

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 fundamentals of the Australian economy remain sound. Employment growth has been strong, the unemployment rate is at its lowest level in more than seven years and the participation rate is at a near-record high. Non-mining business investment growth is solid and economic growth is being supported by the roll-out of major public infrastructure projects across the country.

Real GDP is forecast to grow at around its estimated potential rate of 2¾ per cent in 2019-20 and 2020-21, sustaining solid employment growth and supporting a pick-up in wage growth. Household consumption, business investment, public final demand and exports are all expected to contribute to growth.

Internationally, there has been some loss of momentum in key economies including in the euro area, with the IMF and OECD revising down their growth projections for the global economy. However, global growth is expected to remain solid with strong labour market conditions evident across most advanced economies. The Australian economy is expected to continue to benefit from growth in major trading partners, with economies in the Asian region growing relatively strongly.

Accommodative monetary policy settings continue to support the domestic economy, despite some evidence of tightening credit conditions and a recent decline in housing prices, which appear to be weighing on activity. The Australian dollar remains at levels which are supportive of growth – around one-third lower than the 2011 peak against the US dollar.

Household consumption growth is expected to pick up over the forecast period, supported by continued growth in employment, increasing wage growth, historically low interest rates and the Government's personal income tax relief measures, which have been further enhanced in this Budget. More than 1.2 million jobs have been created since September 2013, driving the unemployment rate down to its lowest level in more than seven years. The participation rate is at a near-record high. Solid employment growth is expected to continue over the forecast period, with the unemployment rate forecast to be 5 per cent. As growth in the economy picks up and spare capacity in the labour market continues to be reduced, wage growth is expected to increase further.

Non-mining business investment is forecast to record solid growth, supported by historically low interest rates, while mining investment is expected to make its first positive contribution to real GDP growth in around seven years. Public final demand will also contribute to growth as the Government continues to provide essential services such as the National Disability Insurance Scheme and deliver on its \$100 billion infrastructure package.

Statement 2: Economic Outlook

Growth in exports in 2019-20 is expected to be supported by major liquefied natural gas (LNG) projects ramping up production along with continuing strong demand for education and travel services from Asia. Rural exports are expected to contribute to growth in 2019-20 on the basis of an assumed return to average seasonal conditions, after detracting from growth in 2018-19 due to the drought.

Dwelling investment, while remaining at a high historical level, is expected to detract from growth over the forecast period. The fall in housing prices accelerated over 2018 and continued into 2019, partly reflecting a rebalancing of supply and demand. As at February 2019, capital city housing prices had fallen by 8.6 per cent from their most recent peak in September 2017. Price falls were largest in Sydney and Melbourne over that period, although prices remain around 40 to 50 per cent higher in those cities relative to their 2012 levels.

Nominal GDP is forecast to grow by 5 per cent in 2018-19, 3¼ per cent in 2019-20 and 3¾ per cent in 2020-21. Nominal GDP growth is influenced by the terms of trade, which have been supported recently by higher-than-assumed commodity prices, in particular for iron ore and metallurgical coal. The terms of trade are forecast to fall in 2019-20, consistent with an assumed decline in key commodity prices. This is reflected in a moderation in nominal GDP growth.

As always there are a number of risks and uncertainties around the forecasts. Internationally, while some risks have lessened somewhat since the MYEFO, downside risks remain around trade tensions, emerging market debt vulnerabilities and geopolitical issues. The risks associated with Brexit have become more pronounced in recent months, although Australia's trade is oriented more towards Asia than Europe. In the near term, there is also uncertainty associated with how quickly some of the temporary factors that affected global growth in the second half of 2018, such as natural disasters in Japan, will dissipate.

Domestically, uncertainty about the outlook for the housing market, in particular the extent to which housing prices fall, poses a downside risk to the forecasts for both dwelling investment and consumption. A more subdued outlook for household income, or a further tightening in credit conditions, could constrain household spending amid high levels of household debt. In contrast, faster-than-expected wage or employment growth could lead to household consumption growth being stronger than forecast. There are also uncertainties around the pace of recovery in rural exports given that the outlook will depend on how weather conditions develop and how the sector recovers from recent drought and flood events.

The outlook for commodity prices is also a source of significant uncertainty for nominal GDP. Consistent with recent practice, the assumptions for these prices remain prudent. Further details on the effect of commodity price movements on nominal GDP and revenue forecasts are discussed in *Budget Statement 7: Forecasting Performance and Scenario Analysis*.

Table 1: Domestic economy forecasts ^(a)

	Outcomes(b)	Forecasts		
	2017-18	2018-19	2019-20	2020-21
Real gross domestic product	2.8	2 1/4	2 3/4	2 3/4
Household consumption	2.8	2 1/4	2 3/4	3
Dwelling investment	0.2	1/2	-7	-4
Total business investment(c)	6.0	1	5	4 1/2
<i>By industry</i>				
Mining investment	-4.1	-10 1/2	4	4 1/2
Non-mining investment	9.7	4 1/2	5 1/2	4 1/2
Private final demand(c)	3.0	1 1/2	2 1/4	2 3/4
Public final demand(c)	4.5	5 1/2	3 1/4	3
Change in inventories(d)	0.0	0	0	0
Gross national expenditure	3.4	2 1/2	2 1/2	2 3/4
Exports of goods and services	4.1	3 1/2	4	1 1/2
Imports of goods and services	7.1	1 1/2	3	2 1/2
Net exports(d)	-0.6	1/2	1/4	- 1/4
Nominal gross domestic product	4.7	5	3 1/4	3 3/4
Prices and wages				
Consumer price index(e)	2.1	1 1/2	2 1/4	2 1/2
Wage price index(f)	2.1	2 1/2	2 3/4	3 1/4
GDP deflator	1.8	2 1/2	1/2	1
Labour market				
Participation rate (per cent)(g)	65.6	65 1/2	65 1/2	65 1/2
Employment(f)	2.7	2	1 3/4	1 3/4
Unemployment rate (per cent)(g)	5.4	5	5	5
Balance of payments				
Terms of trade(h)	1.9	4	-5 1/4	-4 3/4
Current account balance (per cent of GDP)	-2.8	-1 3/4	-2 3/4	-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 falling over the year to reach US\$55 per tonne free-on-board (FOB) by the end of the March quarter 2020; metallurgical coal spot price falling over the year to reach US\$150 per tonne FOB by the end of the March quarter 2020; and the thermal coal spot price remaining at US\$91 per 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 61 and a US\$ exchange rate of around 71 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. Population growth is assumed to average around 1.7 per cent per year over the forecast period.

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

OUTLOOK FOR THE INTERNATIONAL ECONOMY

Global growth strengthened in 2017 and into 2018, with a pick-up in activity in advanced, emerging market and developing economies leading to an economic expansion estimated to be around 3.7 per cent in both of these years. However, some moderation in growth occurred in the second half of 2018 as the expansion matured in the advanced economies, and as some emerging markets, such as Turkey and Argentina, experienced difficulties. Global growth is forecast to be 3½ per cent in 2019, 2020 and 2021.

A slight downgrade to the forecast for global growth compared with the MYEFO largely reflects slowing growth outside of Australia's major trading partners. Major trading partner growth is forecast to be 4 per cent in 2019, 2020 and 2021. Growth in Australia's major trading partners has outpaced global growth over the past decade and this is expected to continue over the forecast horizon as growth in the Asian region remains relatively strong.

Global labour market conditions continue to be robust. Unemployment rates in the United States, euro area and Japan are all near record lows. There has been an increase in wage growth in the United States after a number of years of modest growth, reflecting the strong labour market, and wage growth has picked up in the euro area and Japan. US non-farm labour productivity also rose solidly in 2018. Core inflation increased slightly in the US and the US Federal Reserve tightened monetary policy through 2018. Inflation remains relatively contained in major advanced economies compared with historical experience. Headline inflation has eased in response to the decline in global oil prices between October and December 2018.

There is a high degree of uncertainty around the global growth outlook amid a range of economic and geopolitical risks that continue to evolve. This uncertainty appears to be weighing on measures of global confidence, which have been falling in recent months. Some risks have lessened somewhat since the MYEFO, notably those from a further escalation in trade tensions between the US and China and those associated with tightening monetary policy. Others, such as risks around the Italian financial sector, are largely unchanged, while the risks associated with Brexit have become more pronounced in recent months, noting that Australia's trade is oriented more towards Asia than Europe. In the near term, there is also uncertainty associated with how quickly some of the temporary factors that affected global growth in the second half of 2018, such as natural disasters in Japan, will dissipate.

There have been recent signs that an escalation of trade tensions between the US and China is less likely; however, trade policy uncertainty remains elevated between a number of economies and global trade growth has eased. This uncertain outlook for trade tensions has been weighing on confidence, new export orders and investment intentions. Escalation of tensions would be expected to negatively affect growth in a number of countries including in Australia's major trading partners. Conversely, a resolution of tensions could result in global growth that is stronger than forecast.

Financial markets are now expecting monetary policy to remain accommodative or neutral for longer than previously. In particular, the indication by the US Federal Reserve that it will be patient as it determines future policy adjustments helped stabilise financial markets. This has lessened the risks associated with emerging economy debt in the near term, but high debt levels in certain economies and certain market segments remain a risk in the medium term.

Over the longer term, unfavourable demographics will constrain potential growth rates in some of the world's major economies. Slower productivity growth could also limit productive capacity in many countries. Future global productivity growth will depend on the dispersion of technology, the mobility of capital and the degree of openness and competition maintained across economies.

Table 2: International GDP growth forecasts ^(a)

	Outcomes		Forecasts	
	2018	2019	2020	2021
China	6.6	6	6	5 3/4
India	7.3	7 1/2	7 3/4	7 3/4
Japan	0.8	1	3/4	3/4
United States	3.0	2 1/4	2	1 3/4
Euro area	1.8	1 1/4	1 1/2	1 1/2
Other East Asia (b)	4.3	4 1/4	4 1/4	4 1/4
Major trading partners (c)	4.2	4	4	4
World (c)	3.7	3 1/2	3 1/2	3 1/2

(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.

(c) These growth rates are estimates in 2018 rather than outcomes.

Source: National statistical agencies, Refinitiv, International Monetary Fund and Treasury.

The **United States** economy continues to grow solidly. Most leading indicators remain favourable, suggesting that above-potential growth will be sustained in 2019, albeit at a slower pace as the effects of fiscal stimulus diminish. The recent government shutdown is not expected to have a material impact on annual average growth rates, but will shift growth between quarters, with growth expected to pick up from the second quarter with the resumption of usual operations. Wage growth has picked up and inflation has increased slightly, closer to the target rate.

Growth in **China** slowed to 6.6 per cent in 2018, consistent with the authorities' target. The slowing largely reflected weaker domestic demand as authorities addressed risks in the financial system and trade pressures weighed on business confidence. These factors are expected to continue to weigh on growth through 2019, despite some targeted support from macroeconomic policies. There are signs of weakness in China's trade outlook, reflecting both trade tensions and a softer global outlook. Despite these factors, China is expected to meet the authorities' target of 6.0 to 6.5 per cent growth in 2019. A softening of growth is expected from 2021, reflecting the longer-term structural adjustments that China faces, including a declining working-age population.

India experienced a moderation in growth in the second half of 2018, reflecting higher global oil prices between August and October, tighter financial conditions and lower consumer sentiment. Considering these developments, the Reserve Bank of India cut its policy rate and changed its policy stance to neutral in February. Further focus on GST compliance, bringing more firms into the formal economy, and progress on non-performing asset resolutions are expected to lift growth outcomes for 2020 and 2021. Looking forward, India's economic growth will depend on its reform agenda following the national elections in the first half of 2019.

Japan's growth is expected to pick up slightly in 2019 to 1 per cent following a disrupted 2018. However, a planned increase in value-added tax in October 2019 is expected to weigh on private consumption. Real GDP growth is forecast to moderate in 2020 as capacity constraints become more binding, despite a small boost in demand from hosting the Tokyo 2020 Olympics. Alongside a steady tightening of labour market conditions and accommodative monetary policy settings, wage growth has picked up over the past few years. Core inflation is positive but continues to remain more muted than expected given the tightening in labour market conditions.

Growth in the **euro area** slowed in late 2018. While some temporary factors weighed on growth, such as political uncertainty as well as revised auto emission standards and drought in Germany, there was also a broad-based weakening in momentum which is expected to persist in the near term. Industrial output has softened, owing to reduced external demand and weaker trade growth. Sentiment across the region has also been easing, which is expected to weigh on business investment going forward. On the other hand, domestic demand is expected to be supported by historically low interest rates, improved labour market conditions and slightly expansionary fiscal policy. Ongoing uncertainty related to geopolitical factors, the threat of protectionism, management of financial sector risks in Italy and continued uncertainty over Brexit, including the possibility of the United Kingdom leaving the European Union without an agreement in place, remain risks for euro area growth.

ASEAN-5 economies continue to perform solidly, with domestic demand and favourable demographics supporting growth. The near-term risks associated with the withdrawal of supportive monetary policy settings globally have eased somewhat. However, the ASEAN-5 economies face some challenges this year, including moderating global trade growth and election uncertainty.

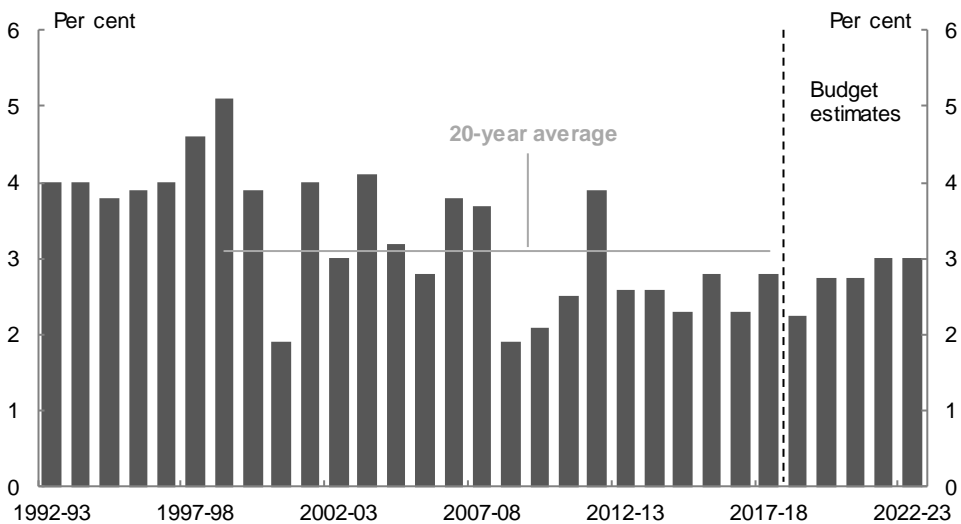
OUTLOOK FOR THE DOMESTIC ECONOMY

Outlook for real GDP growth

The fundamentals of the Australian economy remain sound. Real GDP is forecast to grow at around its estimated potential rate of 2¾ per cent in 2019-20 and 2020-21 (Chart 1). Household consumption, business investment, public final demand and exports are all expected to contribute to growth. Following declines in housing prices and building approvals, partly in response to a rebalancing in supply and demand, dwelling investment is expected to detract from growth.

Solid employment growth is expected to continue over the forecast period and the unemployment rate is forecast to be 5 per cent. Wage growth is expected to pick up as growth in the economy strengthens and spare capacity in the labour market continues to be reduced.

Chart 1: Real GDP growth



Source: ABS cat. no. 5206.0 and Treasury.

Households

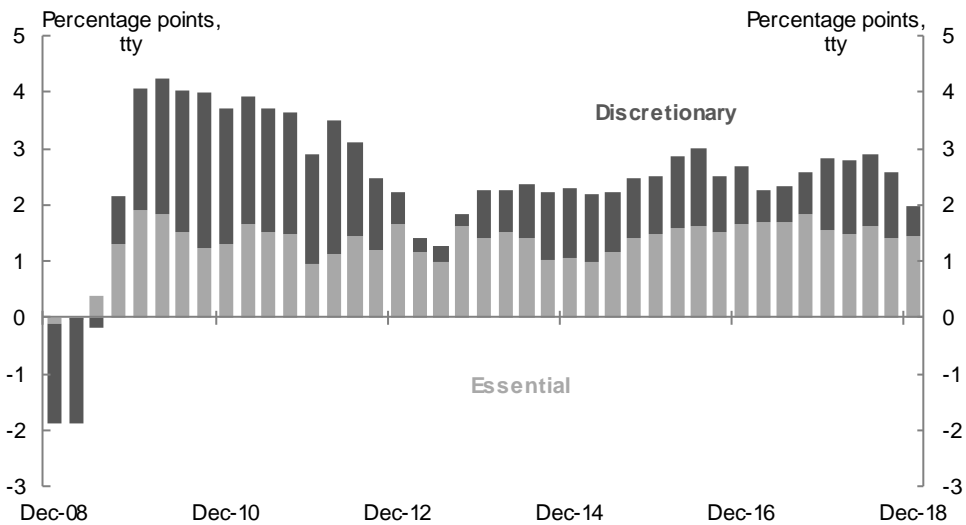
Household consumption growth moderated in the second half of 2018. Consumption of discretionary items was particularly soft, including for those that relate to housing market conditions, such as household furnishings and motor vehicles (Chart 2). The forecast for consumption growth has been downgraded to 2¼ per cent in 2018-19. However, household consumption growth is forecast to pick up to 2¾ per cent in 2019-20 and 3 per cent in 2020-21, underpinned by continued growth in employment and increasing wage growth. Household disposable income and consumption growth are also expected to be supported by continued low interest rates and the Government's personal income tax relief measures, which have been further enhanced in this Budget. The household saving ratio is expected to be broadly steady over the forecast period.

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There is uncertainty, however, about the extent to which the outlook for the housing market will influence overall household consumption (Box 1). Housing price falls accelerated over 2018 and have continued into 2019. As at February 2019, capital city housing prices had fallen by 8.6 per cent from their most recent peak in September 2017. Price falls were largest in Sydney and Melbourne over that period, although prices remain around 40 to 50 per cent higher in those cities relative to 2012. The price falls partly reflect an increase in housing supply in recent years following a period of under-building relative to population growth. Demand has also declined from a tightening in credit conditions, including from macro-prudential measures to address credit quality, and a reduction in demand from overseas buyers.

A more subdued outlook for household income, or a further tightening in credit conditions could constrain household spending amid high levels of household debt. By contrast, faster-than-expected wage or employment growth could lead to household consumption being stronger than forecast. The sensitivity of the forecasts to changes in household consumption is discussed in Budget Statement 7.

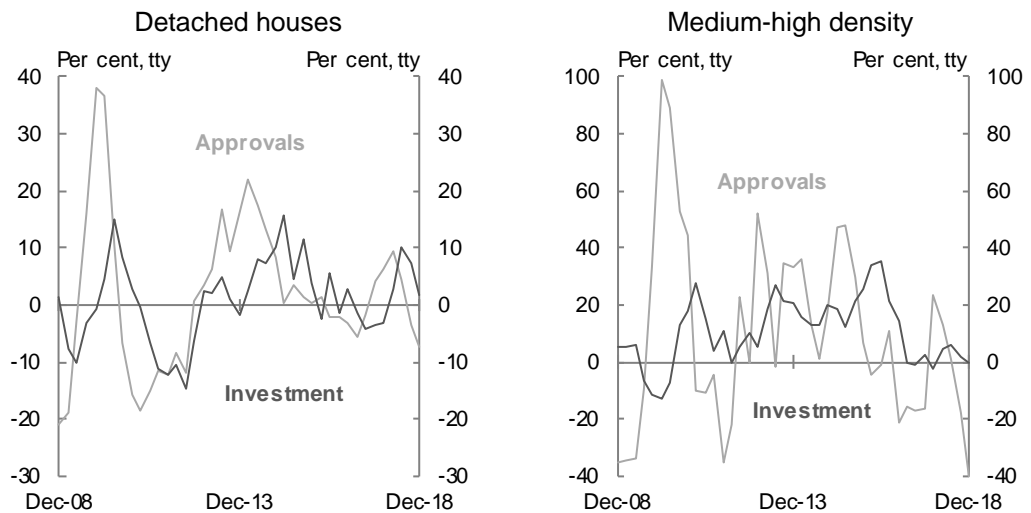
Chart 2: Household consumption growth contributions



Source: ABS cat. no. 5206.0, ABS unpublished data and Treasury.

Housing price declines have also affected the outlook for **dwelling investment**. As at January 2019, residential building approvals had fallen by almost 40 per cent relative to late 2017, with the fall concentrated in higher-density projects (Chart 3). Liaison with industry suggests that softer investment intentions reflect both tighter credit conditions and a weakening in sentiment amongst buyers. Nonetheless, a compositional shift towards higher-density dwellings, which can take almost three times as long as houses to complete, has resulted in a solid pipeline of work yet to be done. This pipeline of work is expected to support dwelling investment activity in 2018-19, with forecast growth of ½ per cent, following average annual growth of 5.5 per cent over the previous five years. Dwelling investment is then forecast to fall by 7 per cent in 2019-20 and by a further 4 per cent in 2020-21 as existing projects are completed.

Chart 3: Dwelling approvals and investment growth by sector



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

Box 1: Housing prices, consumption and investment

Buying a dwelling is the largest financial decision made by most households. Housing assets account for around half of total household assets in Australia, and borrowing for housing accounts for the majority of household debt. Overall, Australian households have a ‘net asset’ position in housing, which has strengthened substantially over the past five years. Positive housing wealth is a source of collateral for household borrowing. Changes in housing prices also affect the expected returns to building new dwellings. As such, movements in housing prices can directly influence household consumption and investment in the short to medium term, with flow-on effects to the broader economy.

One of the main channels through which housing prices affect demand in the economy is through dwelling investment. This is because movements in housing prices alter the expected returns to residential construction. Dwelling investment and housing price growth also move together due to the influence of common factors such as interest rates (Chart A). To the extent that housing turnover is affected, movements in housing prices also affect spending on household goods such as furnishings. Further, housing price movements can affect consumption by reducing or increasing borrowing constraints through changes to collateral, affecting confidence and expected future income growth, or by shifting the distribution of wealth. Some households will have more resources to spend if housing prices rise, while other households will have to spend more on a dwelling over their lifetime, and thus less on other goods and services.

Chart A: Housing prices and dwelling investment growth



Note: Housing prices reflect quarterly averages of monthly data for the eight capital cities combined.
 Source: ABS cat. no. 5206.0 and CoreLogic.

Box 1: Housing prices, consumption and investment (continued)

There are other channels through which housing prices can affect the economy. For example, the incomes of real estate agents are correlated with housing prices and turnover, as are state government revenues from stamp duty. Changes in housing prices can also affect the borrowing capacity of small and medium-sized businesses given that housing wealth is often used as collateral. Changes to individual components of demand can have flow-on effects to other areas of the economy, including demand for imports and employment, prices and wages.

The precise magnitude of the effect of housing prices on the economy is difficult to estimate as it will vary depending on the reason prices are shifting and other conditions in the economy at the time.

The recent decline in Australian housing prices has followed several years of strong price growth and, unusually, is occurring alongside generally strong labour market conditions, rising incomes, and low interest rates. This adds uncertainty around the estimated response of consumption. In addition, the compositional shift towards the construction of higher-density dwellings, which has changed how the pipeline of work flows through to activity, increases uncertainty around the dwelling investment response.

A plausible central estimate is that housing prices that are (immediately) 10 per cent lower than they otherwise would be due to a reduction in demand for dwellings could result in the level of real GDP being lower by about ½ per cent after two years. Importantly, this estimate is based on the historical relationship between the relevant variables, makes assumptions about the composition of dwellings affected and does not account for any moderating influences from macroeconomic policy settings in response to lower demand.

In the long run, however, changes in housing prices should have a limited effect on the size of the economy. Changes in the relative price of one asset, housing, over another have not been shown to have a strong relationship with aggregate productivity, participation or population – the long-run determinants of economic growth.

Business investment

Business investment is expected to continue to be supported by historically low interest rates, positive business conditions, and the lower Australian dollar. Business investment is forecast to grow by 5 per cent in 2019-20 and 4½ per cent in 2020-21. While falling mining investment will continue to drag on growth in the near term, it is expected to grow by 4 per cent in 2019-20, as mining companies invest to maintain their large capital stocks and sustain current production levels. This will be its first contribution to real GDP growth in around seven years.

Following robust growth of 9.7 per cent in 2017-18, non-mining business investment is expected to grow steadily over the forecast period. The latest ABS capital expenditure survey showed a firming in non-mining business investment intentions for 2018-19. Although recent survey measures suggest that business conditions have softened from their record highs over 2018, they remain positive, and an elevated pipeline of building and engineering work is expected to support growth in 2019-20. Non-mining business investment is expected to grow by 5½ per cent in 2019-20 and 4½ per cent in 2020-21.

While steady growth in non-mining business investment is expected to continue, there are some risks. Further declines in business conditions and confidence would weigh on the outlook. In contrast, business investment could benefit from additional opportunities arising from large public infrastructure projects.

Box 2: Non-mining business investment

Business investment is an important driver of labour productivity as it increases the capital available per worker and can facilitate the uptake and diffusion of technology across the economy. This raises the demand for labour and results in higher real wages and higher employment as businesses seek to fully utilise the capital stock and maximise output. Following the peak in mining investment in 2012-13, non-mining business investment experienced a period of weak growth and this was a source of uncertainty for the economic outlook.

Over the past two years, there has been an encouraging pick-up in non-mining business investment (Chart A). This pick-up in growth occurred alongside an increase in business conditions which reached record levels in 2018. Non-mining business investment grew by 6.9 per cent in 2016-17 and a further 9.7 per cent in 2017-18, its fastest pace in over a decade. This compares with average annual growth of 1.5 per cent over the preceding ten years.

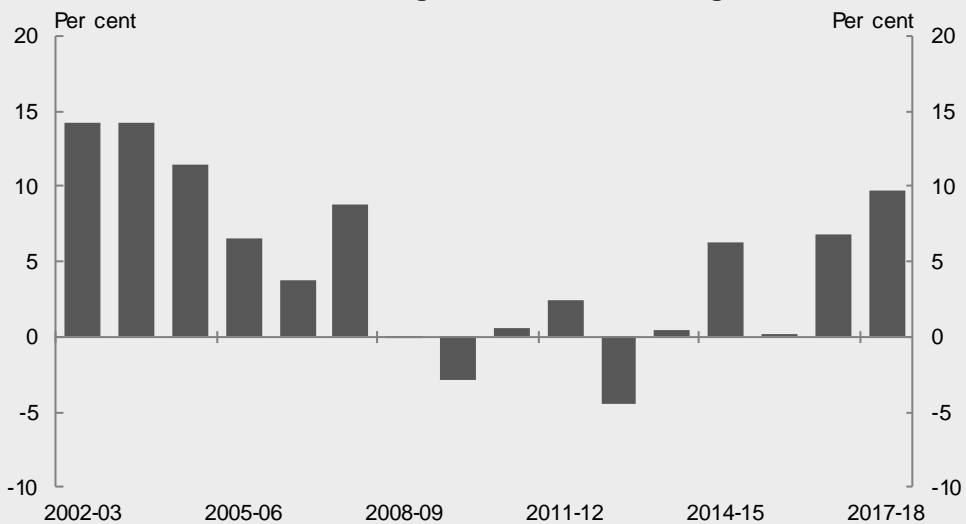
Although most components of business investment have contributed to growth since 2013-14, investment in non-residential buildings made a particularly large contribution. Growth has been supported in recent years by investment in hotels and aged care facilities, while office building activity improved in 2017-18 notably in Victoria and New South Wales. Recent strength in office construction activity has occurred in response to tightness in office property markets in those states.

Box 2: Non-mining business investment (continued)

Growth in business investment in intellectual property products has also been solid in recent years, led by investment in computer software. Businesses have been investing in technology to improve their processes, including data management processes, and to increase their online presence. Investment in computer software grew by over 13 per cent in 2017-18. This was higher than the average annual growth of around 9 per cent over the past decade.

There has also been a pick-up in machinery and equipment investment in recent years, with growth of almost 7 per cent in 2017-18. This largely reflects investment in the non-mining sector, with businesses taking advantage of opportunities in the construction sector, including from public infrastructure investment.

Chart A: Non-mining business investment growth



Source: ABS cat. no. 5206.0, ABS unpublished data and Treasury.

Public final demand

Public final demand has been a source of strong growth for the economy over the past three years, with solid contributions from both public consumption and investment. Growth is expected to continue to be strong in 2018-19 before moderating to 3¼ per cent in 2019-20 and 3 per cent in 2020-21. Contributions to growth are expected to come from the Government's expenditure on the National Disability Insurance Scheme and its \$100 billion infrastructure package roll-out, which is supporting and complementing investment by the states and territories.

Net exports

Exports are forecast to grow by 4 per cent in 2019-20, driven by mining and services exports. Mining exports are forecast to grow by 4½ per cent as major liquefied natural gas (LNG) projects ramp up production, and services exports are forecast to grow by 4½ per cent as demand from Asia continues to support tourism and education exports. Rural exports are forecast to increase by 2½ per cent in 2019-20 on the basis of a return to average seasonal conditions following the drought-affected fall of 8 per cent in 2018-19. However, growth in rural exports and farm production overall will depend on how weather conditions develop and how the sector recovers from recent drought and flood events (Box 3).

Export growth is forecast to slow to 1½ per cent in 2020-21, largely as growth in mining exports slows. Iron ore export volumes are expected to have increased by 12 per cent over the five years to 2020-21, while LNG export volumes are expected to have doubled. Recent high bulk commodity prices which have arisen as a result of global supply issues are not expected to generate a significant supply response from Australian producers – there is little spare capacity in the domestic market at present and prices are not expected to be sustained for a sufficiently long period to warrant a significant expansion of capacity. Mining exports are forecast to grow by ½ per cent in 2020-21, while services exports are forecast to grow by 3½ per cent and rural exports by 4 per cent.

Imports are expected to grow moderately over the forecast period, with capital imports forecast to grow at rates slower than those experienced recently, given that the investment phase for the remaining major LNG projects is close to complete. Imports are forecast to grow by 3 per cent in 2019-20 and 2½ per cent in 2020-21.

Box 3: Economic impact of weather events

Drought conditions in southern and eastern Australia are weighing on real GDP growth. Based on the latest information from the Australian Bureau of Agricultural and Resource Economics and Sciences, the fall in farm production is expected to detract around $\frac{1}{4}$ of a percentage point from real GDP growth in 2018-19, consistent with the MYEFO forecast. *2018-19 MYEFO Part 2: Economic outlook Box A – Impact of the drought on agricultural production and rural exports* outlined the expected effect of the drought on the economy. Assuming seasonal conditions improve, farm production is forecast to recover in 2019-20 with increased crop output partly offset by a decline in livestock slaughter as herds and flocks are rebuilt.

Another significant weather event saw severe flooding in north Queensland in February 2019, resulting in widespread damage across the region. It has significantly affected the local agricultural industry, and had some impact on mining and tourism activity. The Government is committed to supporting individuals, communities and local economies to help them recover and rebuild following natural disasters and periods of severe drought.

While it will be some time before the full extent of the flood damage is known, 300,000 dead cattle would account for around 3 per cent of the Queensland herd and 1 per cent of the Australian herd. A large proportion of stock losses are expected to be breeding stock, due to the nature of the grazing enterprises in the affected region and the run of below-average dry seasons leading up to the floods. Farming infrastructure has also been damaged or destroyed in the floods.

Sugar cane yields may also be affected. The record rainfall that led to flooding in the region has affected the industry just months after the Mackay region was devastated by bushfires. Other crops in the region are also expected to be negatively affected, both from lost output and transport disruptions.

Two of the northern-most mines in Queensland were impacted by the floods. Glencore's production was temporarily affected by heavy rain at Collinsville and Newlands. The Abbot Point coal export terminal – a major coal export hub – was also closed for around nine days. These temporary closures had a minimal impact on overall operations and production.

The tourism sector was affected as certain tourism operators along the coast had to temporarily curtail their operations. Damage to infrastructure may also contribute to some disruption in the short term.

While the regional and industry specific impacts of the floods are material, the impact on the overall economy is expected to be relatively modest.

More recently, tropical cyclones Veronica and Trevor have resulted in evacuations, flooding and damage. Cyclone Veronica has caused temporary halts to commodity exports from Western Australia, in particular iron ore. It is often the case that tropical cyclones occur in the March quarter.

The labour market

Labour market conditions in Australia continue to be strong. Employment growth has been above its long-run average rate for almost two years and has outpaced population growth. The unemployment rate has fallen to 4.9 per cent, its lowest level in more than seven years (Chart 4). The participation rate is also high relative to historical standards and the employment-to-population ratio for those aged 15-64 is close to record highs (Chart 5). Solid growth in output is expected to continue to support employment growth at 1¾ per cent through the year to the June quarter 2020 and the June quarter 2021. The participation rate is forecast to be 65½ per cent, consistent with continuing strong employment prospects. The unemployment rate is forecast to be 5 per cent across the forecast period.

Chart 4: Unemployment rate

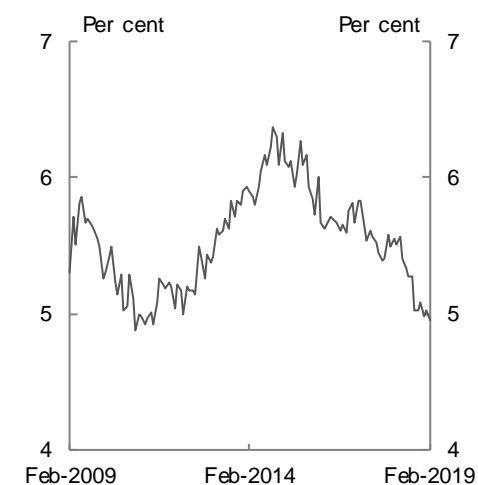
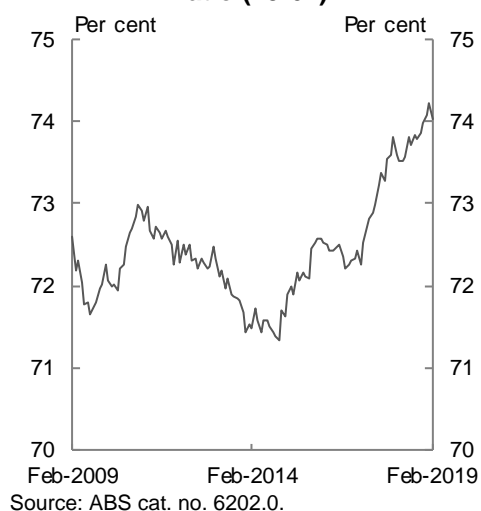


Chart 5: Employment-to-population ratio (15-64)



As economic growth strengthens and spare capacity in the labour market continues to be reduced, **wage growth** is expected to pick up to 2¾ per cent through the year to the June quarter 2020 and 3¼ per cent through the year to the June quarter 2021. Growth in the Wage Price Index was 2.3 per cent through the year to the December quarter 2018, its equal strongest outcome in more than three years. All states and territories and most industries recorded higher wage growth compared with a year ago. 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. This is partly explained by lower inflation expectations and spare capacity in the labour market as indicated by broader measures of labour underutilisation. Strong employment growth has also drawn people into the labour market who were not previously looking for work. In Australia, slower wage growth also reflects adjustments associated with the unwinding of the terms of trade boom.

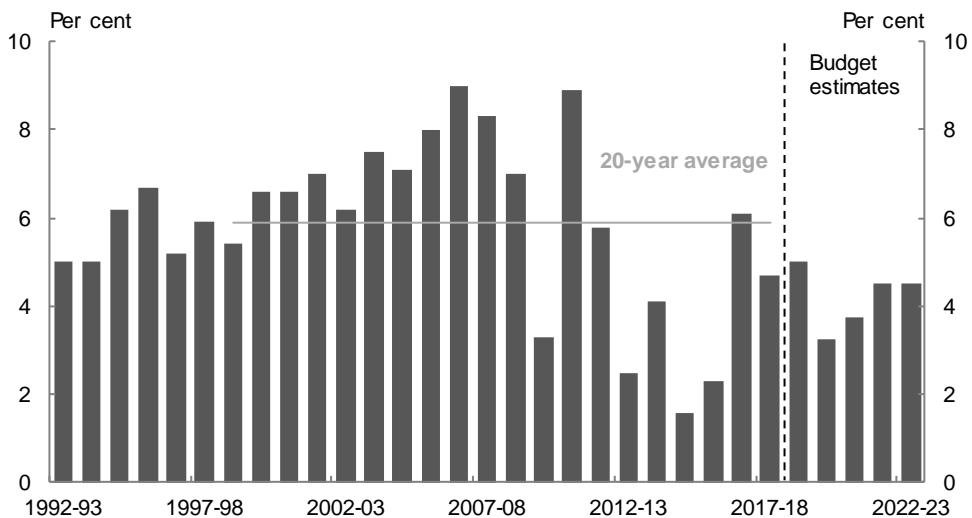
Consumer price inflation has eased a little over recent quarters and was 1.8 per cent through the year to the December quarter 2018. A slowing in administered price inflation, partly reflecting child care policy changes and lower growth in electricity prices, has contributed to softer inflation recently. Housing prices, including both dwelling rents and the cost of building a new dwelling, have also contributed to lower inflation. In contrast, the depreciation of the Australian dollar and associated increase in tradable inflation has put upward pressure on prices over the past year. In the near term, lower petrol prices are expected to reduce inflation. Inflation is expected to increase over the forecast period as growth in the economy picks up and spare capacity in the labour market continues to be reduced. Consumer price inflation is forecast to be 2¼ per cent through the year to the June quarter 2020 and 2½ per cent though the year to the June quarter 2021.

Outlook for nominal GDP growth

Nominal GDP is forecast to grow by 5 per cent in 2018-19, 3¼ per cent in 2019-20 and 3¾ per cent in 2020-21 (Chart 6). The moderation in growth in 2019-20 reflects a fall in the terms of trade as key commodity prices are assumed to decline to more sustainable levels. This is partially offset by a pick-up in real GDP growth and in wage and domestic price growth.

The level of nominal GDP is expected to be around \$42.7 billion lower over the four years to 2022-23 compared with the 2018-19 MYEFO, with downgrades to the outlook for compensation of employees, non-mining profits and gross mixed income. This is partially offset by an upgrade to the outlook for mining profits.

Chart 6: Nominal GDP growth

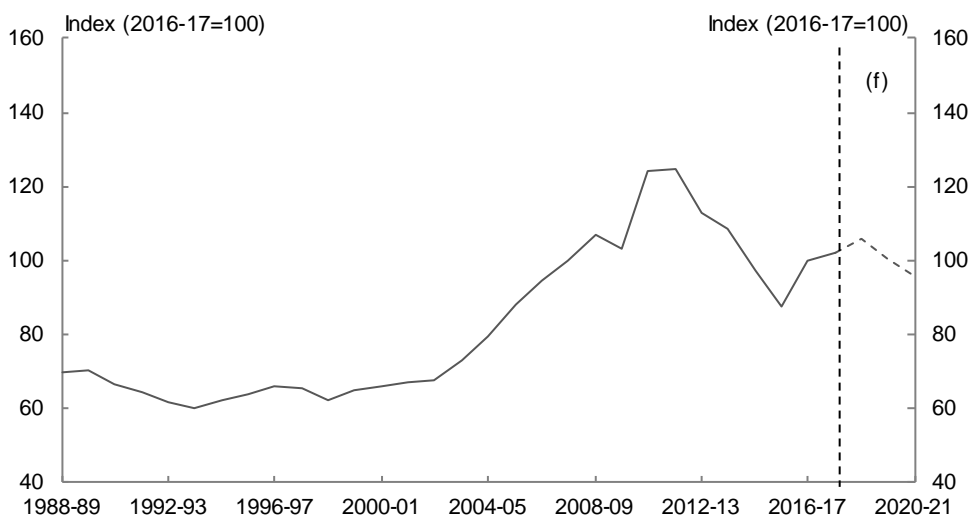


Source: ABS cat. no. 5206.0 and Treasury.

Wage and price growth are expected to increase over the forecast horizon reflecting the pick-up in economic growth and the continued reduction of spare capacity in the labour market. If inflation and wage growth outcomes are lower than forecast, slower nominal GDP growth would constrain taxation receipts, though this will be partially offset by a fall in payments. For example, if inflation outcomes were ½ of a percentage point lower in each of 2019-20 and 2020-21, the direct impact on the level of nominal GDP could result in it being around 0.8 per cent lower than forecast by 2020-21, resulting in a deterioration in the underlying cash balance of around \$2.7 billion by 2020-21.

The terms of trade are expected to support nominal GDP growth in 2018-19, but to detract from growth in 2019-20. The near-term strength in the terms of trade reflects higher iron ore and metallurgical coal prices. The terms of trade are expected to fall in 2019-20, as supply and demand rebalance in these markets (Chart 7). The assumptions regarding commodity prices are supported by comprehensive market and industry consultation undertaken by Treasury. There is greater uncertainty than usual around commodity prices as a result of heightened price volatility and policies in China and Brazil. As such, a prudent approach to the bulk commodity price assumptions continues to be appropriate.

Chart 7: Terms of trade



Note: (f) are forecasts.

Source: ABS cat. no. 5206.0 and Treasury.

The iron ore price remained relatively steady during much of 2018, but the tailings dam collapse in Brazil resulted in the price reaching its highest level since early 2017. There are a wide range of market estimates around the impact of the dam collapse and subsequent policy actions in Brazil on the global supply of iron ore. Consultation by Treasury highlighted a relatively common view that the iron ore price will remain elevated over the next four quarters, and that the spot price is expected to decline as supply-side issues are addressed. As such, the iron ore price is assumed to decline over

the year to reach US\$55 per tonne free-on-board (FOB) by the end of the March quarter 2020. Some market and industry participants have highlighted a risk that prices could remain high for an even longer period of time.

The metallurgical coal price remained high during 2018, with an average price of over US\$200 per tonne FOB. Market and industry consultation undertaken by Treasury supports the view that prices will decline from recent highs, but that the MYEFO assumption of a decline in the price to US\$120 per tonne FOB is now too low. The metallurgical coal price has averaged around US\$200 per tonne since the 2016-17 MYEFO (when the US\$120 per tonne assumption was first implemented) and was last below US\$120 per tonne in August 2016. As such, consistent with market and industry participants' views, the metallurgical coal price is assumed to decline over the year to reach US\$150 per tonne FOB by the end of the March quarter 2020.

During 2018, the thermal coal spot price ranged from around US\$90 per tonne to US\$125 per tonne. The thermal coal price was affected by both supply and demand factors during the year, including constrained supply of high-grade Australian coal and unseasonably hot weather in China in the middle of the year. The thermal coal price is assumed to remain around recent levels of US\$91 per tonne FOB over the forecast period, which is close to the MYEFO assumption of US\$93 per tonne FOB. Policies affecting clearances at Chinese ports, however, are a source of uncertainty for coal prices.

Commodity prices are volatile and the outlook for commodity prices remains a key uncertainty in the outlook for nominal GDP (Box 4).

Box 4: Sensitivity analysis of the iron ore and metallurgical coal spot prices

Movements in commodity prices can have significant effects on nominal GDP and Commonwealth government tax revenue. The analysis below provides an indication of the direct impacts on nominal GDP and company tax receipts of altering the timing around the iron ore and metallurgical coal price assumptions.

If the iron ore price was to fall immediately to US\$55 per tonne FOB, four quarters earlier than assumed, nominal GDP could be around \$5.8 billion lower than forecast in 2018-19 and \$10.6 billion lower in 2019-20. This would result in a decrease in tax receipts of around \$0.5 billion in 2018-19, \$2.6 billion in 2019-20 and \$1.0 billion in 2020-21 (Table A).

By contrast, if the iron ore price was to remain elevated for four quarters longer than currently assumed, before falling immediately to US\$55 per tonne FOB, nominal GDP could be around \$0.8 billion higher than forecast in 2018-19 and \$15.5 billion higher in 2019-20. This would result in an increase in tax receipts of around \$0.1 billion in 2018-19, \$2.0 billion in 2019-20 and \$2.1 billion in 2020-21.

Box 4: Sensitivity analysis of the iron ore and metallurgical coal spot prices (continued)**Table A: Sensitivity analysis of an earlier and later fall in the iron ore spot price**

	Earlier fall to US\$55/tonne FOB			Later fall to US\$55/tonne FOB ^(a)		
	2018-19	2019-20	2020-21	2018-19	2019-20	2020-21
Nominal GDP (\$billion)	-5.8	-10.6	-	0.8	15.5	-
Tax receipts (\$billion)	-0.5	-2.6	-1.0	0.1	2.0	2.1

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

Source: Treasury.

Similarly, if the metallurgical coal price was to fall immediately to US\$150 per tonne FOB, four quarters earlier than assumed, nominal GDP could be around \$0.7 billion lower than forecast in 2018-19 and \$5.7 billion lower in 2019-20. This would result in a decrease in tax receipts of around \$0.1 billion in 2018-19, \$0.9 billion in 2019-20 and \$0.6 billion in 2020-21 (Table B).

By contrast, if the metallurgical coal price was to remain elevated for four quarters longer than currently assumed, before falling immediately to US\$150 per tonne FOB, nominal GDP could be around \$0.1 billion higher than forecast in 2018-19, \$6.1 billion higher in 2019-20 and \$0.3 billion higher in 2020-21. This would result in an increase in tax receipts of around \$0.6 billion in 2019-20 and \$1.0 billion in 2020-21.

Table B: Sensitivity analysis of an earlier and later fall in the metallurgical coal spot price

	Earlier fall to US\$150/tonne FOB			Later fall to US\$150/tonne FOB ^(a)		
	2018-19	2019-20	2020-21	2018-19	2019-20	2020-21
Nominal GDP (\$billion)	-0.7	-5.7	0.0	0.1	6.1	0.3
Tax receipts (\$billion)	-0.1	-0.9	-0.6	0.0	0.6	1.0

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

Source: Treasury.

Further analysis concerning how movements in commodity prices can affect the Australian economy and fiscal estimates is detailed in Budget Statement 7.

Medium-term projections

The fiscal aggregates in this year's Budget are underpinned by economic forecasts for the current financial year, 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 supply-side assumptions.

The medium-term projection methodology, as outlined in the 2014-15 Budget, assumes that any spare capacity in the economy is absorbed over five years following the forecast period. This is a well-established approach but it is not without drawbacks.

The growth rate of potential GDP is estimated to be $2\frac{3}{4}$ per cent over the next few years. As spare capacity is absorbed, productivity and labour market variables – including employment and the participation rate – are assumed to converge to their potential levels. To absorb the spare capacity in the economy, real GDP from 2021-22 is then projected to grow faster than potential at 3 per cent. By the end of 2025-26 spare capacity is absorbed and real GDP is projected to grow at its potential rate thereafter.

Potential GDP is estimated based on an analysis of underlying trends for population, productivity and participation. In the long run, estimates of participation are affected by demographic factors, including the ageing of the population, while productivity is assumed to grow at its 30-year average rate. The unemployment rate is projected to be 5 per cent consistent with estimates of the non-accelerating inflation rate of unemployment (NAIRU). Inflation is projected to be $2\frac{1}{2}$ per cent, consistent with the mid-point of the RBA's medium-term target band. The terms of trade are projected to remain flat at around their 2005 level from 2022-23. For a discussion of the sensitivity of the GDP growth projections to estimates of potential output, see Budget Statement 7.

