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 entering its 26th consecutive year of economic growth and is forecast to strengthen over the forecast period despite continuing uncertainty internationally. As our economy transitions to broader-based growth, near-term economic activity will continue to be supported by household consumption, dwelling investment and exports, while falling mining investment is expected to continue to detract from growth over the forecast period.

Expectations for global growth have moderated since the 2015-16 Mid-Year Economic and Fiscal Outlook (MYEFO). The global economy is nevertheless forecast to grow by 3¼ per cent in 2016 and 3½ per cent in 2017 but downside risks are increasing. That said, the overall outlook for growth in Australia's major trading partners is expected to be stronger than global growth at 4 per cent in each year of the forecast period, unchanged from the 2015-16 MYEFO.

The world economy continues to struggle to regain sustained momentum. China is expected to support near-term growth but still has a major rebalancing task ahead. While India is expected to be the fastest growing major economy — supported by strengthening domestic demand and a growing working age population — the forecast is dependent on continued favourable conditions, including ongoing low commodity prices. The United States has recorded strong labour market performance but real GDP growth has slowed in recent quarters. Growth in the euro area is expected to remain moderate over the forward estimates, and sluggish growth is expected to continue in Japan.

The US dollar price of Tapis crude oil fell by close to 30 per cent through the year to the end of March 2016. The response to lower oil prices during 2015 has not resulted in as strong an uplift in global demand as in the past. Continuing uncertainty about the global impact of oil prices on consumption and investment presents a risk to the economic outlook over the forecast period.

Domestically, the transition to broader-based growth is well underway, supported by historically low interest rates and a lower exchange rate. Real GDP is forecast to grow by 2½ per cent in both 2015-16 and 2016-17 before strengthening to 3 per cent in 2017-18, little changed from the outlook at the 2015-16 MYEFO.

By lowering borrowing costs for households and businesses, historically low interest rates are supporting growth. The lower exchange rate over the past year has facilitated the shift of resources to the service sectors and moderate wage growth is underpinning strong employment growth. This is expected to continue during the forecast period with the unemployment rate forecast to fall to around 5½ per cent by the June quarter of 2017.

Household consumption is forecast to grow steadily, supported by employment growth, lower petrol prices and a falling household saving rate. The outlook for dwelling investment remains positive with a solid pipeline of work yet to be done, but the rate of growth is expected to ease over the forecast period.

Similar to many advanced economies, moderate wage growth is expected to continue to keep inflation contained. Low petrol prices and competition in the retail sector are also expected to weigh on inflation.

The outlook for business investment will continue to be dominated by shrinking mining investment, which is expected to fall by 27½ per cent in 2015-16 and 25½ per cent in 2016-17. While this drag on growth is expected to lessen by 2017-18, uncertainty remains as to when the transition to broader-based sources of growth, already evident in the labour market, will translate into stronger non-mining investment.

Australia's non-rural commodity exports are expected to grow by 7 per cent in 2016-17 and 7½ per cent in 2017-18 as iron ore and LNG production continues to ramp up. The lower exchange rate over the past year and rising demand from Asia are also expected to support service exports, such as tourism and education. Tourist numbers in 2015 have increased by around 560,000 people or around 8 per cent compared with 2014.

There has been renewed strength over the past quarter in some key commodity export prices — particularly iron ore — driven in part by expectations of ongoing stimulus to meet China's GDP growth targets. Commodity prices are, however, weaker than those seen over recent years leading to lower terms of trade and there is a risk that more recent increases in commodity prices will not be sustained. Nevertheless, current prices are more representative of longer-term averages than the extraordinary peaks experienced during the mining boom. See *Statement 7: Forecasting Performance and Scenario Analysis* (Statement 7) for a discussion of the impact of still lower terms of trade on the Budget estimates.

Australia is currently a net importer of oil and petroleum products and Australian households and businesses are benefiting from lower fuel prices. A sustained drop in oil prices, however, would affect the price of LNG exports going forward as they are linked to oil prices through long-term contracts.

The moderate outlook for wages is weighing on forecasts of nominal GDP. Nominal GDP growth is expected to be 2½ per cent in 2015-16 and 4¼ per cent in 2016-17, before increasing to 5 per cent in 2017-18. Forecasts of nominal GDP are also being affected by weaker forecast inflation than at the 2015-16 MYEFO. Since the 2015-16 MYEFO, the forecast level of nominal GDP has been revised down by $27½ billion over the four years to 2018-19. This has contributed to a downward revision to tax receipts, excluding new policy, of $13.5 billion over the four years to 2018-19 compared with the 2015-16 MYEFO.

There are positive and negative risks to the forecasts for the Australian economy. A lower exchange rate than that underpinning the forecasts would generate stronger economic growth and provide further impetus to broader-based growth. Alternatively, uncertainty around the global economic outlook could result in households becoming more cautious, leading to more saving and less consumption than expected. Growth in non-mining business investment also remains a key source of uncertainty as the economy transitions from capital-intensive resource investment to labour-intensive service sectors.

Table 1: Domestic economy forecasts[a]

	Outcomes(b)	Forecasts		
	2014-15	2015-16	2016-17	2017-18
Real gross domestic product	**2.2**	**2 1/2**	**2 1/2**	**3**
Household consumption	2.7	3	3	3
Dwelling investment	7.9	8	2	1
Total business investment(c)	-6.2	-11	-5	0
By industry				
Mining investment	-17.3	-27 1/2	-25 1/2	-14
Non-mining investment	1.2	-2	3 1/2	4 1/2
Private final demand(c)	1.0	1/2	1 1/2	2 1/2
Public final demand(c)	0.0	2 1/4	2 1/4	2
Change in inventories(d)	0.2	0	0	0
Gross national expenditure	0.9	1	1 3/4	2 1/2
Exports of goods and services	6.5	6	5	5 1/2
Imports of goods and services	0.0	0	2 1/2	3
Net exports(d)	1.4	1 1/4	3/4	3/4
Nominal gross domestic product	1.6	2 1/2	4 1/4	5
Prices and wages				
Consumer price index(e)	1.5	1 1/4	2	2 1/4
Wage price index(f)	2.3	2 1/4	2 1/2	2 3/4
GDP deflator	-0.6	0	1 3/4	1 3/4
Labour market				
Participation rate (per cent)(g)	64.8	65	65	65
Employment(f)	1.6	2	1 3/4	1 3/4
Unemployment rate (per cent)(g)	6.1	5 3/4	5 1/2	5 1/2
Balance of payments				
Terms of trade(h)	-10.3	-8 3/4	1 1/4	0
Current account balance (per cent of GDP)	-3.7	-4 3/4	-4	-3 1/2

(a) Percentage change on preceding year unless otherwise indicated.
(b) Calculated using original data unless otherwise indicated.
(c) Excluding second hand asset sales from the public sector to the private sector.
(d) Percentage point contribution to growth in GDP.
(e) Through the year growth rate to the June quarter.
(f) Seasonally adjusted, through the year growth rate to the June quarter.
(g) Seasonally adjusted rate for the June quarter.
(h) The forecasts are underpinned by spot prices of $55 ($US/t, FOB) for iron ore; $91 ($US/t, FOB) for metallurgical coal and $52 ($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$43 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

Australia is still a relatively small, open economy and trade and foreign investment continue to be very important to our economic outlook. Exports and imports, which together represent around 40 per cent of GDP, tangibly demonstrate the importance of global markets to future economic growth. The Australian economy has also always relied on capital from overseas to take full advantage of its resources.

Expectations for global growth have moderated over the course of 2016 and are lower than at the 2015-16 MYEFO, with lower growth forecast for the United States and economic difficulties in a number of commodity exporting countries weighing on the outlook.

Monetary policy settings remain accommodative in advanced economies reflecting low inflation and a weaker growth outlook. The Bank of Japan moved to supplement its quantitative easing programme with negative interest rates on excess bank reserves in early 2016, while the European Central Bank has recently expanded its easing measures. By contrast, the United States Federal Reserve raised interest rates in December 2015 for the first time in more than nine years. A divergence of monetary policy stances across major advanced economies may pose challenges for emerging market economies, with any downward pressure on their currencies making servicing foreign debt more costly. That said, since the United States Federal Reserve’s initial step to normalise its monetary policy settings, markets have scaled back expectations for a further rate rise in 2016. The longer-term impact of negative interest rates remains uncertain.

Significant shifts are underway in the international economy. The output of emerging market economies has exceeded advanced economies since 2008. China’s share of world GDP has grown continuously from 4 per cent in 1990 to 17 per cent in 2015. India is the world’s fastest growing major economy and its share of world GDP is expected to continue to grow, driven by a rising working-age population.

The International Monetary Fund (IMF) has reduced its estimates of medium-term potential growth for both advanced and emerging economies. The softer outlook reflects unresolved crisis legacies, low productivity growth and unfavourable demographics (particularly in advanced economies).

Commodity prices have recovered somewhat since the 2015-16 MYEFO, but remain well below recent peaks. Increases in supply and lower growth in demand, particularly from China, will continue to place downward pressure on prices. Global growth is expected to be supported by continued low energy prices, but the consumer and business response to lower petrol prices has so far been more muted than in the past.

Lower commodity prices and moderating growth in China are having a significant impact on global investment and trade. Investment growth in China is slowing, while lower commodity prices are also contributing to reduced investment in mining projects and exploration globally. The IMF estimates that investment spending in the oil and gas sector in major energy exporting economies has fallen 24 per cent in 2015 relative to a year earlier in US dollar terms. Investment is typically more import intensive than consumption, and slower investment growth has put downward pressure on global trade. Since the 2015-16 MYEFO, global trade is showing signs of a pick up, although growth remains relatively low.

Inflation remains low globally reflecting, in part, the impact of low energy costs and excess capacity in many countries. In major advanced economies, inflation remains below policy targets, and this is expected to remain the case for at least the near term. Low wage growth has also contributed to low inflation in major advanced economies. In some countries, including the United States and the United Kingdom, wage growth has been relatively low despite robust employment growth.

The risks to growth are broadening and are evident in both advanced and emerging economies. The uncertainties around the implications of the transition task ahead of the Chinese economy from investment-led to consumption-led growth are particularly significant for Australia given the exposure both Australia and its major trading partners have to China.

There is also a risk that the low inflation, low wage growth and low productivity growth being experienced in many advanced economies could become embedded in lower potential growth over time.

Globally, banks are better capitalised than they were prior to the global financial crisis. But a number of major economies continue to face financial challenges, particularly the euro area, Japan and a range of emerging market economies. Additionally, there are risks if the renewed volatility in financial markets seen at the start of 2016 were to re-emerge. There are concerns in equity and credit markets as to whether global growth will be strong enough to drive corporate earnings and maintain low default rates in order to sustain current valuations.

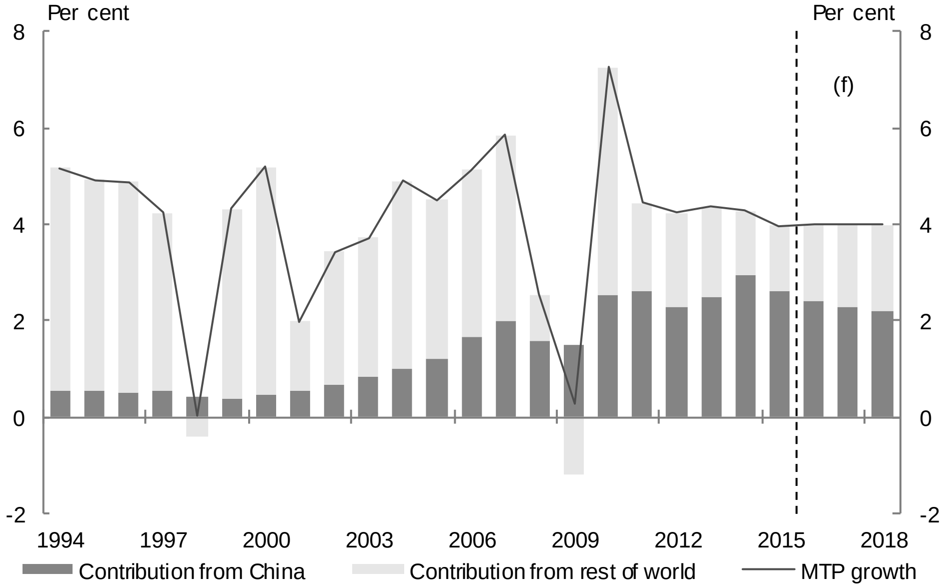
Table 2: International GDP growth forecasts

	Outcomes	Forecasts		
	2015	2016	2017	2018
China	6.9	6 1/2	6 1/4	6
India	7.3	7 1/2	7 1/2	7 3/4
Japan	0.5	1/2	1/4	1/2
United States	2.4	2	2 1/4	2 1/4
Euro area	1.6	1 1/2	1 1/2	1 1/2
Other East Asia(a)	3.7	4	4	4 1/4
Major trading partners	4.0	4	4	4
World	3.1	3 1/4	3 1/2	3 3/4

(a) Other East Asia comprises the newly industrialised economies of Hong Kong, South Korea, Singapore and Taiwan and the Association of Southeast Asian Nations group of five (ASEAN-5), comprising Indonesia, Malaysia, the Philippines, Thailand and Vietnam.
Note: World, euro area and other East Asia growth rates are calculated using GDP weights based on purchasing power parity (PPP), while growth rates for major trading partners are calculated using export trade weights.
Source: National Statistical Agencies, IMF World Economic Outlook April 2016, Thomson Reuters and Treasury.

The outlook for growth in Australia's major trading partners is of particular importance to domestic economic activity. **Australia's major trading partner** growth is forecast to remain higher than global growth, at 4 per cent across the forecast period (Chart 1). This reflects Australia's trade links to Asia, where growth remains relatively strong.

Chart 1: Major trading partner growth and China's contribution



Source: ABS cat. no. 5368.0, IMF April 2016 World Economic Outlook and Treasury.
Note: MTP growth aggregated using Australia's export shares.

Growth in **China** is moderating as the economy transitions towards a more balanced growth model that is increasingly reliant on consumption and services and less on investment (see Box 1). The Chinese authorities are targeting growth of between 6½ and 7 per cent for 2016, down from a target of around 7 per cent for 2015. China is forecast to grow at 6½ per cent in 2016, 6¼ per cent in 2017 and 6 per cent in 2018.

Despite moderating growth, China is expected to continue to make a sizeable contribution to global growth. The Chinese economy is now more than twice the size it was in 2006 and as a result, growth of just below 7 per cent in 2015 equates to growth of more than 13 per cent in 2006.

A key risk to the global economy is that China's transition does not proceed smoothly. China is one of the main trading partners for more than 100 economies. These economies account for about 80 per cent of world GDP, and a larger-than-expected slowdown in China's economy would have a significant impact globally.

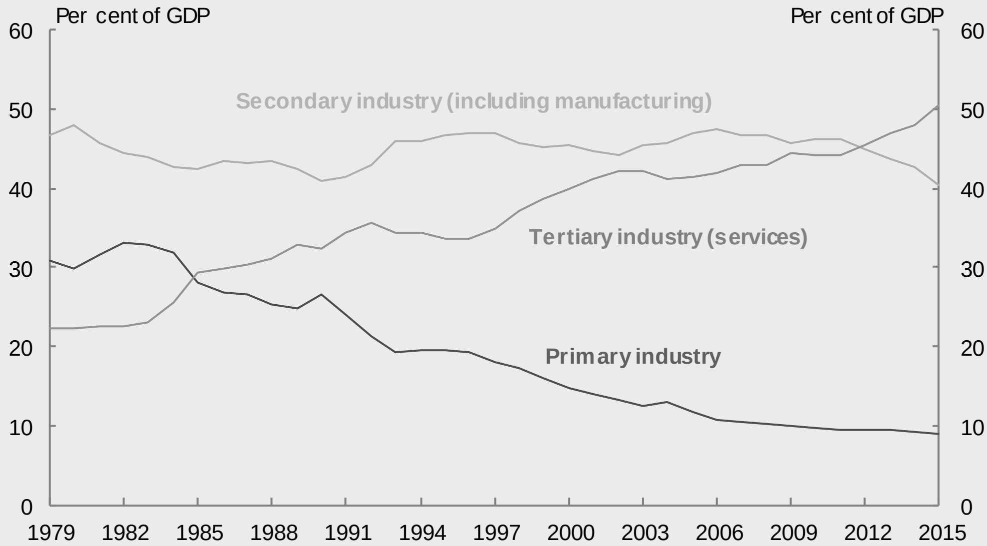
Box 1: Economic transitions — China and Australia

A period of extraordinary growth has made China one of the largest economies in the world. Australia benefited significantly as demand for Australia's commodities surged, leading to a record increase in mining investment in order to expand capacity. Australia is now benefiting from increasing commodity exports.

China is entering a new stage of development, which the authorities have characterised as the 'new normal'. The Chinese economy now faces the task of transitioning to a more balanced growth model. Unlike recent decades, growth will increasingly be driven by consumption and services, and be less reliant on investment.

Since 2011, nominal consumption growth has outstripped nominal GDP growth and, in a country that has traditionally been an important global manufacturing producer, the service sectors now contribute over 50 per cent of GDP (Chart A).

Chart A: Changing composition of the Chinese economy



Source: CEIC China database.

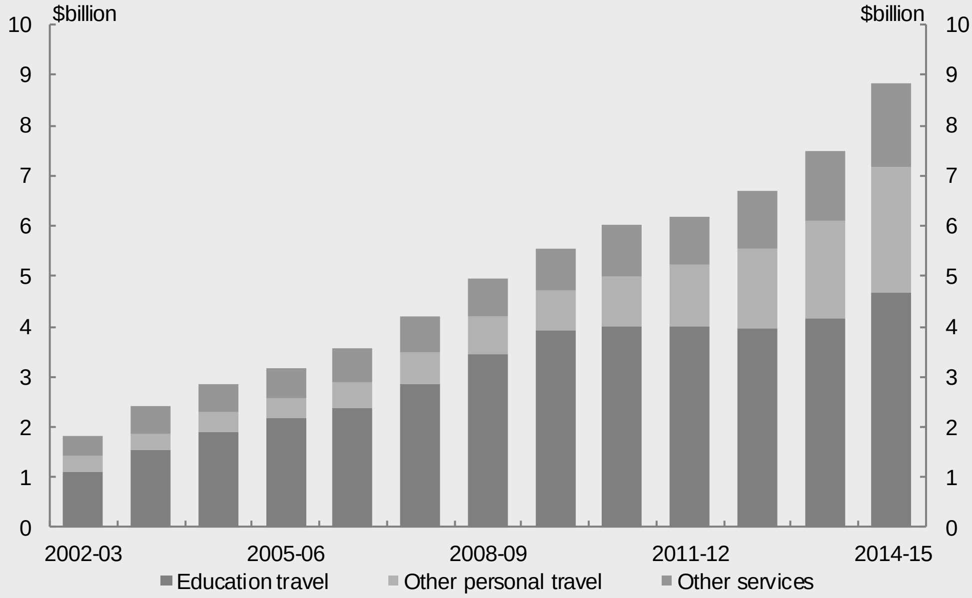
China's economic transition presents significant opportunities for Australia. Demand for Australian goods and services is expected to benefit from China's rising middle class, which according to some estimates is expected to grow to more than 850 million people by 2030. Australia's service exports have seen a substantial rise, with China now Australia's largest service export destination. China is also Australia's second largest source of overseas visitors, with the number of tourists exceeding one million for the first time in 2015.

Box 1: Economic transitions — China and Australia (continued)

The growing investment relationship between Australia and China is also bringing opportunities. Continued Chinese investment into Australia will be a key enabler of the ongoing trade relationship as Australia's export base broadens.

Through the China-Australia Free Trade Agreement, China will further open its economy to Australian businesses by removing or reducing market access barriers in a range of sectors, including health, financial and legal services (Chart B).

Chart B: Australian service exports to China



Source: ABS cat. no. 5368.0.55.003.

China's economic transition is expected to contribute to more sustainable growth over the longer term. But in the near to medium term, increasing consumption and rising service sectors are unlikely to fully offset the decline in investment and a slowing industrial sector. The key risks to China's transition are its current industrial overcapacity and domestic debt challenges. Effectively managing these risks will be important in ensuring a smooth rebalancing of the economy.

India was the fastest growing major economy in 2015 and is expected to remain so over the forecast period. Growth is forecast to be 7½ per cent in 2016 and 2017, rising to 7¾ per cent in 2018, supported by low commodity prices and strengthening domestic demand. Inflation has halved since 2012, assisted by weak global inflation, falling commodity prices and the adoption of inflation targeting by the Reserve Bank of India. Other reforms to improve business conditions are also in progress, including the removal of some subsidies (including for fuel), more efficient delivery of other subsidies and relaxation of foreign investment rules.

Already the world's third largest economy in purchasing power parity terms, India will benefit from the largest and youngest workforce in history, with a working age population projected to reach one billion by 2030. This demographic dividend will drive growth and expand India's demand for imports, including from Australia.

Growth in the **United States** is forecast to remain moderate. The United States recovery will continue to be led by the household sector, supported by lower energy costs. Business investment is soft, in part due to a drag from energy sector investment, and a high US dollar is weighing on exports. Following a slow start to this year, the United States is forecast to grow at 2 per cent in 2016, with growth rising to 2¼ per cent in both 2017 and 2018, lower than at the 2015-16 MYEFO. Despite a slowing in GDP growth, and recent job losses in the manufacturing sector, the labour market is expected to continue to absorb discouraged or underutilised workers.

The recovery in the **euro area** is forecast to remain modest. Growth will be supported by accommodative monetary policy and lower energy prices. Relatively low levels of investment and weaker global growth are weighing on growth prospects. Euro area growth is forecast to be 1½ per cent in 2016, 2017 and 2018.

Geopolitical tensions and political risk will also weigh on the outlook for the euro area and recent migration flows into Europe are presenting challenges. The expansionary fiscal policy needed to accommodate migrants, and their gradual integration into the labour market, may support growth in the shorter term. The possibility that the United Kingdom may exit the European Union, with the vote on 'Brexit' scheduled for June 2016, is adding to economic uncertainty in the euro area given the deep trade and financial links between the bloc and the United Kingdom.

Growth in **Japan** is expected to be subdued through to 2018. Weaker growth in the second half of 2015 and sluggish increases in wages are weighing on the outlook. Further, the recent appreciation of the yen, coinciding with slower global growth, is also weighing on prospects for Japanese exports.

The impact of the Bank of Japan's move to supplement its quantitative easing programme with negative interest rates on excess bank reserves is still unclear. While consumption growth is expected to be lifted by low energy prices, the scheduled increase in the consumption tax rate is expected to detract from growth in 2017.

Growth in the **ASEAN-5** grouping has been relatively slow by historical standards, partly reflecting changes to its external environment, including China's transition and lower regional trade growth. In **Indonesia**, the largest economy of the ASEAN-5 grouping, growth in 2015 was affected by softer external demand and lower commodity prices. From 2016 domestic consumption coupled with higher public infrastructure spending is expected to support growth.

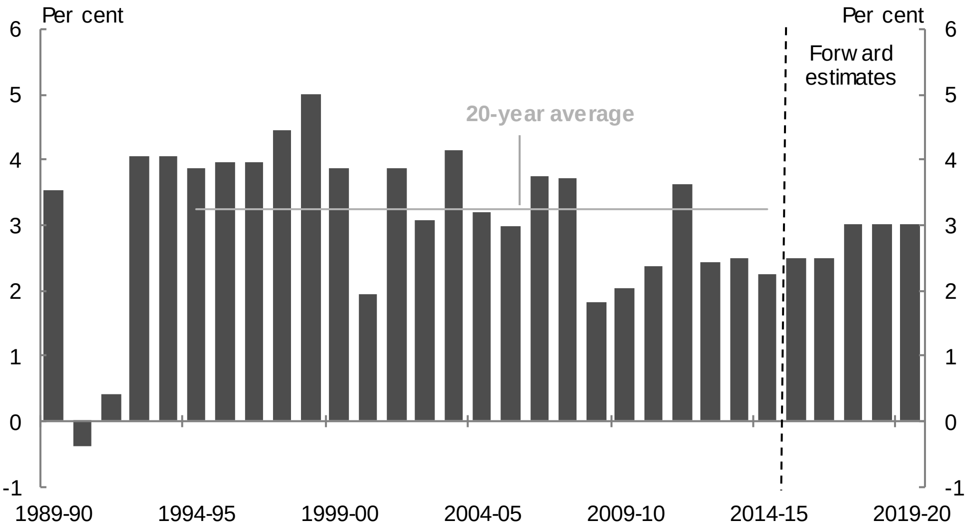
Outlook for the domestic economy

Outlook for real GDP growth

The Australian economy continues its transition to broader-based growth. In 2011-12 mining investment contributed 2.8 percentage points to GDP growth. In 2015-16 it is expected to detract 1½ percentage points from growth. Household consumption, dwelling investment and exports are supporting near-term economic activity, and there has been strong employment growth, particularly in the service sectors.

The Australian economy is expected to grow at 2½ per cent in both 2015-16 and 2016-17 before strengthening to 3 per cent growth in 2017-18 as the detraction from falling mining investment eases (Chart 2).

Chart 2: Real GDP growth



Source: ABS cat. no. 5206.0 and Treasury.

Growth is being supported by historically low interest rates, with the Reserve Bank of Australia's official cash rate set at a record low since May 2015. The accommodative stance of monetary policy is supporting the economy by lowering borrowing costs for businesses and households. The weighted average lending rates faced by businesses are around their lowest levels in at least two decades, while the standard variable mortgage rate is close to its lowest level since the late 1960s.

The depreciation of the Australian dollar is also assisting the transition away from resources investment-led growth to more diverse sources, by improving the competitiveness of Australia's export and import-competing businesses. While the Australian dollar has risen somewhat against the US dollar and on a trade weighted basis since the 2015-16 MYEFO, it remains around 30 per cent lower than its 2011 peak against the US dollar. Since the 2015-16 MYEFO, the Australian dollar has returned to a similar level as at the 2015-16 Budget, both against the US dollar and on a trade weighted basis.

Box 2: Supporting the economic transition

The transition of the Australian economy from the mining investment boom to broader-based growth is well underway.

Flexibility within the economy has allowed it to perform well and minimised the negative effects of the uneven growth and underutilisation of resources that can accompany commodity price booms. Unlike the terms of trade boom in the 1970s, there has been relatively limited volatility in output, employment and domestic inflation.

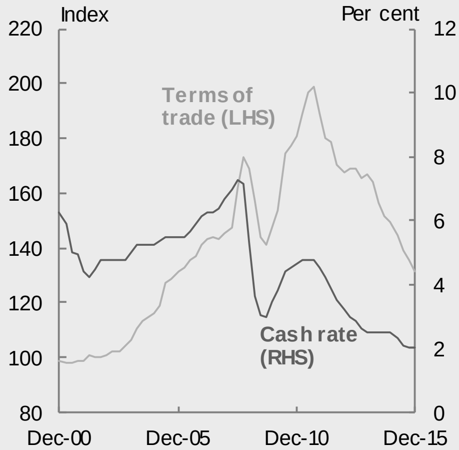
The agility of the economy to respond to changing drivers of growth reflects, in part, the ability of three key prices to adjust: the exchange rate, interest rates and wages.

Flexible prices direct resources to where they are most valued so that the economy's resources are used most efficiently.

During the mining boom price movements helped allocate resources to the mining sector while reducing overheating.

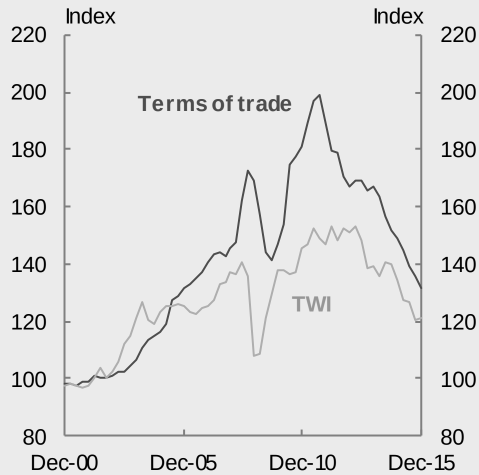
The higher Australian dollar freed up resources from other sectors to make way for the mining expansion while higher interest rates helped to cool aggregate demand.

Chart A: The terms of trade and the official cash rate



Source: ABS cat. no. 5206.0, Reserve Bank of Australia and Treasury.
Note: September 2002 = 100 for the terms of trade.

Chart B: The terms of trade and the TWI



Source: ABS cat. no. 5206.0 and 5302.0.
Note: September 2002 = 100, TWI is the quarterly average Trade Weighted Index.

Box 2: Supporting the economic transition (continued)

Wages in the mining sector grew strongly, which helped attract labour to the sector. Non-mining wages also rose reflecting the overall scarcity of labour resources. This reduced the demand for labour in other sectors and helped to attract higher overseas migration to meet the labour supply shortfall.

Prices also adjust to changes in government spending. For example, when governments increase their spending, flexible prices will adjust to draw resources away from the private sector.

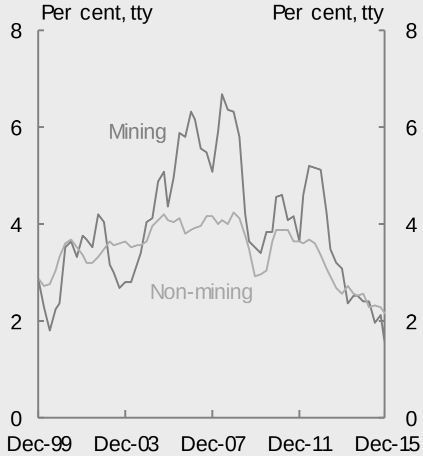
When economic activity is weak, this can draw on spare capacity from the private sector but when the economy is growing it can result in higher interest rates or higher wages, which can crowd out productive private sector activity.

Just as the earlier adjustments during the mining boom helped the economy avoid overheating, they are now helping the economy adjust to lower commodity prices and less investment in the resources sector.

The effect of the exchange rate depreciation over the past year is evident in the improved conditions and prospects for a number of industries, including tourism, education, agriculture and parts of manufacturing.

The effect of low interest rates is most clearly evident in residential construction activity, which increased by 10 per cent over 2015. This strong growth is having positive spillovers to other parts of the economy, for instance in engineering and legal services. A buoyant housing market has also supported consumption through expenditure on related items such as furnishings.

Chart C: Mining and non-mining wages



Source: ABS cat. no. 6345.0 and Treasury.
Note: Wage growth rates are those of the Wage Price Index.

Wage rises due to strong demand for labour during the resources boom have eased and are re-adjusting in response to the changing demand for employment in other sectors.

Moderate wage growth is also supporting employment growth in the non-mining economy, particularly in the service sectors.

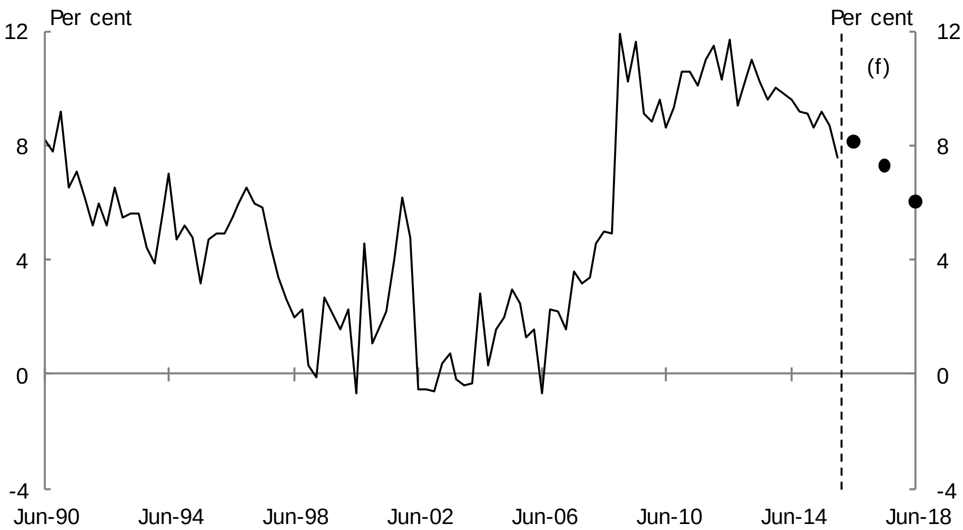
Households

Household consumption is growing steadily, underpinned by strong employment growth, a fall in petrol prices of around 15 per cent over the past year, and a declining household saving rate. A buoyant housing market has also been supporting consumption through rising household wealth, as well as through expenditure on housing-related items such as furnishings.

Steady growth is expected to continue with household consumption forecast to grow by 3 per cent each year across the forecast period. In 2015-16, consumption is expected to be supported by low petrol prices and a still strong housing market. Labour market conditions are expected to remain strong and together with low interest rates will continue to sustain consumption growth as support from the housing sector eases in 2016-17.

A falling household saving rate is also supporting consumption growth. The share of household income saved rose strongly during the period of rapid income growth that accompanied the terms of trade boom, and then more sharply during the global financial crisis. The household saving rate has declined since the recovery from the global financial crisis, providing support to consumption. The household saving rate is expected to decline further at a moderate pace, but remain well above pre-crisis lows (Chart 3). Uncertainty around the pace of decline in the household saving rate poses a risk to the rate of consumption growth.

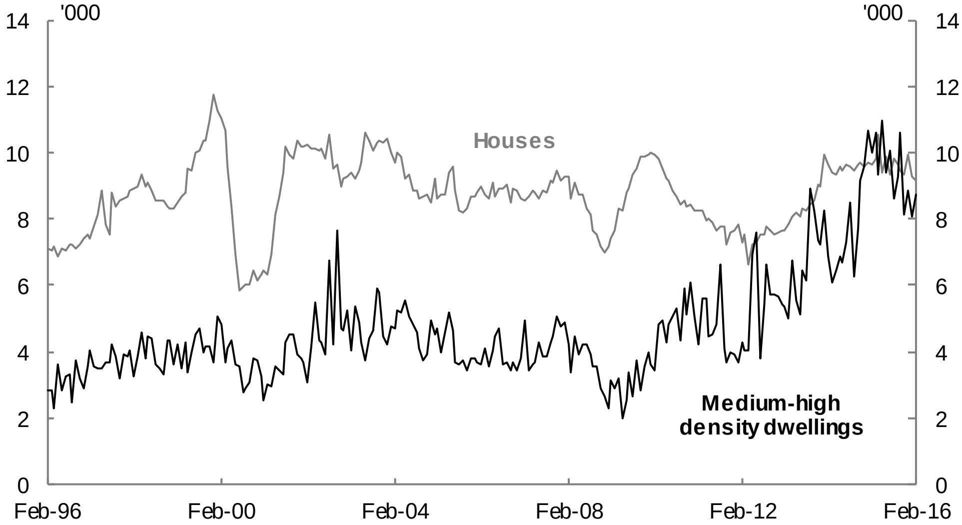
Chart 3: The household saving rate



Source: ABS cat. no. 5206.0 and Treasury.

Dwelling investment grew by 7.9 per cent in 2014-15 — the largest growth seen over the past decade, partly driven by a significant shift towards medium-high density dwellings (Chart 4). Dwelling investment in 2015-16 has remained strong, supported by low interest rates and an elevated level of work under construction. While the level of investment is expected to remain high, growth is expected to ease to 2 per cent in 2016-17 and 1 per cent in 2017-18 as a record number of dwellings reach completion.

Chart 4: Building approvals



Source: ABS cat. no. 8731.0.

Business investment

As the economy transitions from the investment phase of the mining boom to the production phase, the outlook for **business investment** continues to be dominated by steep falls in mining investment as resource projects are completed. This contraction is expected to lessen by 2017-18. At the same time the transition to broader-based sources of growth is expected to drive investment in the non-mining sectors. Overall, business investment is forecast to fall by 5 per cent in 2016-17, then remain flat in 2017-18, driven by mining investment that is forecast to fall by 25½ per cent in 2016-17 and 14 per cent in 2017-18.

Conditions are in place for non-mining investment to pick up. Borrowing costs are low, and domestic demand is forecast to strengthen. There are positive signs of bolstered activity in the service sectors and business surveys are showing improving conditions in the non-mining sector (Chart 5). Non-mining capacity utilisation is at its highest level since the global financial crisis (Chart 6).

To date, however, the recovery of non-mining investment has been slower than expected and leading indicators remain mixed, with some business expectations surveys suggesting the delay may continue into 2016-17. The ABS Private New Capital Expenditure and Expected Expenditure Survey (CAPEX) and Treasury's business liaison programme suggest that non-mining businesses have yet to commit to significant new investment plans, which is offsetting some of the more positive indicators.

Chart 5: Non-mining conditions

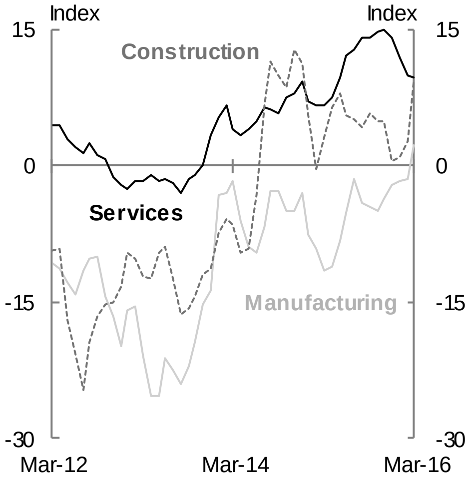
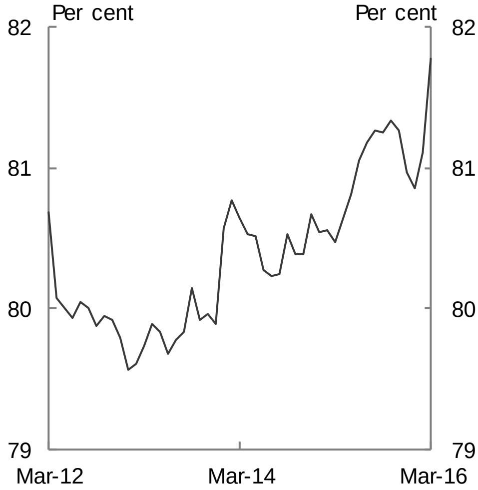


Chart 6: Non-mining capacity utilisation



Note: Figures represent the 3-month moving average.
Source: NAB Monthly Business Survey.

The pace and timing of a pick up in non-mining business investment continues to be a key source of uncertainty for the outlook. Along with mixed indicators, a change in the composition of investment creates uncertainty for the forecasts. As mining investment declines and the economy transitions to broader-based growth, business investment will be underpinned by a greater number of smaller investments, such as investments by small businesses and businesses in the service sectors. The lead times for these kinds of investments are typically shorter than those for large mining projects. This adds to the difficulty in estimating both the timing and scale of the expected pick up in business investment. The sensitivity of the forecasts to a different outlook for business investment is discussed in Statement 7.

Public final demand

The average annual pace of fiscal consolidation in the 2016-17 Budget across the forward estimates is 0.4 per cent of GDP. This is unchanged from the 2015-16 MYEFO.

Public final demand, which captures the direct economic impact of consumption and investment across all levels of government, is forecast to grow modestly as most governments remain focused on budget consolidation. As a result, public final demand is forecast to rise by 2¼ per cent in 2016-17 and 2 per cent 2017-18.

Exports

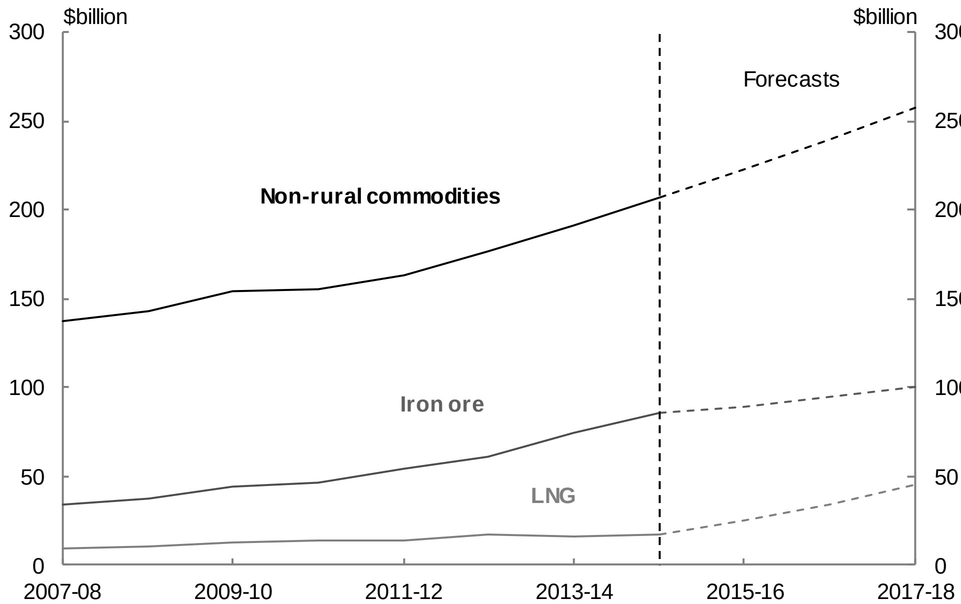
Total exports are expected to increase by 6 per cent in 2015-16, 5 per cent in 2016-17 and 5½ per cent in 2017-18. While forecast growth in 2015-16 is significantly higher than expected at the 2015-16 MYEFO, forecast growth in 2016-17, while still strong, is lower than at the 2015-16 MYEFO. This primarily reflects a higher exchange rate and a weaker outlook for base metal exports.

That said, the resource sector continues to underpin growth in total exports with iron ore and LNG production continuing to ramp up after the investment phase of the mining boom. **Mining exports** are expected to increase by 7 per cent in 2016-17 and 7½ per cent in 2017-18.

In 2015, Australia exported over 760 million tonnes of iron ore, with 625 million tonnes exported to China. This compares with 240 million tonnes of iron ore exported in 2005, with almost 120 million tonnes exported to China. In 2015, China's imports of Australian iron ore increased by around 11 per cent with Australia increasing its share of the Chinese iron ore market.

Over the forecast period iron ore exports are expected to increase by around 16 per cent, while LNG exports are expected to continue to grow strongly, with the Department of Industry, Innovation and Science forecasting exports to triple between 2014-15 and 2020-21 (Chart 7).[1]

Chart 7: Mining volumes



Source: ABS cat. no. 5302.0, ABS Trade Data and Treasury.

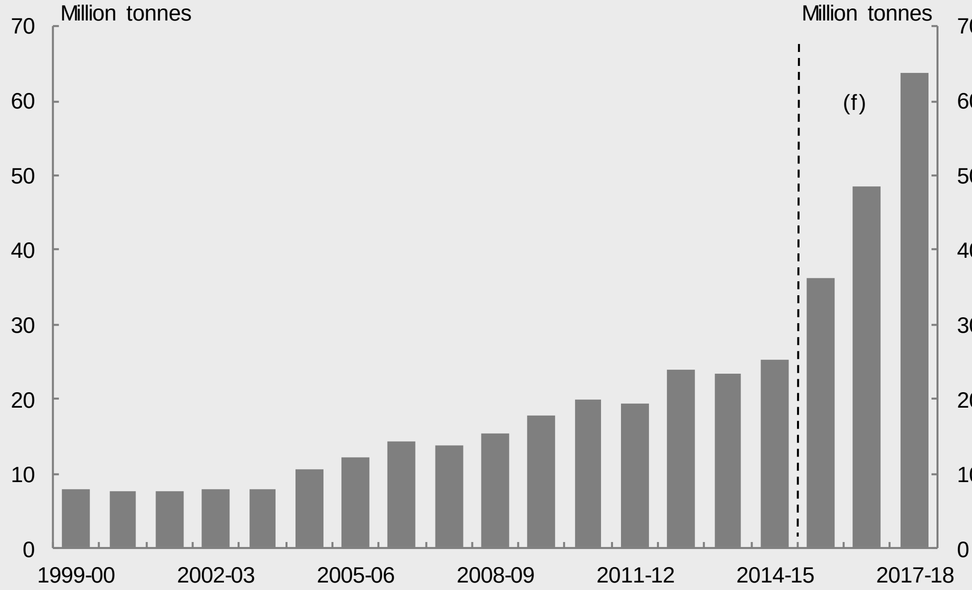
1 *Resources and Energy Quarterly March 2016*, http://www.industry.gov.au/Office-of-the-Chief-Economist/Publications/Documents/req/REQ-March-2016.pdf

Box 3: LNG production increasing

More than $200 billion has been invested in Australia's LNG projects in the past decade. As these projects come online, production will ramp up. Export volumes of LNG from Australia are expected to increase substantially over the forecast period, with Australia expected to become one of the world's largest exporters of LNG in the next five years. Increasing LNG export volumes will also contribute to both real and nominal GDP growth (Chart A).

While the sustained drop in oil prices is benefiting many parts of the Australian economy, it has had a negative impact on LNG prices. Much of Australia's LNG exports are produced under long-term contracts, which broadly link the price of LNG to the price of oil. This means that low oil prices, if sustained, will weigh on the price of Australia's LNG exports going forward and increasingly offset the positive impact on nominal GDP.

Chart A: Increasing LNG production

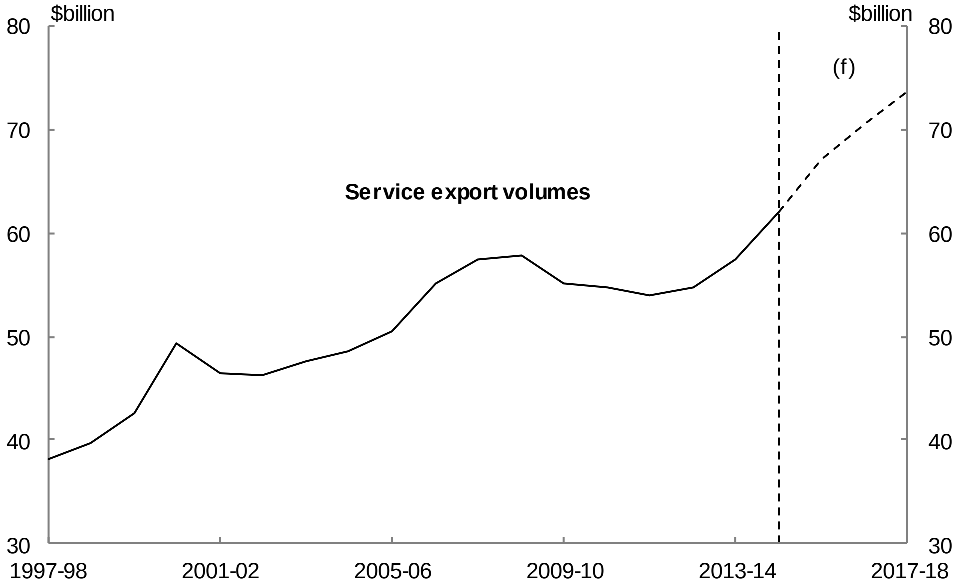


Source: ABS Trade Data and Treasury.

Additionally, as LNG projects are very capital intensive, the sector is expected to have deductions (such as depreciation) that reduce their tax liabilities in the short to medium term. This, and the high level of foreign ownership in the sector, will reduce the impact that any profits would have on Australia's national income.

Strong **service sector exports** have been supported over the past year by a lower exchange rate and rising demand from Asia. Service export volumes are expected to grow by 5 per cent in 2016-17 and 4½ per cent in 2017-18 (Chart 8). More than half of service exports are made up of travel services — business, education and tourism travel. Since 2011 visitor arrivals have increased by almost 30 per cent, while Chinese visitors have almost doubled.

Chart 8: Service export volumes



Source: ABS cat. no. 5302.0 and Treasury.
Note: 2013-14 prices.

A lower Australian dollar since its peak in 2011 and streamlining of student visa policy arrangements have made Australian education exports more attractive over the past two years, with export volumes reaching $18.5 billion in 2015. Asia's economic growth and rising middle class are expected to continue to drive demand for Australia's high quality education sector.

Other service exports have also been growing strongly, albeit from a much lower base. Financial service exports have experienced double-digit growth for the past five years, and computer and information services exports grew strongly in 2015.

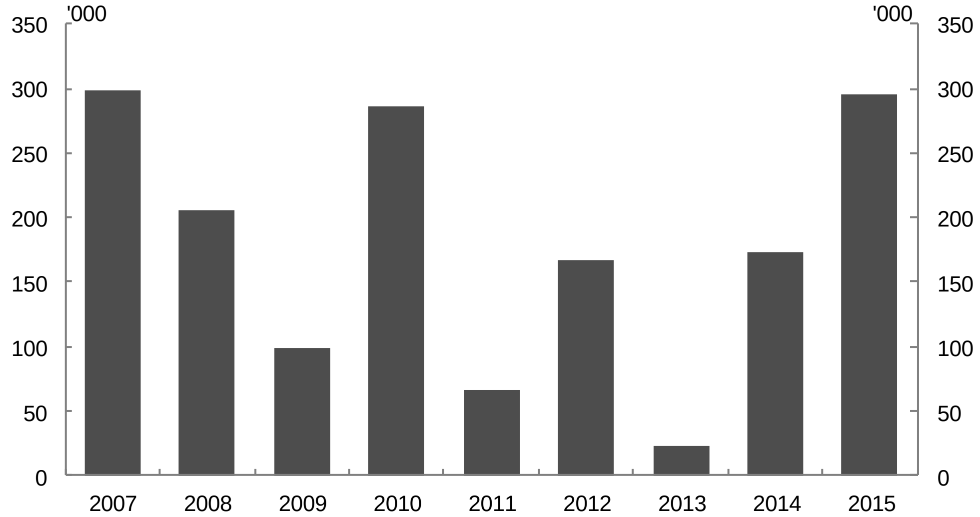
Rural exports are expected to fall in 2016-17. Beef exports are forecast to fall as a result of strong domestic restocking which is expected to more than offset the modest growth in Australian wheat exports. Export volumes are forecast to improve in 2017-18 as beef production recovers in response to higher herd numbers and slaughter rates. A higher exchange rate since the 2015-16 MYEFO is expected to weigh on prices for rural goods in 2016-17 and 2017-18.

Imports continue to reflect the transition of the economy to broader-based growth. Total capital imports are falling as investment in the mining sector winds down, while other imports are rising in line with growth in the broader economy and the appreciation in the Australian dollar since the 2015-16 MYEFO. Total imports are expected to grow by 2½ per cent in 2016-17 and 3 per cent in 2017-18.

The labour market

The transition of the economy towards broader-based drivers of growth has been most evident in the **labour market.** Employment grew strongly over the past two and a half years and with GDP growth picking up to 3 per cent over the year to the December quarter of 2015, employment growth has accelerated. In 2015, there was an almost 300,000 increase in employment, the highest in a calendar year since 2007 (Chart 9). The unemployment rate fell by 0.4 percentage points to 5.7 per cent over the year to March 2016.

Chart 9: Calendar year jobs growth



Source: ABS cat. no. 6202.0.

Employment growth has been supported by moderate wage increases and the transition to more labour-intensive sectors of the economy. The highest level of employment growth over the past year has been in retail trade and health care and social assistance industries (see Box 4).

While the number of people employed has been rising, the average number of hours worked has been falling. This is in line with an increase in part-time work in the service sectors and increased participation of females in the workforce, who have higher rates of part-time employment. The reduction in average hours worked means that total hours worked is spread amongst a larger group of workers, allowing greater employment for a given level of output.

Looking forward, leading indicators such as job advertisements and business survey measures of hiring intentions suggest strong growth in employment will continue. Consistent with the economy's transition, the continuation of strong growth in the labour-intensive service sectors and moderate wage growth are expected to support a further decline in the unemployment rate.

The **unemployment rate** is forecast to be 5¾ per cent in the June quarter of 2016 before falling to 5½ per cent by the June quarter of 2017. The unemployment rate peaked earlier than forecast at the 2015-16 MYEFO and is now at a lower level over the forecast period.

The **participation rate** is expected to remain around recent levels over the forward estimates. The improvement in labour market conditions is expected to continue to encourage job seekers back into the labour force to resume their search for work. Growth in the more flexible service sectors may also increase female participation. These positive effects on workforce participation will be somewhat offset by the ongoing effect of population ageing.

The current strength of the labour market is also being reflected in the opportunities provided to and taken up by Australia's youth. The **youth unemployment** rate has declined significantly to 12.0 per cent in March 2016, down 2.5 percentage points since its recent peak of 14.5 per cent in November 2014. It is now at its lowest level since July 2013.

Moderate **wage growth** is supporting employment and facilitating the economy's transition. Wage growth has been low by historical standards in both the public and private sectors. The Wage Price Index, which measures changes over time in wages and salaries and is unaffected by compositional change in employment, grew by 2.2 per cent through the year to the December quarter of 2015. Wage growth is expected to remain constrained and has been revised down since the 2015-16 MYEFO. It is now forecast to grow by 2¼ per cent through the year to the June quarter of 2016 and 2½ per cent through the year to the June quarter of 2017.

Box 4: Services — a source of strong employment growth

The transition in the economy from the capital-intensive mining sector to the more labour-intensive service sectors has been evident in the strength and composition of employment growth.

Strong growth in labour-intensive service sectors are expected to continue to support strong employment growth over the forecast period.

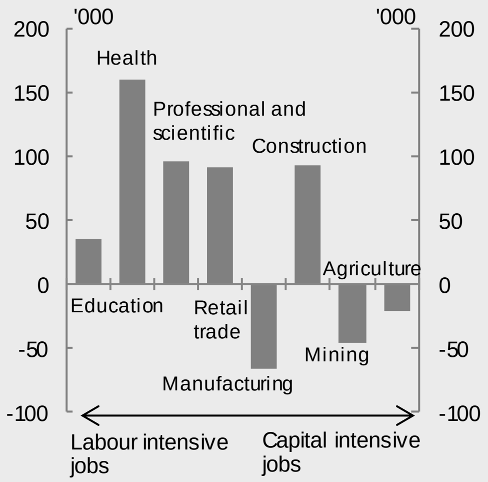
During the resources investment boom, mining employment increased substantially but almost 50,000 jobs have moved out of mining since its peak in May 2012. The mining investment boom also generated demand for construction jobs, however demand for construction jobs is now being generated by dwelling and non-dwelling investment. Since May 2012 total employment has increased by over 500,000 jobs. Most of this growth has been in the service sectors.

Service sectors accounted for 90 per cent of employment growth over the past year.

Within services, retail and health care and social assistance have been the largest contributors, each growing by around 60,000 jobs over the past year. Professional, scientific and technical services has also been contributing strongly to employment growth, driven by the growth in high-skilled consultancy jobs.

The high labour intensity of the service sectors has allowed employment to grow strongly over a period when output has been growing at a little below potential.

Chart A: Change in employment since May 2012



Source: ABS cat. no. 6291.0.55.003 and Treasury.

Chart B: Employment growth since May 2012 — selected industries

Source: ABS cat. no. 6291.055.003.

Consumer prices grew by 1.3 per cent over the year to the March quarter of 2016. This weak result was driven primarily by falls in petrol prices, competition in the retail sector and moderate wage growth. Moderate wage growth is expected to continue to weigh on price growth over the forecast period, which has been downgraded since the 2015-16 MYEFO. CPI inflation is forecast to be 1¼ per cent through the year to the June quarter of 2016 and 2 per cent through the year to the June quarter of 2017. A strengthening economy and increases in tobacco excise are expected to support an increase in inflation to 2¼ per cent through the year to the June quarter of 2018.

Outlook for nominal GDP

Nominal GDP growth is forecast to be a little lower than at the 2015-16 MYEFO, reflecting weaker forecast inflation in 2015-16 and slightly lower forecast growth in real GDP in 2016-17. The level of nominal GDP is expected to be lower than at the 2015-16 MYEFO over the forward estimates, reflecting weaker wages and inflation. This has contributed to lower tax receipts, excluding new policy, of $13.5 billion over the four years to 2018-19 compared with the 2015-16 MYEFO (see *Statement 4: Revenue*).

Low commodity prices continue to weigh on Australia's **terms of trade** but some renewed strength since the beginning of 2016 has led to some upward revisions to the forecast terms of trade since the 2015-16 MYEFO. The terms of trade are now forecast to fall by 8¾ per cent in 2015-16, before increasing by 1¼ per cent in 2016-17 compared with falls of 10½ per cent and 2¼ per cent respectively at the 2015-16 MYEFO.

Continuing the approach taken at the 2015-16 Budget, the price of oil and key commodity export prices that underpin the forecasts are based on a recent average.

Iron ore prices have risen recently in US dollar terms. The iron ore price underpinning the forecasts is $US55 per tonne Free on Board (FOB), compared with $US39 per tonne FOB at the 2015-16 MYEFO. Metallurgical coal is also a key input into steel production. The metallurgical coal price is $US91 per tonne FOB compared with $US73 per tonne at the 2015-16 MYEFO. The price of thermal coal remains unchanged in US dollar terms since the 2015-16 MYEFO.

Although prices for some key commodities have increased in US dollar terms since the 2015-16 MYEFO, the overall impact on nominal GDP has been partly offset by an appreciation in the Australian dollar. Australia's key commodities are traded in US dollars and a higher exchange rate has reduced the price exporters receive in Australian dollar terms. The exchange rate is now assumed to be 77 cents against the US dollar compared with 72 cents at the 2015-16 MYEFO.

A key risk to the nominal GDP forecast is the volatility and uncertainty around movements in commodity prices. The inherent uncertainty around both supply and demand factors means the outlook for the price of iron ore is subject to considerable risk.

The impact of iron ore prices being US$10 per tonne lower/higher, based on the sensitivity analysis presented in Statement 7 is set out in Table 3. A US$10 per tonne reduction/increase in the iron ore price results in just over a $6 billion reduction/increase in nominal GDP in 2016-17. These illustrative impacts differ from those presented in the 2015-16 Budget due to a more comprehensive analysis presented in this year's Statement 7. In particular, the sensitivity analysis now assumes that export commodity prices fall/rise over the course of a year rather than an immediate movement. The effect of this is to reduce the impact in the first year of the analysis. The effect in the second year is in line with the earlier sensitivity analysis. For purposes of comparison an immediate fall/rise in the iron ore price would have a direct effect in the first year of around an $11 billion reduction/increase in nominal GDP in that year.

Table 3: Sensitivity analysis of iron ore price movements[(a)]

	US$45/tonne FOB[(b)] spot price		US$65/tonne FOB spot price	
	2016-17[(c)]	2017-18	2016-17[(c)]	2017-18
Nominal GDP ($billion)	-6.1	-13.4	6.1	13.4
Tax Receipts ($billion)	-1.4	-3.9	1.4	3.9

(a) Key aggregates are shown relative to the 2016-17 Budget iron ore price forecast of US$55/tonne and based on an exchange rate assumption of 77 US cents.
(b) FOB is the free-on-board price which excludes freight costs.
(c) This is the price by the end of 2016-17.
Source: Treasury.

Box 5: Lower oil prices to support economic growth

The price of oil (Tapis crude) has fallen around 50 per cent in Australian dollar terms over the past two years. There have been significant developments in the supply of oil in recent years, including increased production by OPEC members, the US and most recently by Iran following the recent lifting of sanctions. Slower than expected global growth has also contributed to demand for oil being lower than it otherwise would have been.

Oil remains one of the major inputs into the global production process. For this reason, a sustained supply-driven fall in the price of oil in the past has supported global economic growth. During 2015, however, global growth does not appear to have responded as strongly as might have been expected based on historical experience. Factors likely to be muting the positive net impact of lower oil prices on global growth include cutbacks in public expenditure in oil producing nations, detracting from their economic growth; detraction from global economic growth from lower energy investment; and a smaller than expected increase in global private consumption, perhaps as consumers save part of the windfall from lower oil prices.

Australia is currently a net importer of oil and petroleum products, and Australian households and many businesses are benefiting from the fall in oil prices, primarily through lower prices for automotive fuel which fell around 25 per cent over the past two years (Chart A). Lower oil prices also reduce the input costs for a number of consumer and other goods, putting downward pressure on prices. Further, lower travel costs may contribute to a further strengthening in demand for Australia's tourism exports.

Chart A: Oil and petrol prices

Source: Bloomberg and Australian Institute of Petroleum.

Medium-term projections

The fiscal aggregates in the Budget are underpinned by economic forecasts for the budget year and the subsequent financial year and then by economic projections for the following two financial years. These projections are not forecasts. Rather they are based on a medium-term methodology and some key assumptions.

Crucially, the medium-term projection methodology assumes that spare capacity in the economy is absorbed over five years following the forecast period. The sensitivity of the projections to a different adjustment period is analysed in Statement 7.

As the spare capacity is absorbed, labour market variables, including employment and the participation rate, converge to their long-run trend levels. To absorb the spare capacity in the economy, from 2018-19 real GDP is projected to grow faster than potential at 3 per cent. By the end of 2022-23 spare capacity is absorbed and real GDP grows at its potential rate thereafter.

Potential GDP is estimated based on an analysis of underlying trends for population, productivity and participation. Australia's potential GDP growth rate is estimated to be 2¾ per cent over the next few years. 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 level from 2019-20.

In the 2015-16 MYEFO, the medium-term projections were updated in response to new data on population and participation. An update in response to changes in the data to account for developments in commodity markets has now been completed resulting in changes to the terms of trade outlook in the medium term (see Box 6).

Box 6: Long-run terms of trade

In the 2013-14 MYEFO a new framework was adopted for projecting the terms of trade over the medium term. The framework has been updated to incorporate data from the past two years and more specifically to account for the significant developments in commodity markets such as updated cost curves. Further information on the methodology underpinning the framework can be found in the 2013-14 MYEFO and the published Treasury Working Paper *Long-run forecasts of Australia's terms of trade*.

The update now suggests a slightly lower terms of trade outlook over the medium term compared with at the 2013-14 MYEFO, primarily reflecting a fall in the export price outlook for bulk commodities (iron ore, metallurgical coal and thermal coal).

Chart A: The terms of trade outlook

Source: ABS cat. no. 5206.0 and Treasury.

Australia's terms of trade is affected significantly by the evolving supply and demand dynamics for commodities exports, especially the bulk commodities. Over the past two years mining companies, including those from Australia, have significantly improved productivity by cutting production costs leading to lower marginal costs of extraction.

Lower production costs for miners combined with a softer demand outlook, particularly from China, has led to a lower export price outlook for the bulk commodities in the medium term.

While lower commodity prices have put downward pressure on the terms of trade, this has been partly offset by a fall in the outlook for import prices. A softer demand outlook has also translated into lower prices for Australia's imports.