PART 2: ECONOMIC OUTLOOK

OVERVIEW

The Australian economy has continued to perform well in 2018, supported by robust global growth, accommodative monetary policy settings and a lower Australian dollar. Labour market conditions have remained strong, with business profits helping to sustain strong employment growth. Over 300,000 jobs were created in the past year, and the unemployment rate has fallen to its lowest level since 2012. Domestic demand is expected to strengthen over the forecast period as mining investment starts to rise again, and growth in household consumption and non-mining business investment increases. Export growth is also forecast to pick up in 2019-20 following a decline in rural exports in 2018-19.

Real GDP is forecast to expand by 2¾ per cent in 2018-19, a little slower than expected at Budget but in line with the economy's estimated potential growth rate. Growth is expected to strengthen to 3 per cent in 2019-20, supporting solid growth in employment and keeping the unemployment rate close to recent lows.

The transition from the investment phase of the mining boom towards broader-based sources of growth has progressed broadly as expected. By the end of the forecast period, all of Australia's large LNG projects are expected to be operational, signalling a full transition to the production phase of the mining boom. The drag from the unwinding of the boom's investment phase has continued to recede over the past year. After falling by more than 60 per cent since 2012-13, mining investment is expected to grow in 2019-20 as mining companies invest to maintain output and the large capital stocks accumulated over the past decade or more.

Accommodative monetary policy settings continue to support the economy, notwithstanding a tightening of credit conditions. Rising growth in household incomes is expected to underpin an expansion in consumer spending. Non-mining business investment is also forecast to increase, supported by strong growth in machinery and equipment investment. Non-mining business investment grew by 9.7 per cent in 2017-18 — its fastest increase since 2004-05.

Growth in mining and services exports is forecast to contribute to real GDP growth in 2018-19. However, exports of rural goods are expected to decline, reflecting the impact on agricultural production of drought conditions in New South Wales and parts of Victoria, Queensland and South Australia. The decline in rural exports is forecast to subtract around ¼ of a percentage point from real GDP growth in 2018-19. An assumption of average seasonal conditions in 2019-20 underpins a forecast return to growth in the farm sector. However, the pace of growth of rural exports and farm GDP will depend on how weather conditions evolve.

Dwelling investment is expected to grow by 1 per cent in 2018-19 before falling by 4 per cent in 2019-20. The forecast decline in 2019-20 reflects the expected unwinding of some of the recent strength in construction activity. Nonetheless, the level of dwelling investment is expected to remain relatively high, reflecting the large stock of work still to be done.

Labour market conditions have remained strong since the 2018-19 Budget. Employment has expanded at a faster rate than the population and the labour force since the start of the year. As a consequence, the unemployment rate has fallen to 5 per cent — its lowest level since 2012. Solid employment growth is expected to continue over the forecast period and the unemployment rate is forecast to remain at 5 per cent. This is expected to support a pick-up in wage and price growth, albeit more gradually than forecast at Budget. As has been the case in other advanced economies, wage growth in Australia has been slow to respond to improving labour market conditions.

Nominal GDP is forecast to grow by 4¾ per cent in 2018-19 and 3½ per cent in 2019-20. Stronger-than-assumed outcomes for non-rural commodity prices have contributed to a 1 percentage point upgrade to forecast growth in nominal GDP in 2018-19. The metallurgical coal price is still assumed to decline from current levels, though later than assumed at Budget. This contributes to slower forecast growth in nominal GDP in 2019-20.

Global growth is expected to remain solid over the forecast period. The global economy is forecast to expand by 3¾ per cent in each of the next two years, faster than the average rate of growth over the past decade. Major trading partner growth is forecast to be 4 per cent in 2019 and 2020.

There are a range of risks to the international outlook. Trade protection measures already announced or imposed by the United States and China are forecast to have a small negative effect on activity in those countries. Additional tariffs would be expected to result in growth that is weaker than forecast. On the other hand, a resolution of current disputes could cause growth to be stronger than forecast, including through reducing uncertainty. Other risks are broadly balanced. Geopolitical uncertainty and vulnerabilities in emerging economies remain a concern for the international outlook, especially to the extent that they provoke broader financial market instability. In contrast, more favourable macroeconomic policy settings in key economies, notably China, could lead growth to be stronger than forecast.

Risks also remain around the domestic outlook. On the downside, subdued household income growth, tighter-than-expected credit conditions and housing price falls could cause consumer spending and dwelling investment to be weaker than forecast. Further, uncertainty around the global outlook could affect business confidence and investment. On the upside, better-than-forecast labour market outcomes could support stronger consumer spending, and improving business conditions and profits could contribute to a stronger-than-expected increase in non-mining business investment.

INTERNATIONAL ECONOMIC OUTLOOK

The global economy has continued to grow at a solid pace since the 2018-19 Budget. The United States economy continues to expand faster than its estimated potential growth rate, while China looks set to achieve its growth target of about 6.5 per cent in 2018. On the other hand, momentum has eased in the euro area and Japan since the start of the year. As a consequence, growth has become less synchronised across countries than was the case in 2017.

The global economy is forecast to grow by 3¾ per cent in 2019 and 2020, while Australia's major trading partners are forecast to grow by 4 per cent in each of the next two years. Since the 2018-19 Budget, the United States has imposed tariffs on US$250 billion of Chinese imports and China has retaliated by imposing tariffs on a range of US-produced imports. Tariffs that have been announced or implemented to date are estimated to affect a little more than 2 per cent of world trade. These measures are expected to have a small negative effect on growth in the United States and China, resulting in a modest downgrade to the forecasts of major trading partner growth.

The extent to which trade protection measures have contributed to a slowdown in global trade growth in 2018 is unclear. However, trade tensions remain a risk to the global outlook, notwithstanding the recent pause in tariff increases agreed by the United States and China. Additional increases in tariffs would be expected to further weaken growth outcomes. In contrast, a resolution of current disputes could result in faster-than-expected growth, including by reducing uncertainty and boosting investment.

Mounting external pressures add to the challenges China faces domestically in addressing its financial sector risks. Vulnerabilities associated with an increase in global indebtedness, including in emerging economies, also present a risk to the international outlook. Such vulnerabilities could expose financial markets to greater volatility, especially in an environment where monetary stimulus in advanced economies is being gradually removed.

Output gaps – which measure the difference between a country's actual and estimated potential GDP – are closing, or have already closed, in the United States, Japan and economies in the euro area. If capacity constraints in these economies bind sooner than expected, inflation in these countries could rise more quickly than expected. This could prompt a faster-than-expected withdrawal of monetary accommodation, with attendant risks around capital flows to other markets.

A modest tightening in global financial conditions is already exposing vulnerabilities across a range of emerging market economies. Argentina and Turkey have been among the worst-affected countries, with the IMF stepping in to support Argentina with a US$56 billion package – the largest in the IMF's history. Emerging market economies in Asia have demonstrated resilience in the face of financial market

volatility over the course of the year. India, Indonesia and the Philippines have used macroeconomic policy levers to address currency and inflation pressures.

Over the longer term, unfavourable demographics are likely to constrain potential growth rates in some of the world's major economies. Slower productivity growth could also limit productive capacity in many countries.

Table 2.1: International GDP growth forecasts[(a)]

	Actuals	Forecasts		
	2017	2018	2019	2020
China	6.9	6 1/2	6	6
India	6.2	7 1/2	7 3/4	7 3/4
Japan	1.9	3/4	1	3/4
United States	2.2	2 3/4	2 1/4	2
Euro area	2.4	2	1 3/4	1 1/2
Other East Asia (b)	4.5	4 1/4	4 1/4	4 1/4
Major trading partners	4.5	4 1/4	4	4
World	3.7	3 3/4	3 3/4	3 3/4

(a) World 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 goods export trade weights.
(b) Other East Asia comprises the Association of Southeast Asian Nations group of five (ASEAN‑5), comprising Indonesia, Malaysia, the Philippines, Thailand and Vietnam, along with Hong Kong, South Korea, Singapore and Taiwan.
Source: National statistical agencies, IMF World Economic Outlook October 2018, Thomson Reuters and Treasury.

The **United States** economy is continuing to grow strongly and the unemployment rate has fallen to 3.7 per cent – its lowest level since 1969. Wage growth has increased and core personal consumption expenditure inflation is just below the Federal Open Market Committee's (FOMC) target of 2 per cent. The FOMC has signalled that it expects to make further increases in the federal funds rate. As monetary stimulus is gradually withdrawn, and the impact of fiscal stimulus diminishes, growth in the US economy is expected to slow.

The United States has announced tariffs on US$250 billion of imports from China, while China has announced retaliatory tariffs on imports from the United States. These measures are expected to have a negative effect on growth in the world's two biggest economies. Trade tensions remain a live issue, notwithstanding the negotiation in September of a new trade agreement between the United States, Mexico and Canada, and the recent agreement to delay a planned step-up in the US tariff rate on Chinese imports for 90 days. The United States has raised the possibility of imposing tariffs on automobiles.

Growth in **China**'s economy has slowed in 2018 amid efforts by the authorities to address risks in the financial system. The economy remains on track to meet the growth target of about 6.5 per cent for 2018. Real GDP growth is expected to moderate further in 2019 as trade measures weigh on growth and further steps are taken to

address financial sector risks. The recent adjustment to macroeconomic policy settings is designed to support demand in the near term, partly offsetting these pressures.

Momentum in **India**'s economy picked up in 2018 following slower growth in 2017, with structural reforms starting to contribute to activity. The economy is estimated to be operating close to its productive capacity. The Reserve Bank of India tightened monetary policy earlier in the year in response to rising headline inflation. Oil price increases contributed to stronger growth in consumer prices, while the value of the rupee depreciated amid broader pressure on emerging market currencies. Tighter financial conditions are weighing on India's near-term outlook. However, as a net importer of oil, India stands to benefit from recent falls in the oil price. Looking forward, strong fundamentals and strengthening domestic demand are expected to support growth of 7¾ per cent in 2019 and 2020.

Japan's economy is expected to grow by ¾ per cent in 2018 following weaker-than-expected outcomes in the year to date. Natural disasters disrupted growth in the third quarter of 2018 and underlying momentum appears to have slowed. Real GDP growth is expected to pick up a little in 2019, despite a planned increase in value-added tax that is likely to affect private consumption. Real GDP growth is then forecast to moderate in 2020 as capacity constraints become binding. Japan's economy is already operating around estimates of its productive capacity, with the unemployment rate having fallen to levels last seen in the early 1990s. Population ageing will limit future potential growth in the economy.

Euro area growth has slowed in 2018, reflecting weaker domestic demand and softer growth in exports. However, a number of factors should support the euro area economic expansion. Interest rates remain at historical lows, employment is growing, and above-average levels of capacity utilisation should lead to solid business investment in the near term. Over the medium term, as output gaps close, and capacity constraints begin to bind in some countries, the rate of growth is expected to decline. The United Kingdom is scheduled to exit the European Union on 29 March 2019 and there are a number of uncertainties around the future UK-EU relationship. This, together with the dispute over Italy's budget, and a possible escalation of global trade tensions, adds to risks around the euro area outlook.

Most **ASEAN-5** economies have recorded solid growth in 2018. This is forecast to continue in 2019 and 2020, supported by solid global growth and expanding domestic demand. However, escalating trade tensions, a moderation in growth in the Chinese economy, and the tightening of monetary policy in the United States have increased uncertainty around the outlook for the ASEAN-5.

DOMESTIC ECONOMIC OUTLOOK

Australia's economy continues to perform well and has been expanding at around its estimated potential growth rate. Real GDP is forecast to grow by 2¾ per cent in 2018-19 and 3 per cent in 2019-20. This growth outlook is forecast to support continuing employment growth, helping to keep the unemployment rate around recent lows.

The growth forecast for 2018-19 is slightly lower than the 2018-19 Budget estimate. Declining mining investment is expected to partly offset growth in other parts of the domestic economy. A fall in rural exports is also expected to weaken overall growth in real GDP in 2018-19, reflecting the effects of drought conditions in parts of southern and eastern Australia. Growth in mining and services exports is forecast to contribute to real GDP growth.

Economic growth is forecast to increase in 2019-20, with growth strengthening in household consumption, non-mining business investment and exports. Mining investment is also forecast to rise in 2019-20, making its first positive contribution to growth in seven years. This will mark an important turning point in the economy's adjustment to the end of the mining investment boom.

As output growth rises over the forecast horizon, employment is forecast to expand solidly. Labour force participation is expected to remain at high levels in 2018-19 and 2019-20 and the unemployment rate is forecast to remain at 5 per cent. Growth in wages and consumer prices is expected to increase over the forecast period, though more gradually than forecast at Budget.

Table 2.2: Domestic economy forecasts[(a)]

	Outcomes(b)	Forecasts			
	2017-18	2018-19		2019-20	
		Budget	MYEFO	Budget	MYEFO
Real gross domestic product	**2.8**	**3**	**2 3/4**	**3**	**3**
Household consumption	2.8	2 3/4	2 1/2	3	3
Dwelling investment	0.1	1 1/2	1	0	-4
Total business investment(c)	6.0	3	1	4 1/2	5
By industry					
Mining investment	-4.1	-7	-8	3 1/2	4
Non-mining investment	9.7	5 1/2	4	5	5
Private final demand(c)	3.0	2 1/2	2	3	2 3/4
Public final demand(c)	4.5	3	4 1/4	2 3/4	3
Change in inventories(d)	0.0	0	0	0	0
Gross national expenditure	3.3	2 3/4	2 1/2	3	2 3/4
Exports of goods and services	4.1	4	2	2 1/2	3 1/2
Imports of goods and services	7.0	2	1 1/2	2 1/2	3
Net exports(d)	-0.6	1/4	1/4	0	0
Nominal gross domestic product	4.7	3 3/4	4 3/4	4 3/4	3 1/2
Prices and wages					
Consumer price index(e)	2.1	2 1/4	2	2 1/2	2 1/4
Wage price index(f)	2.1	2 3/4	2 1/2	3 1/4	3
GDP deflator	1.8	3/4	2	1 1/2	1/2
Labour market					
Participation rate (per cent)(g)	65.6	65 1/2	65 1/2	65 1/2	65 1/2
Employment(f)	2.7	1 1/2	1 3/4	1 1/2	1 3/4
Unemployment rate (per cent)(g)	5.4	5 1/4	5	5 1/4	5
Balance of payments					
Terms of trade(h)	1.9	-5 1/4	1 1/4	-2 1/4	-6
Current account balance (per cent of GDP)	-2.8	-2 3/4	-2 3/4	-3 1/4	-3 3/4

(a) Percentage change on preceding year unless otherwise indicated.
(b) Calculated using original data unless otherwise indicated.
(c) Excluding second-hand asset sales from the public sector to the private sector.
(d) Percentage point contribution to growth in GDP.
(e) Through-the-year growth rate to the June quarter.
(f) Seasonally adjusted, through-the-year growth rate to the June quarter.
(g) Seasonally adjusted rate for the June quarter.
(h) The forecasts are underpinned by price assumptions for key commodities: Iron ore spot price of US$55/tonne free-on-board (FOB); metallurgical coal spot price falling over the March and June quarters of 2019 to reach US$120/tonne FOB by the September quarter 2019; and thermal coal spot price of US$93/tonne FOB.

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 63 and a US$ exchange rate of around 73 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$67 per barrel.
Source: ABS cat. no. 5204.0, 5206.0, 5302.0, 6202.0, 6345.0, 6401.0, unpublished ABS data and Treasury.

Household consumption is forecast to grow by 2½ per cent in 2018-19 and 3 per cent in 2019-20. Consumer spending was supported by a pick-up in household income growth in 2017-18. Income growth increased due mainly to strong growth in employment, with a smaller contribution from a modest rise in average earnings. Consumer sentiment has remained positive since the start of the year. Continued growth in employment and stronger wage growth is expected to support an expansion in household consumption over the forecast period, albeit at a slightly slower rate in

2018-19 than forecast at Budget. Personal income tax measures announced in the 2018-19 Budget are expected to support disposable income over this period. After declining over four years, the household saving ratio is expected to stabilise in 2019-20.

Interest rates remain low by historical standards. However, there are signs of a tightening in credit conditions, and this adds to the risks around consumer spending and investment. The recent tightening in credit conditions has occurred against the background of actions taken by regulators to improve lending standards in recent years, which have strengthened household balance sheets and therefore reduced vulnerability to future shocks. There remains a risk that household spending could be affected by any unanticipated further tightening in financial conditions. This may be a result of greater risk aversion following the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry.

Dwelling investment is forecast to rise by 1 per cent in 2018-19 and then fall by 4 per cent in 2019-20. Residential construction activity has been stronger than expected over the past year, due to an acceleration of work on existing projects. Activity should be supported in the near term by the large amount of construction work that remains to be done, particularly in New South Wales and Victoria. But a downward trend in building approvals means that some moderation in the future level of activity remains likely. Housing price declines also present a downside risk to the outlook for dwelling investment. Price falls in Sydney and Melbourne contributed to aggregate declines in capital city housing prices over the past year, with smaller price falls registered in Perth and Darwin. However, recent falls in housing prices in Australia's two largest capital cities have only partly unwound strong growth recorded in those cities between 2012 and 2017. Capital city housing prices overall remain around 40 per cent higher than in 2012.

Business investment is forecast to expand by 1 per cent in 2018-19 and 5 per cent in 2019-20. **Mining investment** has fallen by over 60 per cent since the peak of the mining investment boom. A further 8 per cent fall is expected in 2018-19 as the last of Australia's large LNG projects move into production. Investment in the mining industry is then expected to rise by 4 per cent in 2019-20 as mining companies invest to maintain large capital stocks and sustain production at existing levels.

Non-mining business investment grew strongly in 2017-18, with survey measures of business conditions at high levels. Non-mining business investment increased across a range of goods and services industries, a sign of the strength and breadth of the recent expansion. Evidence continues to suggest some firms are benefiting from opportunities related to large public infrastructure projects, particularly in New South Wales. Sustained growth in profits is expected to support non-mining business investment over the forecast period. Non-mining business investment is expected to expand by 4 per cent in 2018-19. This is a little weaker than forecast in the 2018-19 Budget, due to softer growth in non-dwelling construction. In 2019-20, growth in non-mining business investment is forecast to rise to 5 per cent, supported by strong growth in machinery and equipment investment.

Public final demand is forecast to grow by 4¼ per cent in 2018-19 and 3 per cent in 2019-20. Large contributions to growth are expected from state and territory spending on transport infrastructure projects, supported by the Australian Government's record $75 billion infrastructure rollout, and ongoing Commonwealth expenditure on the National Disability Insurance Scheme.

Exports are forecast to grow by 2 per cent in 2018-19 and 3½ per cent in 2019-20. Drought conditions in New South Wales and parts of Victoria, Queensland and South Australia are expected to reduce farm production in 2018-19. This is expected to result in a 10 per cent fall in **rural exports**. In 2019-20, the assumption of average seasonal conditions supports a forecast return to growth in the farm sector. However, the pace of growth of rural exports and farm GDP will depend on how weather conditions evolve. Box A explains the effect of the drought on farm production and rural exports.

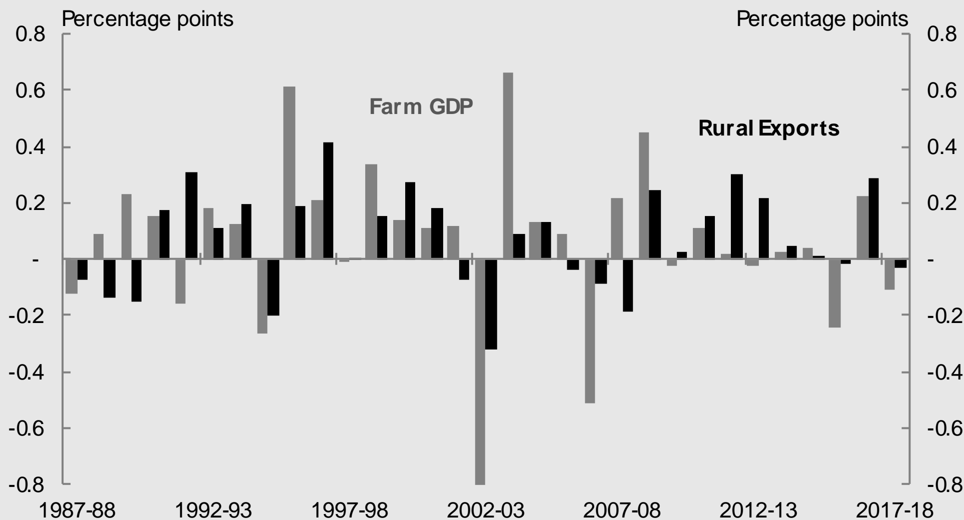
Box A — Impact of the drought on agricultural production and rural exports

Drought conditions affecting parts of southern and eastern Australia have resulted in a downgrade to farm GDP forecasts for 2018-19. Below-average rainfall and a deterioration in soil moisture levels have particularly affected the winter crop in 2018-19, which accounts for the vast bulk of Australia's crop-related production each year.

Based on the latest information from the Australian Bureau of Agriculture and Resources Economics and Sciences, the forecast for agricultural production is for a decline in 2018-19. This is expected to subtract around ¼ of a percentage point from real GDP growth. Downgrades to winter crop production are expected to be partly offset in the short term by increased livestock slaughter rates, although this is likely to reduce productive stock available for future years.

Drought conditions have had a devastating impact on a number of regions, with particularly severe effects across large parts of south-eastern Australia. In contrast, parts of Western Australia have experienced more favourable conditions. The asymmetric nature of the drought and its duration has meant that at an aggregate level the economic impact is expected to be smaller than was the case in some previous droughts. Over the past 20 years, droughts have subtracted up to 0.8 percentage points from real GDP growth in a given financial year (Chart A).

Chart A: Agricultural contributions to real GDP growth



Source: ABS cat. no. 5206.0, 5302.0 and Treasury.

Current dry conditions follow favourable seasonal conditions and record crop production in 2016-17. This, combined with growth in rural commodity prices in recent years, has helped to support farm incomes and boosted Farm Management Deposits to record levels.

As a variety of factors continue to play out across Australia's agricultural sector, the outlook for farm production and exports will remain a risk to the economic outlook.

Non-rural commodity exports are forecast to grow by 4½ per cent in 2018-19, slower than forecast in the 2018-19 Budget. Temporary supply disruptions have affected exports of iron ore and coal in the second half of 2018 following stronger-than-expected outcomes earlier in the year. Growth is forecast to moderate to 3½ per cent in 2019-20, with the remaining large LNG projects expected to have ramped up production by that time.

Services exports are forecast to grow by 4 per cent in 2018-19 and 2019-20, in line with the 2018-19 Budget forecasts. Growth in services exports has remained strong over the past year. Demand from Asia is expected to support continued growth in Australia's tourism and education exports over the forecast period.

Strengthening domestic economic activity is expected to lift demand for imported goods and services over the forecast period. **Imports** are forecast to grow by 1½ per cent in 2018-19 and 3 per cent in 2019-20, with imports of consumption, capital and intermediate goods, and services all expected to expand.

Labour market conditions have remained strong over the past 12 months, with employment increasing in most states and territories and in 12 out of 19 industries. As growth in employment exceeded growth in the labour force over this period, the unemployment rate has fallen, and at 5 per cent is at its lowest level in six years. Consistent with improved opportunities in the labour market, as well as continued increases in participation by women and older Australians, the headline participation rate remains close to recent highs.

Strong growth in output is expected to bring the economy closer to its productive capacity over the forecast period and support increased demand for labour. However, consistent with leading indicators of employment growth, further improvements in the labour market are likely to be more gradual than in 2017-18. Year-ended **employment** growth of 1¾ per cent is forecast for both 2018-19 and 2019-20, which is ¼ of a percentage point higher in each year than forecast at Budget. The **labour force participation rate** is forecast to stay relatively high, at 65½ per cent, while the **unemployment rate** is expected to remain at 5 per cent.

Year-ended **wage growth** is expected to rise from 2½ per cent in 2018-19 to 3 per cent in 2019-20. Growth in the Wage Price Index picked up to 2.3 per cent through the year to the September quarter, its strongest outcome in three years, as the unemployment rate fell to a six-year low. Anecdotal evidence from Treasury's business liaison program points to skills shortages and wage pressures in some sectors of the economy, consistent with a tightening labour market.

Nevertheless, the wage growth forecasts are ¼ of a percentage point lower than in the Budget for both 2018-19 and 2019-20. In Australia, as in other advanced economies, the response of wages to improving labour market conditions has been slower and more muted than in past cycles. The United States, Canada and New Zealand have also

experienced subdued wage growth in an environment of low unemployment and solid GDP growth.

In Australia, the slower recovery in wage growth might reflect adjustments associated with the unwinding of high commodity prices following the terms of trade boom. Sustained low inflation outcomes have also affected inflation expectations and wage setting in recent years. Additionally, while the unemployment rate has fallen, broader measures of labour underutilisation indicate that there remains spare capacity in the labour market. Additional capacity has also been found outside the labour force, with strong employment growth helping to draw in people who were not previously looking for work.

Year-ended **consumer price inflation** is forecast to increase from 2 per cent in 2018-19 to 2¼ per cent in 2019-20. Over the past year, higher fuel and tobacco prices have exerted upward pressure on inflation. However, a combination of slow growth in labour costs, subdued increases in dwelling rents and heightened competition in the retail sector has continued to weigh on consumer prices. Slower growth in administered prices, largely a result of child care policy changes introduced in July, contributed to a subdued inflation outcome for the September quarter. The inflation forecasts are ¼ of a percentage point lower in both 2018-19 and 2019-20 compared with the 2018-19 Budget forecasts, reflecting recent outcomes and a more gradual forecast pick-up in wage growth.

The forecasts of the terms of trade and nominal GDP are sensitive to assumptions about **commodity prices**. The iron ore spot price is assumed to be US$55 per tonne free-on-board (FOB) over the forecast period. This is consistent with the price assumption at Budget.

Prices for thermal and metallurgical coal have been higher than expected since Budget. But in recent years there has been heightened volatility in world commodity prices and significant uncertainty around policy changes in China. In view of these factors, and current uncertainties in the global economic outlook, prudent assumptions for coal prices have been retained. The metallurgical coal price is assumed to decline to US$120 per tonne FOB through the March and June quarters of 2019, later than assumed at Budget. The thermal coal price is assumed to be US$93 per tonne FOB over the forecast period, unchanged from Budget.

Volatility in commodity price movements remains a significant source of uncertainty in the outlook for nominal GDP. Box B provides an indication of how nominal GDP and tax receipts could be affected by altered timing around the metallurgical coal price assumption. Further details on how movements in commodity prices can affect the Australian economy are detailed in Attachment A.

Box B — Sensitivity analysis: metallurgical coal price

If the metallurgical coal price were to fall immediately to US$120 per tonne FOB, two quarters earlier than assumed, nominal GDP could be around $4.4 billion lower than forecast in 2018-19 and $1.6 billion lower in 2019-20. This would have a negative flow-on impact to company tax receipts estimated at around $0.3 billion in 2018-19 and $1.0 billion in 2019-20 (Table A).

By contrast, if the metallurgical coal price remained elevated for two quarters longer than currently assumed, before falling immediately to US$120 per tonne FOB, nominal GDP could be around $2.5 billion higher than forecast in 2018-19 and $3.5 billion higher in 2019-20. This would have a flow on impact to company tax receipts estimated at around $0.2 billion in 2018-19 and $1.0 billion in 2019-20. The actual impact on tax receipts may vary due to timing of tax collections and the availability of tax losses.

Table A: Sensitivity analysis of an earlier and later step down in the metallurgical coal spot price

	Later fall to US$120/tonne FOB[(a)]		Earlier fall to US$120/tonne FOB	
	2018-19	2019-20	2018-19	2019-20
Nominal GDP ($billion)	2.5	3.5	-4.4	-1.6
Tax receipts ($billion)	0.2	1.0	-0.3	-1.0

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

The **terms of trade** are forecast to rise by 1¼ per cent in 2018-19 and fall by 6 per cent in 2019-20. Stronger-than-assumed commodity prices in the period since Budget contribute to the higher terms of trade in 2018-19, while the fall in the terms of trade in 2019-20 is consistent with assumed declines in commodity export prices.

Nominal GDP is forecast to grow by 4¾ per cent in 2018-19 and 3½ per cent in 2019-20. The growth forecast for 2018-19 is higher than the forecast in the 2018-19 Budget, reflecting the upgrade to the forecast for the terms of trade. An assumed decline in commodity prices and lower growth in domestic prices contribute to weaker forecast growth in nominal GDP in 2019-20. However, the level of nominal GDP remains higher over the forecast period than at Budget.

There are inherent **uncertainties** in the forecasts. In addition to risks around the international outlook, there are also domestic risks. The outlook for household consumption and business investment is uncertain, with both upside and downside surprises possible. The duration and severity of the drought in parts of southern and eastern Australia is another important source of uncertainty.

Weaker-than-expected wage growth and tightening credit conditions could cause consumer spending to be weaker than forecast. Housing price falls in parts of the country do not appear to have had a significant effect to date, but could dampen spending, especially if prices fall further. On the other hand, faster-than-forecast

employment growth would be expected to support stronger consumer spending, and this remains an upside risk to the growth outlook.

The risks around business investment remain broadly balanced. Non-mining business investment has rebounded strongly over the past two years notwithstanding a softer outcome in the September quarter of 2018. Sustained strength in business conditions and profits could contribute to a stronger-than-expected recovery in non-mining business investment over the forecast period. Counter-balancing these upside risks to the growth forecasts is the possibility that uncertainty around the global outlook could affect business confidence and investment plans.

The expected recovery from the current drought is a key uncertainty for the forecasts. If drought conditions were to deteriorate further, growth outcomes could be weaker than forecast. Equally, a faster-than-expected return to average seasonal conditions could lead to stronger economic outcomes.

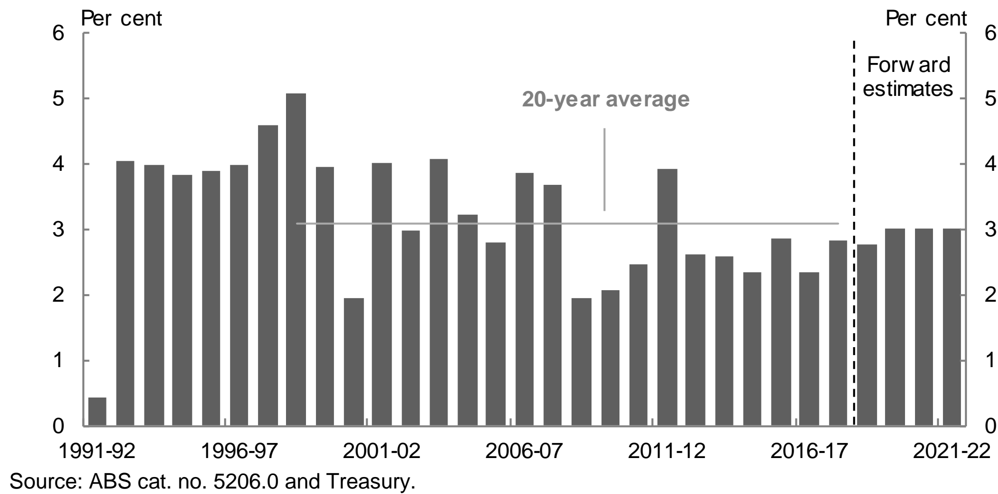
Commodity prices are an important source of uncertainty for the nominal GDP forecasts. Attachment A presents information on the estimated effect on the economy of a movement in the terms of trade.

Medium-term projections

The fiscal aggregates are based on detailed economic forecasts for the Budget year and the subsequent financial year. Economic projections then underpin the fiscal aggregates for the following two financial years. These projections are based on a medium-term methodology and some key assumptions.

The medium-term projection methodology, as outlined in the 2014-15 Budget, assumes that spare capacity in the economy at the end of the forecast period is absorbed over the following five years. Real GDP is projected to grow faster than potential over this five-year adjustment period, at 3 per cent a year from 2020-21. As this occurs, productivity, employment and the labour force participation rate are assumed to converge to their long-run sustainable levels. By the end of 2024-25, spare capacity in the economy is assumed to be completely absorbed. Real GDP is projected to grow at its potential growth rate thereafter.

Chart 2.1: Real GDP growth



Source: ABS cat. no. 5206.0 and Treasury.

The growth rate of potential GDP is currently estimated to be 2¾ per cent. The unemployment rate is projected to remain at 5 per cent over the medium term, consistent with estimates of the non-accelerating inflation rate of unemployment. Annual consumer price inflation is projected to be 2½ per cent, the midpoint of the RBA's medium-term target band. The terms of trade are projected to remain flat at around levels recorded in 2005 from 2021-22.

The medium-term economic and fiscal projections are sensitive to the assumptions that underpin Treasury's estimate of potential GDP and the pace at which the economy is assumed to return to potential. Analysis in the 2018-19 Budget presented the sensitivity of Budget projections to different assumptions about trend productivity growth — a key determinant of potential growth — and shorter or longer periods of adjustment back to potential output. This information is reported in Budget Paper No. 1 Statement 8: *Forecasting Performance and Scenario Analysis*.