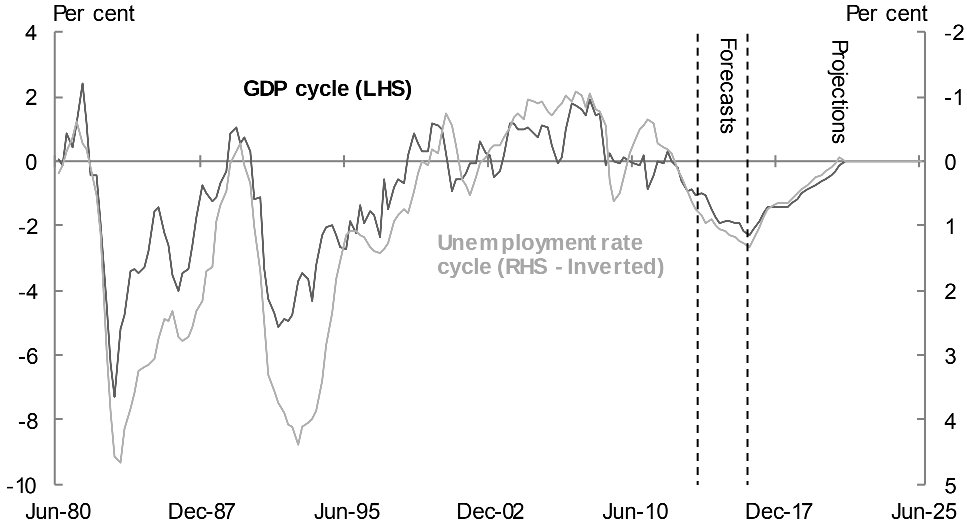
The budget forward estimates contain economic forecasts for the budget year and the subsequent financial year, and projections for the next two financial years. These projections are not forecasts, but rather are based on a set of medium-term assumptions.

In previous Budgets, and MYEFOs prior to 2013-14, real GDP was projected to grow at its estimated trend rate, and the unemployment rate was assumed to immediately return to 5 per cent, Treasury's estimate of the non-accelerating inflation rate of unemployment (NAIRU). In times when the degree of spare capacity in the economy was small, and the unemployment rate was close to the NAIRU, this approach had significant merit.

However, as flagged at MYEFO and subsequently, these medium-term assumptions have been revisited to consider whether they remain appropriate in the face of a large and rising level of spare capacity in the economy. In the 2013 PEFO, an alternative assumption of above trend growth and gradually declining unemployment was presented for the projection years, recognising that the economy would be operating with spare capacity by the end of the forecast period. In the 2013-14 MYEFO, real GDP in the two projection years was assumed to grow at its trend rate, and unemployment was maintained at its rate at the end of the forecast period, 6¼ per cent. If this approach had been maintained over the years beyond the forward estimates, it would have been akin to assuming the spare capacity was permanent — meaning real GDP would never return to trend levels and unemployment would remain permanently above the NAIRU.

Based on current forecasts, by the end of 2015-16, the economy will have grown slower than trend for seven of the past eight years. As a result, it is estimated that the economy will be operating at that time with a gap between potential output and actual output of about 2 per cent (Chart 12) — the largest such output gap since the mid-1990s.

Chart 12: Output and unemployment gap estimates



Source: Treasury.

Building on the revised assumptions made in MYEFO, Treasury has reviewed the projection methodology with the aim of incorporating a path of adjustment that closes this gap over the medium term. The 2014-15 Budget adopts a new framework, which assumes that the spare capacity is absorbed over the five years following the two-year forecast period. This new framework is laid out in Treasury Working Paper 2014-02.[3]

Under this framework, real GDP returns to its trend level by 2020-21. As this occurs, labour market variables, including employment and the participation rate, converge from their levels at the end of the forecast period to their long-run trend levels.

With spare capacity at the end of the forecast period, real GDP is projected to grow above trend for a period of five years from 2016-17. Real GDP growth over this period is therefore stronger than projected at MYEFO.

However, the level of output remains below potential over these years, resulting in projected wage growth that is weaker than at MYEFO. The extended period of below-trend wage growth helps to facilitate sufficient employment growth to transition unemployment gradually back to the NAIRU. In turn, weaker wage costs are projected to flow through to subdued prices growth, with correspondingly slower growth in the GDP deflator, and hence in nominal GDP.

Over the projection period, as a result of the revised methodology nominal GDP is higher, with stronger real GDP growth only partially offset by a lower GDP deflator, the number of unemployment benefit recipients is lower and growth in wage-indexed

3 http://www.treasury.gov.au/PublicationsAndMedia/Publications/2014/Tsy-Medium-Term-Projection.

payments is slower. Compared with MYEFO, the revised projection methodology results in a reduction in the underlying cash balance of $0.3 billion (0.02 per cent of GDP) in 2016-17 and an increase of $0.9 billion (0.05 per cent of GDP) in 2017-18. By 2024-25, the new methodology increases the underlying cash balance by $3.4 billion (0.12 per cent of GDP).

APPENDIX A: MACROECONOMIC FORECASTING PERFORMANCE

The Government's macroeconomic forecasts are prepared using a range of modelling techniques, including structural macroeconometric models and equations, spreadsheet analyses and accounting frameworks. These are supplemented by survey data, business liaison, expert opinion and judgement.

In 2012, the Secretary to the Treasury commissioned an independently-overseen Review of Treasury Macroeconomic and Revenue Forecasting.[4]

The Review concluded that the forecasts draw upon 'the full range of information and modelling techniques used by comparable agencies overseas', and place broadly appropriate weight on the various tools available to forecasters. The Review made 11 recommendations on how to improve forecasting performance, all of which are being implemented. This appendix responds to Recommendation 5:

> *Treasury should include in the Budget papers a high level review of the economic forecast errors (nominal and real GDP) for the previous financial year, as a complement to the existing discussion of revenue forecasting errors.*

Macroeconomic forecasts are always subject to a margin of error.[5] Charts A.1 and A.2 show the magnitude of the Budget year forecast errors for real and nominal GDP growth over the past 20 years. The independent review concluded that, over the 20 years to 2011-12, Treasury's forecasts of real GDP growth exhibited little evidence of bias, with accuracy generally remaining within a range of ½ to 1 percentage point. While forecasts of real GDP growth were less accurate in years during and immediately after the financial crisis, forecast errors have since returned to that range. The Budget year forecast error for nominal GDP in 2012-13 was larger than its 20-year average.

2012-13 real and nominal GDP growth forecasts

Economic forecasts for 2012-13 were first published in the 2011-12 Budget. Subsequent forecasts were published in the 2011-12 MYEFO, 2012-13 Budget, 2012-13 MYEFO and 2013-14 Budget.

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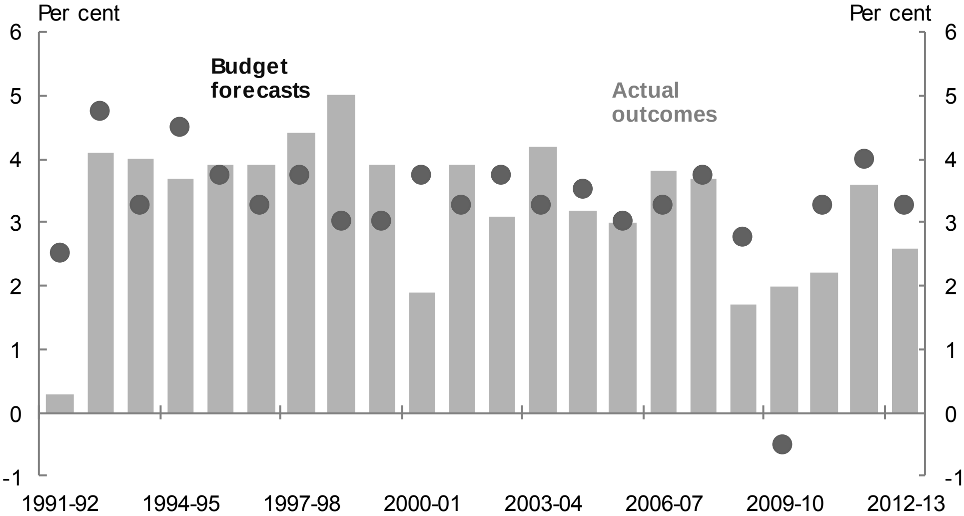
4 http://www.treasury.gov.au/~/media/Treasury/Publications%20and%20Media/Publications/2013/forecasting_review/downloads/PDF/forecasting-review.ashx.

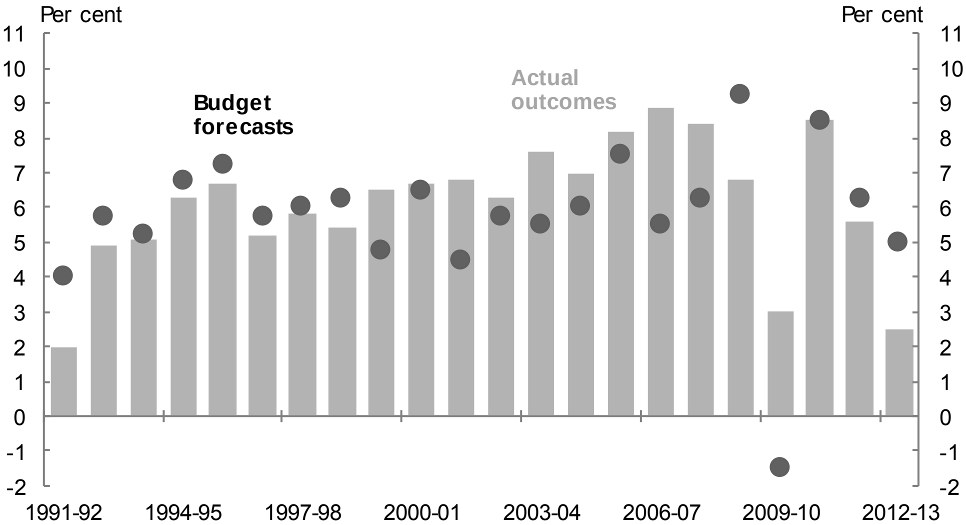
5 The uncertainty around the Government's GDP forecasts is quantified and presented as confidence intervals in Appendix B of Statement 3.

Chart A.1: Budget forecast of real GDP growth



Note: Outcome is as published in the December quarter 2013 National Accounts. Forecast is that published in the Budget for that year.
Source: ABS cat. no. 5206.0 and Treasury.

Chart A.2: Budget forecast of nominal GDP growth



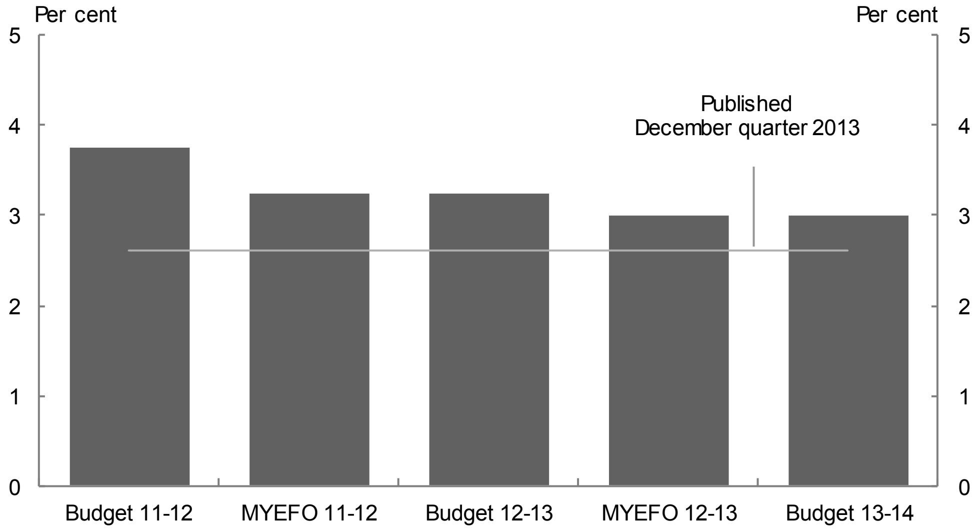
Note: Outcome is as published in the December quarter 2013 National Accounts. Forecast is that published in the Budget for that year.
Source: ABS cat. no. 5206.0 and Treasury.

In 2012-13, Australia recorded another year of below-trend economic growth, with activity remaining patchy across certain sectors of the economy. Despite continued strength in resources investment, subdued activity in the household sector and non-resources business sectors weighed on growth. Households continued to exercise caution as income growth slowed and non-resources businesses remained reluctant to invest in the face of subdued profit growth and poor trading conditions. New public final demand also contracted for the first time since 1993-94, reflecting efforts to consolidate fiscal balances at the Commonwealth and state levels. Below-trend growth saw the unemployment rate start to rise, while inflation remained in the bottom half of the RBA's target band.

Chart A.3 presents the evolution of Treasury's forecasts for 2012-13 real GDP growth. The absolute percentage errors for forecasts of 2012-13 real GDP growth were largest in the 2011-12 Budget (at 1.2 percentage points) and smallest in the 2012-13 MYEFO and 2013-14 Budget (at 0.4 percentage points), while the 2012-13 Budget absolute percentage error was 0.7 percentage points.[6] Over the past 20 years, Treasury's mean absolute percentage error for the Budget forecast of real GDP growth in the budget year has been 0.8 percentage points.

The main contributors to the GDP forecast errors were business investment and household consumption. Business investment in 2012-13 was overestimated as both resources and non-resources firms repeatedly scaled back investment plans, while household consumption was subdued by much weaker than expected wage growth.

Chart A.3: Evolution of real GDP growth forecasts for 2012-13



Source: ABS cat. no. 5206.0 and Treasury.

In 2012-13, nominal GDP grew by 2.5 per cent — the weakest growth since the early 1990s recession — with large falls in bulk commodity export prices contributing to a 9.8 per cent fall in the terms of trade and compensation of employees growing at its

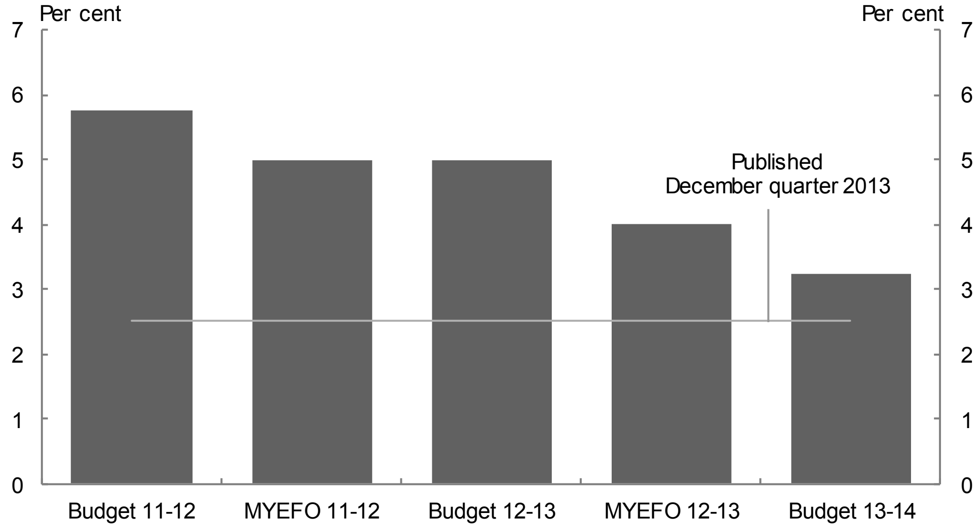
6 The absolute percentage error is an indicator of the accuracy of the forecasts, as it measures the distance between the forecast percentage growth rate and the outcome. All other things equal, a smaller number indicates a better forecasting performance.

weakest rate since 1991-92. Chart A.4 presents the evolution of Treasury's forecasts for 2012-13 nominal GDP growth.

The absolute percentage error in the forecast of 2012-13 nominal GDP growth was largest in the 2011-12 Budget (at 3.3 percentage points) and smallest in the 2013-14 Budget (at 0.8 percentage points), while the 2012-13 Budget absolute percentage error was 2.5 percentage points. Over the past 20 years, Treasury's mean absolute percentage error for the budget forecast of nominal GDP growth in the budget year has been 1.4 percentage points.

The largest absolute forecast error in the components of nominal GDP growth was in the terms of trade, with a smaller forecast error recorded in domestic prices and real GDP growth. The forecast error for the terms of trade was largest for export prices, reflecting the difficulty of forecasting commodity prices during periods of substantial price volatility. The forecast error for domestic price growth reflected a smaller than expected increase in business investment prices, with cost overruns reported by resources companies not flowing through into higher investment prices as expected, and weaker consumer price inflation, which was muted by a higher than expected unemployment rate.

Chart A.4: Evolution of nominal GDP growth forecasts for 2012-13



Source: ABS cat. no. 5206.0 and Treasury.

APPENDIX B: COMPARISON WITH CONSENSUS FORECASTS

Consensus Economics collect forecasts on key macroeconomic variables from a number of prominent economists. The mean and range of these forecasts provide benchmarks with which to compare the Government's economic forecasts. Forecasts from the International Monetary Fund (IMF) provide a benchmark from an international institution.

IMF and Consensus forecasts are provided on a calendar year basis. The 2014-15 Budget forecast for real GDP growth in calendar year 2014 is lower than the Consensus Economics mean forecast and broadly in line with the IMF's forecast (Chart B.1). The Budget forecast for calendar year 2015 is broadly in line with the Consensus Economics mean forecast and higher than the IMF's forecast (Chart B.2).

Chart B.1: Consensus economics real GDP forecasts for calendar year 2014

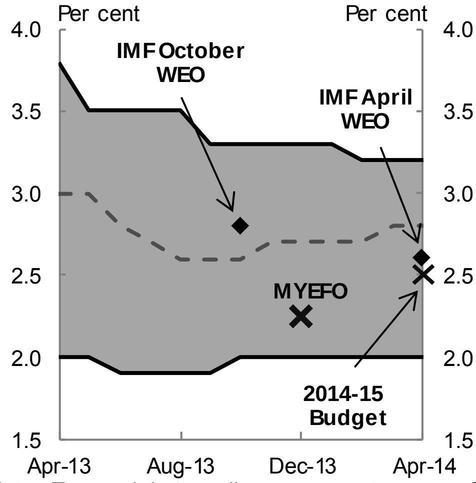
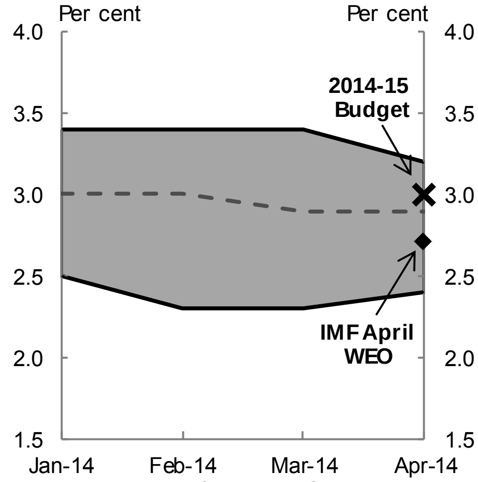


Chart B.2: Consensus economics real GDP forecasts for calendar year 2015



Note: Top and bottom lines represent range of Consensus Economics forecasts. Centre dotted line represents Consensus Economics mean forecast.
Consensus Economics forecasts for 2015 were published for the first time in January 2014. The 2013-14 MYEFO did not contain forecasts for the full 2015 calendar year.
Source: Consensus Economics, IMF and Treasury.

The 2014-15 Budget unemployment rate forecast for calendar year 2014 is broadly in line with the Consensus Economics mean forecast and lower than the IMF's forecast (Chart B.3). The Budget forecast for calendar year 2015 is higher than the Consensus Economics mean forecast and in line with the IMF's forecast (Chart B.4).

Chart B.3: Consensus economics unemployment rate forecasts for calendar year 2014

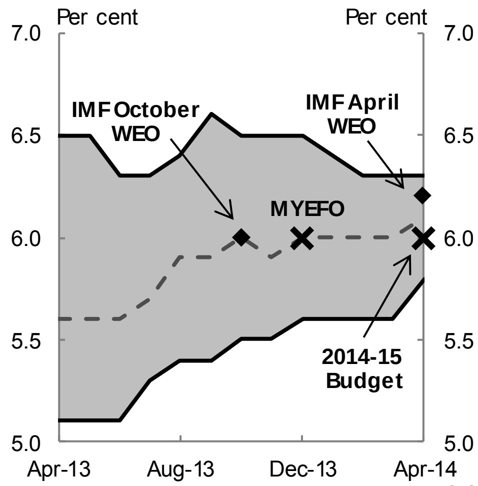
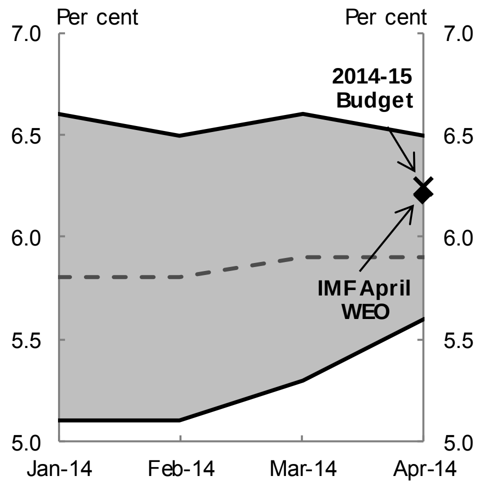


Chart B.4: Consensus economics unemployment rate forecasts for calendar year 2015



Note: Top and bottom lines represent range of Consensus Economics forecasts. Centre line represents Consensus Economics mean forecast.
Consensus Economics forecasts for 2015 were published for the first time in January 2014. The 2013-14 MYEFO did not contain forecasts for the full 2015 calendar year.
Source: Consensus Economics, IMF and Treasury.