

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 has displayed remarkable resilience in the face of the COVID-19 pandemic. Following the first recession in almost 30 years over early 2020, the economy grew at its fastest pace on record over the latter half of the year and outperformed all major advanced economies in 2020. Labour market outcomes have surpassed even the most optimistic of expectations. With close to one million jobs added to the economy since May 2020, employment levels have more than recovered the losses seen through the pandemic to reach record highs. The peak in the unemployment rate is now expected to have passed and labour force participation has increased to a record high.

Together with the success in managing the spread of the COVID-19 virus, the Government's significant fiscal policy response has been central to Australia's economic performance throughout the pandemic. Immediate temporary, targeted assistance to individuals, households and businesses provided a crucial lifeline to the economy during the worst of the downturn and the Government's total economic support response to the crisis now stands at \$291 billion or around 14.7 per cent of GDP. As the recovery continues and emergency support concludes, additional assistance focused on supporting private sector activity remains in place to underpin the recovery over the forecast period. Further measures announced as part of this Budget, such as extensions to temporary full expensing, temporary loss carry-back and the low and middle income tax offset will further support strong growth in economic activity over the forecast period, helping to drive the unemployment rate lower.

The global economic recovery is also gathering pace, with stronger-than-expected activity in the December quarter of 2020 for most major trading partners. Further progress on vaccine rollouts in advanced economies, major fiscal policy support and accumulated household savings have all contributed to increased confidence in the global economic outlook. However, the pace of recovery is uneven and significant risks to the global outlook remain, heightened by ongoing outbreaks of the virus in major economies, most notably in India.

The outlook for the Australian economy has strengthened and output is expected to have exceeded its pre-pandemic level in the March quarter of 2021, nine months earlier than forecast last Budget. Real GDP grew strongly over the September and December quarters of 2020 and recovered around 85 per cent of the fall since the onset of the pandemic. Growth in economic activity has also been supported by strong employment outcomes. Employment increased to a record high in March 2021, with almost 75,000 more people employed than prior to the pandemic.

Following the strong rebound in economic activity to date, recent record rates of growth are expected to moderate as the economy transitions from the initial reopening phase of the recovery. Nevertheless, ongoing momentum, the rollout of the vaccine and continued fiscal policy support, including new initiatives announced as part of this Budget, are expected to drive strong growth over the forecast period. Real GDP is forecast to grow by 1¼ per cent in 2020-21, by 4¼ per cent in 2021-22 and 2½ per cent in 2022-23.

Robust growth over the forecast period is expected to drive continued steady growth in employment and further declines in the unemployment rate, which is forecast to fall below 5 per cent by late 2022, to reach 4¾ per cent in the June quarter 2023. This would mark the first time that Australia has seen a sustained period of unemployment below 5 per cent since the years leading up to the Global Financial Crisis, and only the second time since the early 1970s.

A lower-than-expected peak and faster-than-anticipated fall in the unemployment rate is expected to reduce the potential for scarring in the labour market and support growth in the medium term. This has also helped to sustain household incomes and has supported ongoing strength in consumer activity.

The outlook for household spending and housing construction has strengthened. Consumer sentiment has recovered substantially and is currently at its highest level in 11 years, with household consumption rebounding at record rates over the second half of 2020. Robust activity in the housing market has also been sustained, reflecting Commonwealth, state and territory government programs to support first home buyers and residential construction, as well as highly accommodative monetary policy settings, which are expected to remain in place for some time.

In the business sector, the Government's business tax incentives have provided a key boost to business investment and are expected to continue to support the outlook in the near term. Overall, while new business investment will take some time to fully recover from the uncertainty following the recession, business conditions reached a record high in March 2021, confidence indicators have recovered to be well above average and there has been an improvement in firms' capital expenditure intentions, with some measures at their highest level since 1994.

As international borders reopen and international tourism gradually returns over 2022, spending from incoming tourists is expected to be more than offset by Australians spending more on overseas travel and less on domestic consumption. However, the gradual arrival of international students and migrants over 2022 will support growth, particularly for education services exports and consumption, and assist in filling skill gaps.

The recent strength in key commodity prices, particularly iron ore, has seen a significant resurgence in Australia's terms of trade and has supported profitability in the mining sector, the benefits of which will flow through to the broader economy. As a result, nominal GDP is expected to grow strongly in the near term, before moderating to grow at a slower pace than real GDP, as strength in the terms of trade unwinds over the forecast period.

Overall, the outlook remains positive, though considerable risks remain. The continued economic recovery will rely on the effective containment of COVID-19 outbreaks both here and abroad. This will be a key factor in the timing of the reopening of international borders, which could weigh on the outlook for the tourism and education sectors. More broadly, downside risks to the outlook for the global economy from ongoing outbreaks of the virus in major economies, including India, could also have implications for Australia's economy.

Box 2.1: Key assumptions underpinning the economic forecasts

The control of the virus in Australia and globally remains a significant risk to the economic outlook. The key assumptions that underpin the economic forecasts are set out below. Outcomes could be substantially different to the forecasts, depending upon the extent to which these assumptions hold.

- The first phase of Australia’s vaccination program, our COVID-19 Vaccine and Treatment Strategy, commenced in late February 2021 with most priority populations having been vaccinated. It is assumed that a population-wide vaccination program is likely to be in place by the end of 2021.
- During 2021, localised outbreaks of COVID-19 are assumed to occur but are effectively contained.
- While most domestic activity restrictions have been lifted, it is assumed that general social distancing restrictions and hygiene practices will continue until medical advice recommends removing them. The lifting of domestic activity restrictions will help support consumer and business activity.
- It is assumed that there are no extended or sustained state border restrictions in place over the forecast period.
- A gradual return of temporary and permanent migrants is assumed to occur from mid-2022. Small phased programs for international students will commence in late 2021 and gradually increase from 2022. The rate of international arrivals will continue to be constrained by state and territory quarantine caps over 2021 and the first half of 2022, with the exception of passengers from Safe Travel Zones.
- Inbound and outbound international travel is expected to remain low through to mid-2022, after which a gradual recovery in international tourism is assumed to occur.

Table 2.1: Domestic economy — detailed forecasts^(a)

| | Outcomes ^(b) | Forecasts | | |
|--|-------------------------|--------------|--------------|--------------|
| | 2019-20 | 2020-21 | 2021-22 | 2022-23 |
| Real gross domestic product | -0.2 | 1 1/4 | 4 1/4 | 2 1/2 |
| Household consumption | -3.0 | 1 1/4 | 5 1/2 | 4 |
| Dwelling investment | -8.1 | 2 1/2 | 0 | -1 1/2 |
| Total business investment ^(c) | -2.0 | -5 | 1 1/2 | 10 |
| <i>By industry</i> | | | | |
| Mining investment | 6.8 | 1/2 | 3 | 3 1/2 |
| Non-mining investment | -4.5 | -6 1/2 | 1 1/2 | 12 1/2 |
| Private final demand ^(c) | -3.2 | 3/4 | 4 1/2 | 4 1/2 |
| Public final demand ^(c) | 5.5 | 5 3/4 | 5 | 1 3/4 |
| Change in inventories ^(d) | -0.3 | 1/4 | 0 | 0 |
| Gross national expenditure | -1.4 | 2 1/2 | 4 3/4 | 3 3/4 |
| Exports of goods and services | -1.8 | -8 | 4 | 3 |
| Imports of goods and services | -7.4 | -4 | 6 1/2 | 9 1/2 |
| Net exports ^(d) | 1.2 | -1 | - 1/4 | -1 1/4 |
| Nominal gross domestic product | 1.7 | 3 3/4 | 3 1/2 | 2 |
| Prices and wages | | | | |
| Consumer price index ^(e) | -0.3 | 3 1/2 | 1 3/4 | 2 1/4 |
| Wage price index ^(f) | 1.8 | 1 1/4 | 1 1/2 | 2 1/4 |
| GDP deflator | 1.9 | 2 1/2 | - 1/2 | - 1/2 |
| Labour market | | | | |
| Participation rate (per cent) ^(g) | 63.4 | 66 1/4 | 66 1/4 | 66 |
| Employment ^(f) | -4.2 | 6 1/2 | 1 | 1 |
| Unemployment rate (per cent) ^(g) | 6.9 | 5 1/2 | 5 | 4 3/4 |
| Balance of payments | | | | |
| Terms of trade ^(h) | 0.9 | 10 | -8 | -10 1/2 |
| Current account balance (per cent of GDP) | 1.8 | 3 3/4 | 1 1/4 | -2 1/4 |

(a) Percentage change on preceding year unless otherwise indicated.

(b) Calculated using original data unless otherwise indicated.

(c) Excluding second-hand asset sales between the public and 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 detailed forecasts are underpinned by price assumptions for key commodities: Iron ore spot price assumed to decline to US\$55/tonne free on board (FOB) by the end of the March quarter 2022; metallurgical coal spot price assumed to remain at US\$112/tonne FOB; and thermal coal spot price assumed to remain at US\$93/tonne FOB.

Note: The detailed 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\$65/barrel.

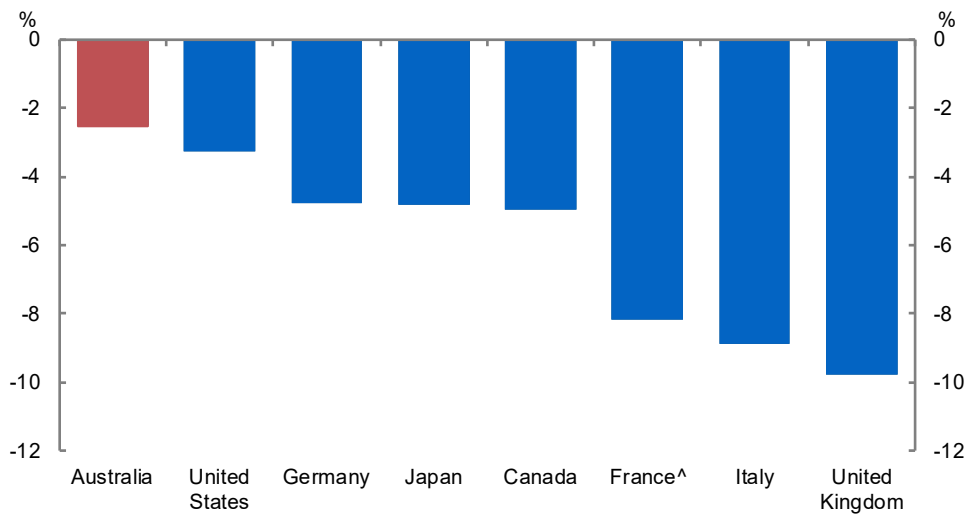
Population growth is around 0.1 per cent in 2020-21, 0.2 per cent in 2021-22 and 0.8 per cent in 2022-23.

Source: ABS Australian National Accounts: National Income, Expenditure and Product; Balance of Payments and International Investment Position, Australia; Labour Force Survey, Australia; Wage Price Index, Australia; Consumer Price Index, Australia; unpublished ABS data and Treasury.

Outlook for the international economy

The COVID-19 pandemic has resulted in the largest contraction in global economic activity since the Great Depression. Global GDP fell by 3.3 per cent in 2020, as mobility and economic activity were restricted to limit the spread of the virus and in response to rising uncertainty. Notwithstanding the health and economic challenges presented by the pandemic, Australia’s economic growth outperformed all major advanced economies in 2020.

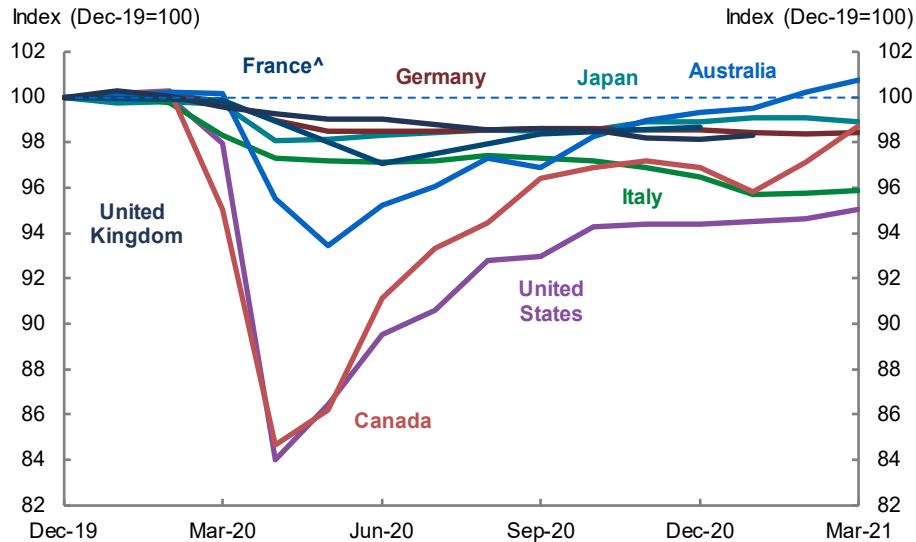
Chart 2.1: Real GDP growth in 2020, Australia and the G7 economies



[^]Data are seasonally adjusted.
Source: National statistical agencies.

The outlook for the global economy has strengthened and global GDP is now expected to grow by 6 per cent in 2021. Positive outcomes across the latter part of 2020, progress on vaccine rollouts across a range of countries, major additional government spending – most notably in the United States – and accumulated household savings have all contributed to increased confidence in the global economic recovery. However, the pace of recovery is uneven, with some economies, such as China, having already returned to pre-pandemic levels of economic activity, while others, like the euro area, are not expected to do so until 2022.

The recovery has also been uneven in international labour markets, with some countries recovering to pre-pandemic levels of employment faster than others. Compared with major advanced economies who have published data for March 2021, Australia is the first economy to have recovered hours worked and employment levels to pre-pandemic levels. For further details on international comparisons of the labour market see *Budget Statement 4: The labour market through COVID-19*.

Chart 2.2: Employment levels, Australia and the G7 economies

[^]Data are quarterly and latest data are for the December quarter.

Note: Data are monthly unless otherwise specified. UK employment data are a 3-month average from December 2020 to February 2021. Due to definitional differences, care must be taken when comparing employment data across countries. Data are up to date as at 6 May 2021.

Source: Refinitiv, National statistical agencies and ABS Labour Force Survey, Australia.

Fiscal support from policy makers has been central to the global economic response to the pandemic. The IMF estimates that overall global support in response to the pandemic totals nearly \$US 16 trillion (15.3 per cent of 2020 global GDP) since January 2020. Of this total, direct health and economic fiscal support accounts for almost \$US 10 trillion (9.2 per cent of 2020 global GDP), with the remainder comprised of loans, guarantees and other support. The majority of this support has been undertaken by the G20, with G20 advanced economies accounting for over 80 per cent of overall global support and G20 emerging economies accounting for a further 10 per cent. It is important to note that countries have taken different approaches in response to the pandemic in line with their domestic circumstances, with the amount and design of fiscal support measures varying across jurisdictions.

The economic recovery has also been supported by highly accommodative monetary policy settings from global central banks. With low inflation across many countries prior to the pandemic resulting in central banks reducing policy rates to the zero lower bound, unconventional monetary policy measures such as asset purchase programs and lending facilities were also implemented to stimulate economic activity. Central banks have signalled that policy settings will remain stimulatory for some time, with some requiring actual employment and inflation outcomes to consistently meet targets before changes to policy setting will be considered.

High COVID-19 transmission rates and ongoing containment measures continue to weigh on activity abroad. However, the severity of their impact on economic activity has moderated since the initial wave of the virus, as consumer and business behaviours have evolved and adapted over the course of the pandemic. Following its deep contraction in 2020, global GDP is expected to recover to pre-pandemic levels in 2021 and is forecast to grow by 4¼ per cent in 2022 and 3½ per cent in 2023.

An improving outlook for global economic growth is supported by ongoing developments in vaccine rollouts, particularly in economies experiencing high rates of virus transmission and stricter containment measures. The forecasts assume that countries relax their internal containment measures and confidence improves throughout 2021, and that vaccine coverage expands throughout 2021 and 2022.

Global economic activity is expected to recover as the increasing vaccine coverage reduces both the need for containment measures and serious health impacts arising from the pandemic. However, uncertainty around the timing, progress, ongoing efficacy and uptake of vaccine rollouts, which is heightened by the emergence of new virus variants, presents downside risks to the global economic outlook.

Global and Australian financial market conditions are accommodative and are supporting the recovery. Yields on government bonds have risen in recent months, reflecting optimism about the outlook for growth and corporate profits, but remain low on an historical basis. Nevertheless, financial market conditions remain sensitive to the outlook for growth and the continued provision of policy stimulus. In addition, some emerging market economies with high levels of external debt or debt denominated in a foreign currency could, in the event of a rise in global interest rates, experience a rapid outflow of capital and a sharp currency depreciation.

Despite significant improvements to the overall outlook, the global economic recovery is likely to be uneven. In general, advanced economies are expected to return closer to their pre-pandemic trajectories for GDP than emerging market economies in coming years. This reflects a broad trend of earlier vaccine access, more accommodative policy conditions, and greater fiscal capacity in advanced economies. By comparison, the outlook for emerging market economies is more varied. Slower vaccine rollouts will weigh on recoveries, particularly in regions that are experiencing high virus caseloads, or are more reliant on contact-intensive industries and international travel.

Despite the uneven global recovery, Australia's major trading partners (MTP) weathered the global economic downturn comparatively well, contracting by 1.8 per cent in 2020, outperforming global GDP more broadly which contracted by 3.3 per cent in the same period. MTP is also forecast to grow faster than the global economy, by 6½ per cent in 2021, partly reflecting China's larger weighting within Australia's MTP basket. MTP is expected to grow by 4¼ per cent in 2022.

Significant uncertainty around the global economic outlook remains. Sustained momentum in the global recovery will depend on how well governments continue to manage the pandemic, along with people’s ongoing willingness to adapt to life with the virus. Some economies, such as the United States, have remained relatively open and achieved favourable economic outcomes despite high virus caseloads. Other economies currently experiencing major outbreaks, most notably India, have so far avoided strict national containment measures, however the health and economic implications are still unknown. It remains to be seen whether relative openness in the face of virus outbreaks is sustainable over the longer-term, particularly in regions where public health services are at or beyond their capacity.

In **China**, GDP is forecast to grow by 8½ per cent in 2021 and 5¼ per cent in 2022. The economy recovered at a stronger-than-expected pace in the second half of 2020, underpinned by a continued expansion in industrial production, property investment, and exports. However, renewed travel restrictions over the Spring Festival period in response to a COVID-19 outbreak have slowed activity in the March quarter of 2021, and a slow recovery in consumption is expected to exert ongoing downwards pressure on growth. Over the remainder of the forecast period, China’s economic growth is expected to normalise towards pre-pandemic trends.

In the **United States**, GDP is forecast to grow by 6¼ per cent in 2021 and 3½ per cent in 2022. Across the past two quarters, the economy continued to expand through the peak of a severe third wave of COVID-19 infections, and substantial progress in the nation’s vaccine rollout is expected to enable a meaningful reduction in social distancing in the first half of 2021. Already unprecedented levels of stimulus have been bolstered by the \$US 1.9 trillion American Rescue Plan Act, equivalent to around 9 per cent of US GDP and over 2 per cent of global GDP, which will further support activity. This expenditure, which is frontloaded over the next two years, is expected to drive a strong recovery in US demand, which is expected to spill over to the global economy. There are upside risks to the forecast, particularly if recoveries in confidence and the labour market are stronger than expected, or if further spending is legislated.

Euro area GDP is forecast to grow by 4½ per cent in 2021 and 4 per cent in 2022. The European recovery has been disrupted as major economies reimposed containment measures in response to rising infections in the final quarter of 2020 and the first quarter of 2021, seeing the region fall into a double-dip recession. While the economic impact of these measures has so far been less severe than during the first wave of COVID-19, high caseloads and ongoing restrictions will continue to weigh on activity in the first half of 2021. Improving vaccine coverage is expected to enable a fuller recovery across the second half of the year, underpinned by rebounding consumption. Ongoing government support remains strong, with payments from the NextGenerationEU recovery fund due to commence in 2021. More broadly within the region, the recovery in the United Kingdom is likely to outpace that of the euro area in the near term, as its

economy reopens following its strict lockdown in early 2021 and its rapid vaccination rollout.

In **Japan**, GDP is expected to grow by 3½ per cent in 2021 and 1¾ per cent in 2022. Containment measures have slowed the recovery in domestic consumption from January this year. However, continued growth in exports is softening the economic impacts of the pandemic, including by spurring business investment. Overall, growth in 2021 is expected to be buoyed by increasing confidence as vaccinations are rolled out in earnest from mid-2021, supported by fiscal stimulus measures and accumulated household and corporate savings. Japan is expected to return to long-term potential growth rates from 2023, which are lower than most other advanced economies, owing to a pre-pandemic trend of a declining working-age population.

GDP in **Other East Asia** is forecast to grow by 4¾ per cent in 2021, and 4 per cent in 2022. Most economies in the region continued to recover in the December quarter of 2020, although momentum slowed for those that implemented further restrictions such as Malaysia. The outlook, and pace of recovery varies across the region. Korea, Taiwan and Vietnam have continued to experience limited virus transmission and have boosted production and exports, while Indonesia’s economy has picked up on the back of strong policy support and exports. Differences in recovery trajectories across the region reflect country-specific factors such as the persistence of virus transmission, fiscal capacity and each economy’s structure. For example, some countries have higher reliance on contact-intensive industries which may lengthen their recovery, relative to countries which rely more strongly on exports of manufactured goods or commodities. Uneven vaccine rollouts across the region will prolong international travel restrictions, and risk further outbreaks. Risks related to financial market volatility and renewed capital outflows also remain.

India’s GDP is forecast to grow by 11 per cent in 2021 and 5¾ per cent in 2022. India is currently facing one of the worst outbreaks of COVID-19 seen during this pandemic. The rapidly evolving situation has added significant downside risks to the outlook, though the full impact on health and economic outcomes remain to be seen. Despite this, the recovery is expected to remain positive, driven by strong resumption in supply-side activity through the second half of 2020. Banking reforms announced in the Indian 2021-22 Budget are expected to support financial-sector resilience and recovery. Nevertheless, economic activity is forecast to remain well below the pre-pandemic trajectory in the near term.

Table 2.2: International economy forecasts^(a)

| | Outcomes | Forecasts | | |
|----------------------------|----------|-----------|-------|-------|
| | 2020 | 2021 | 2022 | 2023 |
| China | 2.3 | 8 1/2 | 5 1/4 | 5 1/2 |
| India | -6.9 | 11 | 5 3/4 | 7 |
| Japan | -4.8 | 3 1/2 | 1 3/4 | 3/4 |
| United States | -3.3 | 6 1/4 | 3 1/2 | 1 3/4 |
| Euro area | -6.6 | 4 1/2 | 4 | 2 |
| Other East Asia (b) | -2.3 | 4 3/4 | 4 | 4 |
| Major trading partners (c) | -1.8 | 6 1/2 | 4 1/4 | 4 |
| World (c) | -3.3 | 6 | 4 1/4 | 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 and services 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 Singapore, along with Hong Kong, South Korea, Vietnam and Taiwan.

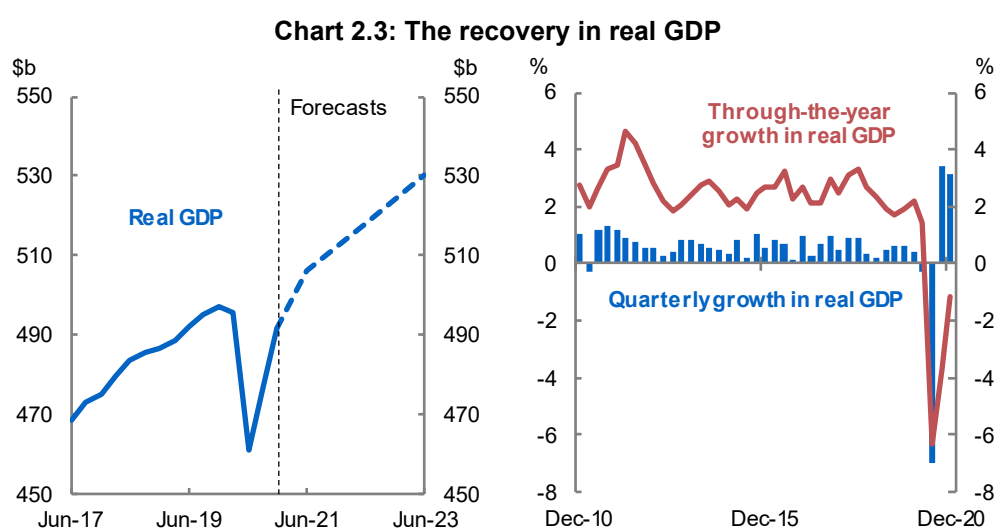
(c) Growth rates are estimates in 2020 rather than outcomes.

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

Outlook for the domestic economy

Outlook for real GDP growth

The recovery in real economic activity from the COVID-19 recession has continued to outperform expectations. On the back of strong growth in the September quarter of 2020, real GDP grew by 3.1 per cent in the December quarter of 2020, and marked the first time on record when Australia has experienced two consecutive quarters of economic growth above 3 per cent (Chart 2.3). Growth over the December quarter was broad-based across most components with strength in household consumption, business investment, residential construction and favourable conditions in the agricultural sector, which saw near-record levels of farm production in late 2020.



Source: ABS Australian National Accounts: National Income, Expenditure and Product and Treasury.

The Government’s significant fiscal policy response has been central to Australia’s economic performance throughout the pandemic, with the total economic support response now amounting to \$291 billion. Initial temporary, targeted support measures, including JobKeeper, JobSeeker and Boosting Cash Flow for Employers helped to limit uncertainty, shielded households and businesses from the worst effects of the pandemic, and enabled Australia to respond to the health crisis.

As emergency economic support concludes, fiscal policy measures aimed at stimulating private sector-led growth are supporting a strong recovery in economic activity and employment. Targeted support has also provided ongoing relief to sectors particularly affected by the pandemic. The Government’s personal income tax changes and business tax incentives will continue to support economic activity and employment over the next few years. These measures have been enhanced in this Budget, with temporary full

expensing and temporary loss carry-back extended until 2022-23 and the low and middle income tax offset retained for an additional year.

The Reserve Bank of Australia (RBA) has also played an important supportive role in the response to the pandemic by helping to keep borrowing costs low and by supporting the flow of credit across the economy. With the cash rate close to the zero lower bound at the onset of the pandemic, the RBA reduced the cash rate target by 65 basis points to 0.1 per cent and took a range of unprecedented unconventional monetary policy actions to support economic activity. This included setting a target for the three-year Australian Government bond yield, currently 0.1 per cent, and implementing a bond purchasing program, which the RBA estimates has led to longer-term yields being 30 basis points lower than otherwise. Accommodative monetary policy settings are expected to remain in place for some time, with the RBA not expecting conditions to warrant an increase in the cash rate until 2024 at the earliest.

The outlook for real GDP has strengthened in the near term and is forecast to grow by 1¼ per cent in 2020-21, rising to 4¼ per cent in 2021-22 before moderating to 2½ per cent in 2022-23 as the recovery in economic activity stabilises. After falling by 2.5 per cent in 2020, real GDP is expected to grow by 5¼ per cent in 2021, and by 2¾ per cent in 2022.

The near-term strengthening in real GDP is broad-based and reflects a stronger outlook for household consumption, dwelling investment and new private business investment. The conclusion of the JobKeeper Payment is not expected to interrupt the recovery in the labour market, nor hinder growth in the broader economy. The labour market is forecast to continue strengthening over 2021-22 and 2022-23 with ongoing growth in employment, strong labour force participation and the unemployment rate falling to below 5 per cent by late 2022.

Looking further ahead, continued growth in household consumption is expected to moderate as the recovery stabilises. As the international border reopens, net exports are also expected to weigh on growth, with outbound tourism activity more than offsetting that of inbound tourists. In addition, demand for imported goods is expected to increase. However, the gradual arrival of international students and migrants over 2022 will support economic growth, particularly for education services exports and consumption.

Net overseas migration is significantly affected by international travel restrictions and weaker labour markets globally. It is forecast to fall from around 194,000 persons in 2019-20 to be around -97,000 persons by the end of 2020-21, and then to -77,000 in 2021-22 before increasing to 235,000 persons in 2024-25. More broadly, the weak outlook for population growth in the near term as a result of border closures will also weigh on the outlook for real GDP growth.

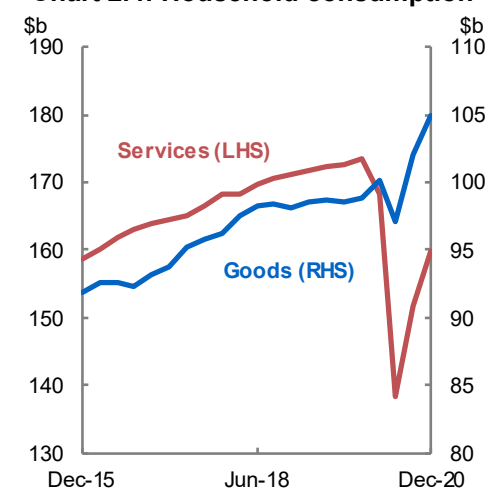
Overall, the strong and broad-based momentum in the economy is expected to see real GDP continue to grow by 2¼ per cent in 2023-24 and 2½ per cent in 2024-25.

Households

Household activity has continued to recover from the pandemic-driven downturn, with stronger-than-expected outcomes for household consumption and dwelling investment through late 2020 and continued strength in leading indicators for 2021.

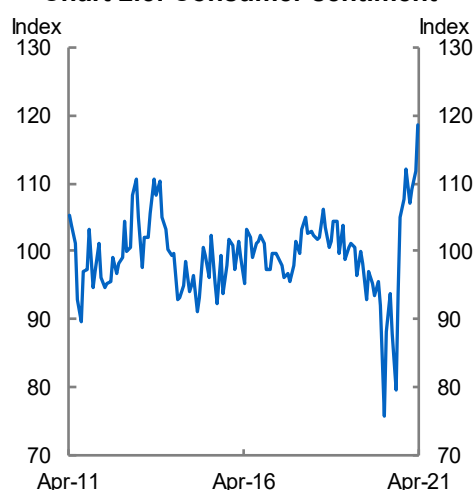
By late 2020, **household consumption** had recovered around 80 per cent of the fall since the onset of the pandemic, following record growth of 7.9 per cent in the September quarter of 2020 and further strong growth of 4.3 per cent in the December quarter of 2020. Growth over the December quarter was driven by the reopening of Victoria from the extensive lockdown and the strongest quarterly rise on record for vehicle purchases. Overall, strength in goods spending has supported the recovery to date (Chart 2.4). The pace of growth is expected to have slowed in the March quarter of 2021 as the boost from the reopening dissipates. Overall, strong growth outcomes and elevated retail spending indicators have contributed to an upgrade to the outlook for household spending in 2020-21.

Chart 2.4: Household consumption



Source: Unpublished ABS data

Chart 2.5: Consumer sentiment



Source: Westpac-Melbourne Institute

Household consumption is forecast to grow by 1¼ per cent in 2020-21, by 5½ per cent in 2021-22 and by 4 per cent in 2022-23. The solid outlook for growth reflects strong household balance sheets and improving labour market conditions. Household balance sheets have been strengthened by the Government’s fiscal policy support, high saving rates during most of 2020 and increased asset prices, including the recent growth in housing prices. Growth in household spending will be further supported by the continued easing of restrictions and robust consumer confidence. Consumer sentiment is currently at its highest level in 11 years (Chart 2.5). Aggregate household consumption is expected to return to pre-pandemic levels in mid-2021, as spending patterns in the

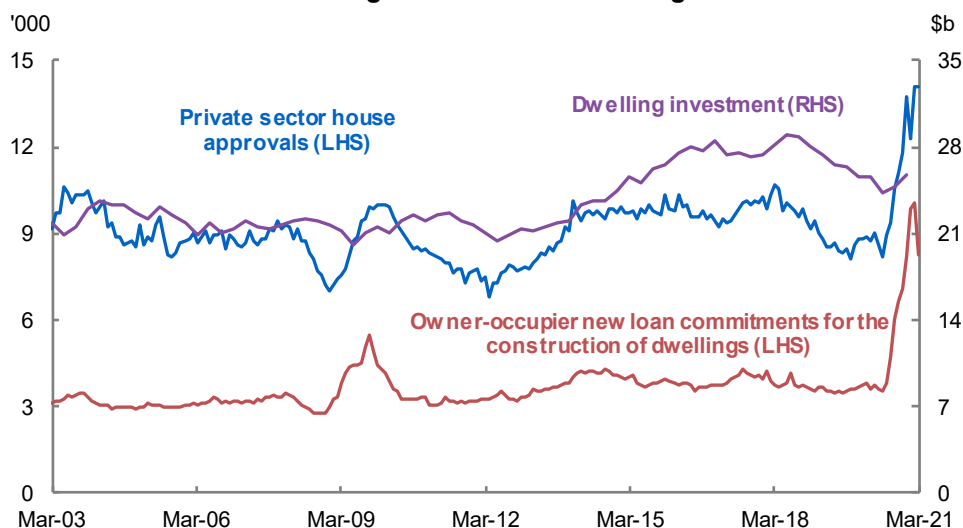
two largest states, New South Wales and Victoria return toward pre-pandemic levels. While strength in goods spending has supported the recovery to date, looking forward, growth is expected to be driven by a recovery in the consumption of services.

The faster-than-anticipated recovery in the labour market will provide support to households, as emergency fiscal support concludes. The JobKeeper Payment provided critical support to household incomes over the course of the crisis and household gross disposable income remained almost 5 per cent higher through the year to the December quarter of 2020. This occurred despite the reduction in JobKeeper assistance, which roughly halved in the quarter, and the reduction in the Coronavirus Supplement. The household saving ratio declined in the quarter and, though it remains elevated at around 12 per cent, it is expected to decline further with improving confidence and greater consumption options.

Continued episodes of short, sharp lockdowns pose downside risks to the outlook for consumer spending through a dampening effect on confidence. Analysis of recent localised lockdowns suggests that while consumption typically rebounds quickly, the level of aggregate consumption over the period is lower than in areas that didn't experience a lockdown.

Dwelling investment has continued to strengthen amid robust housing market fundamentals, including record low interest rates and stimulatory housing policy incentives from Commonwealth, state and territory governments — including the HomeBuilder program (Box 2.2). The housing market rebounded in the second half of 2020 and this has continued into early 2021 with sustained strength in building approvals and owner-occupier lending, including to first home buyers (Chart 2.6). Housing prices have risen significantly in early 2021 and these have been broad-based across the country, with regional growth outpacing rises in capital cities.

Chart 2.6: Dwelling investment and leading indicators



Source: ABS Australian National Accounts: National Income, Expenditure and Product, ABS Building Approvals and ABS Lending Indicators.

Dwelling investment grew at its fastest pace in more than five years in the December quarter 2020, driven by strength in detached housing construction and renovation activity. Demand for established and new housing has predominantly been driven by owner-occupiers, particularly first home buyers.

Dwelling investment is forecast to grow by 2½ per cent in 2020-21 as the large pipeline of work supports construction activity over the next year. Dwelling investment is expected to remain strong, with flat growth in 2021-22, before falling by 1½ per cent in 2022-23 as the elevated pipeline of work, which reflects some bring-forward in demand for residential construction, winds down. The near-term strength in dwelling investment is expected to be led by detached housing construction following record-high house approvals over late 2020 and early 2021.

It is not yet clear what structural changes will result from the pandemic, particularly given the greater propensity to work from home during the pandemic. Changing preferences for more outer-city, spacious and detached housing may also limit growth in apartment construction in coming years.

Box 2.2: Recent strength in the housing market

Australia is experiencing a renewed upturn in residential construction, spurred on by a range of government policies designed to support the sector, alongside record low interest rates. This has seen key leading indicators of residential construction activity surge to levels not seen in previous policy-led growth cycles and is providing significant benefits to the broader economy as it recovers from the pandemic.

Growth in residential construction activity supports growth in the broader economy in multiple ways, including through greater employment in the construction sector and associated industries. Additionally, as housing prices rise, household wealth grows and households who benefit from this are expected to increase their level of consumption as their confidence and financial position improves.

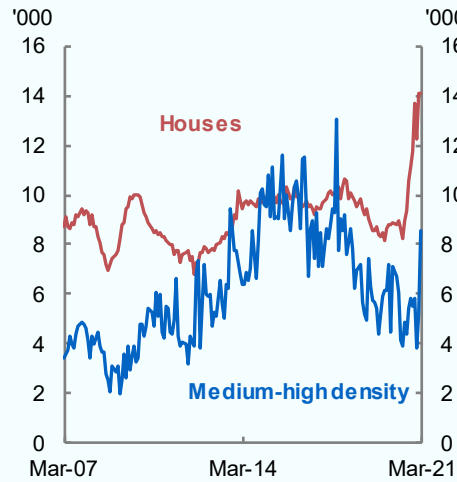
The Commonwealth Government's HomeBuilder program was designed to mitigate the impacts of a significant fall in residential construction activity that was forecast in the early stages of the pandemic. This initiative has been highly successful and has driven a strong recovery in dwelling investment, which is now forecast to increase 2½ per cent in 2020-21 compared to a fall of 11 per cent forecast in the 2020-21 Budget. Announced in June 2020, the program provides eligible owner occupiers with a grant of up to \$25,000 to build a new home or undertake substantial rebuilds of an existing home. Over 120,000 applications have been received, supporting over \$30 billion of residential construction activity.

The HomeBuilder program is now supporting significant activity in detached housing construction, with private sector house approvals reaching a record-high level in March 2021 (Chart 2.7). This contrasts with the residential construction boom of the mid-2010s, which was driven by medium- and high-density housing.

There has been a significant increase in the number of new loans to owner-occupier first home buyers over the past year (Chart 2.8). The proportion of new loan commitments to owner-occupier first home buyers is around its highest level since 2009. Overall, in February 2021, the monthly number of new loan commitments for owner-occupier dwelling construction rose to its highest level since the series began in 2002 (Chart 2.6). This contrasts with the level of investor activity in the housing market, which, despite recent increases remains lower than in previous upturns.

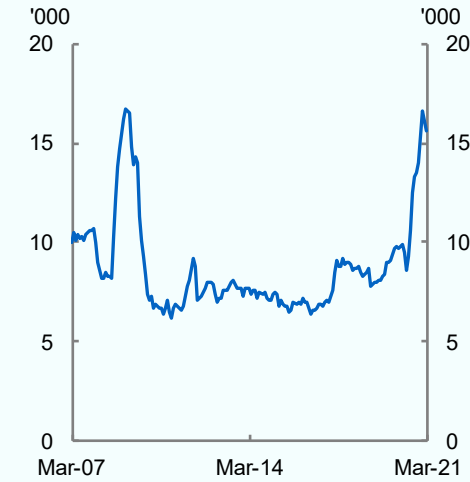
Box 2.2: Recent strength in the housing market (continued)

Chart 2.7: Private sector residential building approvals



Source: ABS Building Approvals.

Chart 2.8: Owner-occupier first home buyer new loan commitments



Source: ABS Lending Indicators.

Highly accommodative monetary policy settings, with record low interest rates and the RBA signalling they will remain in place for some time, have further supported demand for housing, by making it cheaper for prospective homeowners to take out a loan. Lending standards remain sound, although it will be important to continue to monitor standards as market conditions evolve.

This pickup in demand is also reflected in the recent increase in housing prices, which in March 2021 saw the fastest monthly growth in more than 30 years. In contrast to previous cycles, combined regional housing prices have outperformed combined capital city housing prices over the past year. Despite the strengthening in housing prices, record low interest rates have seen mortgage repayments as a proportion of disposable income lower than they were in the mid-2000s.

The near-term outlook for housing activity has strengthened considerably, supported by an elevated pipeline of construction work and rising house prices. However, the policy-driven strength in demand for detached house construction partly reflects a bring-forward in demand from future years and activity is expected to moderate as the current pipeline of work is completed. As the outlook for elevated levels of detached house construction unwinds, slower population growth is also expected to limit demand for higher-density dwellings in coming years, such that the recent strength in housing market activity is not expected to be sustained.

Business investment

Following a large fall over the June and September quarters of 2020 amidst the height of the pandemic, **new business investment** has picked up alongside Australia's broader economic recovery, supported by government policy incentives implemented in response to the pandemic. Total new private business investment rebounded by 2.6 per cent in the December quarter of 2020, driven by robust demand for machinery and equipment which grew at its fastest pace in almost seven years. In particular, demand for vehicles and agricultural equipment picked up as firms benefitted from the Government's business tax incentives, and as favourable conditions in the agricultural sector boosted farm production.

The outlook for new private business investment has strengthened considerably, reflecting a stronger-than-expected pick up in late 2020, improvements in firms' capital expenditure expectations and additional strength from ongoing policy support. Total new business investment is forecast to fall by 5 per cent in 2020-21 as a result of the pandemic, though more moderately than previously expected. Growth is then expected to rise by 1½ per cent in 2021-22 and by a further 10 per cent in 2022-23. Record business conditions, improvements in business confidence, the strong rebound in economic activity and the extension of business tax incentives are expected to bring forward activity and underpin a significant recovery in investment in coming years.

Non-mining business investment is forecast to fall by 6½ per cent in 2020-21 before rising by 1½ per cent in 2021-22 and by a significant 12½ per cent in 2022-23. Investment activity in the non-mining sector rebounded by 3.0 per cent in the December quarter of 2020. Robust fundamentals in the business sector are now evident, providing a strong foundation for further growth in business investment. The Government's extension of the temporary full expensing and temporary loss carry-back measures announced as part of this Budget will also provide significant continued support to non-mining business investment, particularly machinery and equipment spending, within the forecast period (Box 2.3).

Box 2.3: Impacts of policy support on non-mining business investment

With the onset of the once-in-a-century COVID-19 pandemic in early 2020, substantial uncertainty over the economic outlook reverberated across the business sector, with business conditions, confidence and various activity indices all falling to never-before-seen lows.

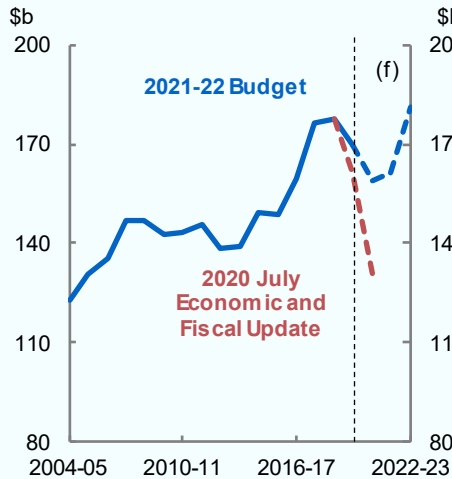
In the early stages of the crisis, new private business investment was forecast to fall by more than 12 per cent in 2020-21, driven by a significant deterioration in the outlook for non-mining investment, which was forecast to fall by an unprecedented 25½ per cent in the June quarter of 2020 alone. Underpinning this rapid deterioration in the outlook were expectations of a record contraction in machinery and equipment investment, as mandated restrictions and associated reductions in economic activity looked set to stifle investment plans. Significant downgrades to forward-looking capital expenditure intentions became evident as firms sought to preserve cash flow, amid declining revenues and heightened risks of insolvencies.

With the rollout of the Government's immediate, targeted fiscal policy response to the pandemic, a range of measures, including accelerated depreciation deductions and expansion of the instant asset write-off, were implemented to stimulate business investment, providing temporary tax incentives that reduce the after-tax cost of new capital investment and deliver cash flow benefits. Such measures, further enhanced through the introduction of the temporary full expensing and loss carry-back policies, have provided a strong incentive for businesses to bring forward investment activity to access the benefits before they expire.

In the months following the immediate response to the pandemic, outcomes for new business investment surprised on the upside. While non-mining business investment fell by 8.0 per cent over the six months to September 2020, this was considerably less weak than the double-digit falls anticipated in the early stages of the crisis (Chart 2.9). On the back of these lower-than-expected declines, non-mining business investment rebounded by 3.0 per cent in the December quarter of 2020, driven by an 8.1 per cent increase in total new machinery and equipment investment (Chart 2.10). This marked the largest quarterly rise in machinery and equipment spending in almost seven years, as firms took advantage of the Government's business tax incentives.

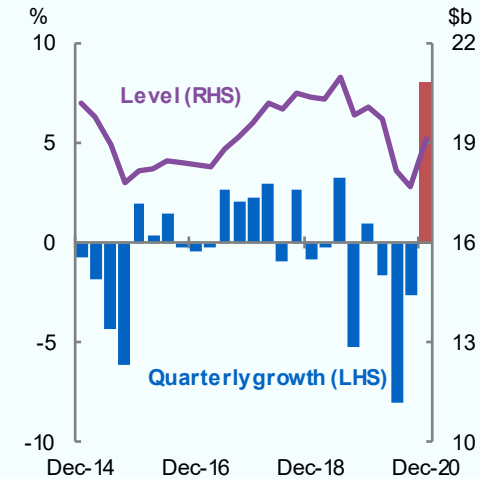
Box 2.3: Impacts of policy support on non-mining business investment (continued)

Chart 2.9: Non-mining business investment



Note: (f) are forecasts.
 Source: ABS Australian National Accounts: National Income, Expenditure and Product and Treasury.

Chart 2.10: New machinery and equipment investment



Source: ABS Australian National Accounts: National Income, Expenditure and Product.

The outlook for the business sector has strengthened considerably and the latest December 2020 quarter ABS capital expenditure survey data suggest that firms' capital investment intentions for 2020-21 have strengthened, while early indications for capital spending in 2021-22 are also positive (Chart 2.11). NAB capital expenditure intentions have also picked up, reaching its highest level since 1994. The improvement in investment intentions has been supported by a solid improvement in business conditions and confidence (Chart 2.12), which have recovered from record lows in 2020, with conditions reaching a record high in March 2021. Industry performance indicators have also reached some of their highest levels in over a decade.

Box 2.3: Impacts of policy support on non-mining business investment (continued)

Chart 2.11: Non-mining CAPEX expectations

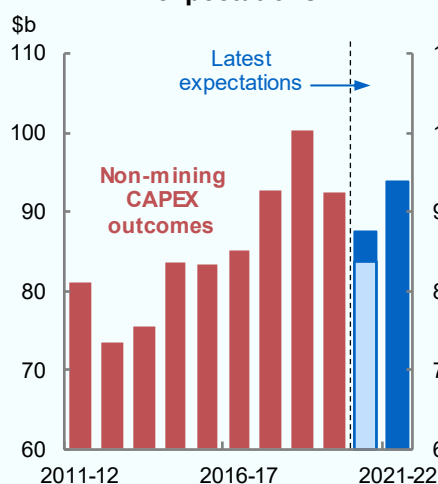
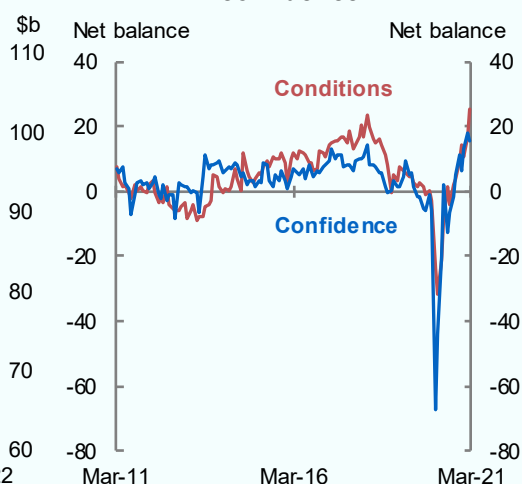


Chart 2.12: Business conditions and confidence



Note: Lighter blue bar represents the previous expectation for 2020-21. Expectations data have been adjusted using long run realisation ratios (LHS chart).
 Source: ABS Private New Capital Expenditure and Expected Expenditure and Treasury (LHS chart), NAB Monthly Business Survey (RHS chart).

On the back of strong indicators for a pick-up in business sector activity, new non-mining business investment is forecast to grow solidly over the forecast period, as Government policy such as temporary full expensing and temporary loss carry-back, remains in place to support the recovery in private sector-led growth. These key measures, including the extensions announced as part of this Budget, are estimated to apply to around \$320 billion worth of investment. They are estimated to create around 60,000 jobs by the end of 2022-23 and boost GDP by around \$2.5 billion in 2020-21, \$7.5 billion in 2021-22 and \$8 billion in 2022-23.

Mining investment is forecast to grow by ½ per cent in 2020-21, although the latest ABS capital expenditure survey data suggests that some mining companies have reduced investment intentions in 2020-21, amid heightened uncertainty from the pandemic. Mining investment is then forecast to grow by 3 per cent in 2021-22 and by a further 3½ per cent in 2022-23. Early ABS survey data for investment intentions in 2021-22 are positive and while strong iron ore prices have not led to expanded investment intentions by major producers, investment to maintain large existing capital stocks and to bring minor iron ore projects online will support mining investment. Recent announcements also indicate that some companies are beginning to proceed with previously delayed

projects as the global outlook improves. Santos has recently made a final investment decision to proceed with the US \$3.6 billion Barossa gas project off the coast of northern Australia, with first gas production targeted for early 2025. This development flags the first green light on delayed LNG investment in Australia since the onset of the pandemic.

Public final demand

New public final demand will continue to make a notable contribution to growth in the near term, as government assistance to steer the course of economic recovery continues. New public final demand is expected to grow strongly by 5¾ per cent in 2020-21, 5 per cent in 2021-22 and by a further 1¾ per cent in 2022-23, driven by continued spending on essential services and the robust infrastructure programs across Commonwealth, state and territory governments. Public consumption remains 7.4 per cent higher through the year to the December quarter of 2020 and spending on key essential services is expected to remain strong throughout the forecast period as the health impacts of the pandemic are managed. Record funding of \$17.7 billion to reform aged care will also support growth in public final demand over the forecast period. A significant investment of \$13.2 billion in the National Disability Insurance Scheme, and \$2.3 billion to support mental health system reform will also contribute to growth.

Net exports

Net exports are forecast to detract from economic growth in coming years, driven by increasing import activity, particularly tourism services imports, as international borders reopen, travel restrictions ease and Australian's resume overseas travel. Net exports are forecast to detract 1 percentage point from real GDP growth in 2020-21, reflecting increasing demand for imported goods from businesses and households. Net exports are then expected to detract ¼ of a percentage point from growth in 2021-22 and 1¼ percentage points in 2022-23, driven by a recovery in outbound tourism which is expected to be larger than inbound tourism once international border restrictions ease. Falling education exports will also weigh on growth over this period as the number of international students finishing their studies is expected to outpace the number of new international students arriving in Australia.

Exports are forecast to fall by 8 per cent in 2020-21 before growing by 4 per cent in 2021-22 and a further 3 per cent in 2022-23. Expected falls in the near-term are driven by substantial falls in services exports as international border restrictions continue to weigh on inbound tourism and international student numbers. Looking forward, tourism exports are expected to increase following the easing of international border restrictions but are not expected to return to pre-pandemic levels for some time.

While the ongoing trade restrictions from China have had significant impacts on specific firms and regions, many goods targeted by the restrictions have so far been successfully re-directed to other export markets, with limited impacts on Australia's overall economic recovery.

Mining exports are expected to fall by 1½ per cent in 2020-21 as subdued global demand from the COVID-19 downturn has weighed on coal and LNG production in 2020. While recent flooding in NSW impacted some coal exporters in the latter part of March, impacts on overall export volumes are not expected to be large as mines and infrastructure are well placed to address seasonal disruptions and volumes had recovered by early April. The pickup in global economic activity and the associated recovery in global industrial production will support a recovery in export growth and sustained demand for iron ore and coal exports. Mining exports are forecast to grow by 5 per cent in 2021-22 and by 2½ per cent in 2022-23.

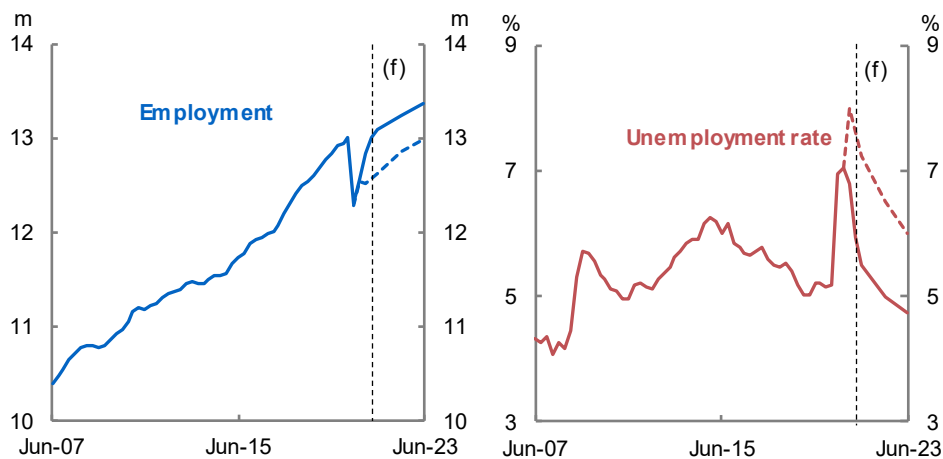
Rural export volumes are forecast to grow by 2 per cent in 2020-21 and by 9 per cent in 2021-22, supported by favourable conditions in the agricultural sector that have yielded near-record levels of crop output in the latter half of 2020. Rural exports are then expected to fall by 3 per cent in 2022-23 as an assumed return to more average seasonal conditions sees rural production and exports returning to longer-term average levels.

Imports are forecast to fall by 4 per cent in 2020-21 as international border restrictions continue to weigh heavily on tourism services imports. This is expected to be partially offset by a strong recovery in consumption and capital goods imports. Imports are expected to grow strongly, by 6½ per cent in 2021-22 and by 9½ per cent in 2022-23 as the easing of international travel restrictions see tourism services recover and as goods imports are supported further by the continuing domestic economic recovery.

The labour market

Australia’s labour market has shown remarkable resilience in the wake of the pandemic, recovering faster than any major advanced economy and surpassing even the most optimistic of expectations. More people are in work than ever before, with close to one million jobs being created or restored since May 2020. By March 2021 almost 75,000 more people were in work than before the pandemic. This, along with a faster-than-anticipated fall in the unemployment rate and participation reaching a record high, has laid a strong foundation for Australia’s economic recovery to continue. Initial indicators suggest that the conclusion of the JobKeeper Payment will not hinder growth in the broader economy and strong momentum in the labour market has been sustained during the early stages of transition. In March 2021, employment reached a record high, as the unemployment rate fell further to 5.6 per cent (Chart 2.13) and labour force participation continued to rebound to reach a record high of 66.3 per cent.

Chart 2.13: Employment and the unemployment rate

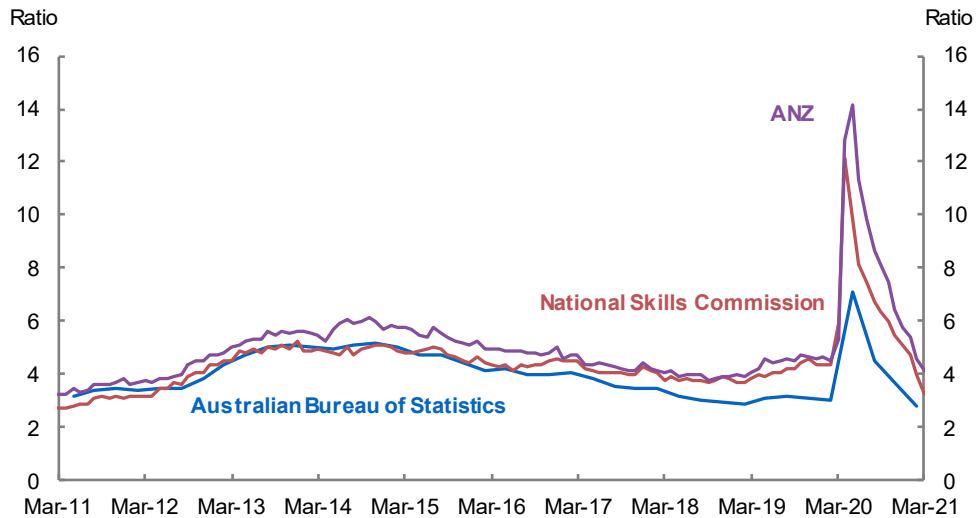


Note: (f) are forecasts. Dashed lines represent 2020-21 Budget forecasts.

Source: ABS Labour Force and Treasury.

Overall, the outlook for the labour market is positive with increasing economic momentum expected to support robust labour demand. Over the four weeks to 30 April, immediately following the conclusion of JobKeeper, the number of people on the JobSeeker Payment and Youth Allowance (other) has fallen by approximately 105,000. Recent data for job advertisements, a key leading indicator for employment growth, have significantly surpassed pre-pandemic levels. ABS Job Vacancies reached a record high in February 2021. In March 2021, ANZ Job Ads were at their highest level since November 2008, before increasing further in April 2021 to be 28 per cent higher than their pre-pandemic level. The ratio of unemployed people to vacancies is now at its lowest level in over a decade (Chart 2.14).

Chart 2.14: Ratio of unemployed to vacancies and advertisements



Source: ABS Labour Force, ABS Job Vacancies, National Skills Commission Internet Vacancy Index and ANZ Job Ads.

Employment is expected to increase strongly by 6½ per cent in 2020-21, before continuing to increase steadily by 1 per cent in both 2021-22 and 2022-23, reflecting the broader pattern of economic growth over the rest of the forecast period and slower population growth.

Employment increased by 321,000 across October 2020 to March 2021, through two transitions in the JobKeeper Payment, and is now 947,000 persons higher than its trough in May 2020 (Box 2.4). Hours worked has also increased by 13.0 per cent since May 2020, to have grown 1.2 per cent through the year to March 2021. Though short, localised lockdowns continue to have an effect, the number of people working zero hours for economic reasons is now lower than it was before the pandemic. The extent of recovery remains different across industries, with employment in several industries having declined over the year to February 2021. Sectors impacted by restrictions, international border closures and reduced tourism remain the most affected.

In contrast, other disparities that were evident across cohorts over the course of the recovery have eased considerably. By region, employment in all states has now recovered to near pre-pandemic levels, while female employment is 1.2 per cent higher than it was in March 2020. Over the same period, full-time employment has returned to pre-pandemic levels, while part-time employment is 1.9 per cent higher than in March 2020. Younger workers were initially the most affected in terms of employment, as industries adversely impacted by the pandemic, such as hospitality and tourism, are heavily comprised of workers in this age cohort. While youth employment has somewhat recovered, employment levels are still 2 per cent below pre-pandemic levels. In addition to exposure to ongoing impacts in some of these industries, this cohort has been impacted by the youth population steadily declining over the course of 2020, reflecting international border closures. Looking through this effect, the employment-to-population ratio for those aged 15-24 is 0.6 percentage points above the March 2020 level.

Despite the strength of the recovery to date, there remain key uncertainties surrounding the outlook for the labour market, posing both upside and downside risks. Ongoing outbreaks of the virus and, to a lesser extent, the end of the JobKeeper Payment, present near-term downside risks to the outlook, while longer-term risks associated with a stronger- or weaker-than-expected recovery in migration and tourism may have significant employment implications. The opening of borders is crucial for the recovery of parts of the tourism and higher education industries, and the return of skilled migrants will be key in filling skill shortages in some industries.

Box 2.4: JobKeeper and labour market recovery

The \$89 billion JobKeeper Payment implemented in the early stages of the pandemic was the largest single fiscal measure in Australia's history. By keeping workers connected to their employers during periods of lockdown and by supporting incomes over the course of the crisis, the JobKeeper Payment has played a pivotal role in the resilience of the economy during both the downturn and the economic recovery. The RBA has estimated that JobKeeper reduced total employment losses by at least 700,000 at the peak of the crisis (April–July 2020).¹

1 Bishop J and Day I (2020), 'How Many Jobs Did JobKeeper Keep?', RBA Research Discussion Paper 2020-07, November 2020.

Box 2.4: JobKeeper and labour market recovery (continued)

JobKeeper supported over 3.8 million individuals, including employees and eligible business participants, and over one million organisations from March to September 2020. In doing so, the JobKeeper Payment was integral to mitigating the impacts on unemployment, underemployment and labour force participation that can persist after a downturn.

Around two million individuals transitioned off the JobKeeper Payment at the end of September 2020. Employment levels at firms that transitioned off JobKeeper at this time remained stable, while more broadly the labour market continued to recover with the creation of 498,000 jobs since September 2020 to March 2021.

In the March quarter of 2021, the JobKeeper Payment supported around 1.1 million individuals and around 385,000 organisations. This is around 650,000 fewer individuals than was estimated in the 2020-21 Budget, consistent with a faster than expected labour market recovery. The creative and performing arts, aviation and tourism related services, and road passenger transport (capturing taxis and ride sharing) sectors were amongst those most reliant on the JobKeeper Payment.

JobKeeper coverage was fairly evenly distributed across regions, although Sydney and Melbourne metropolitan areas, and tourism-dependent South East Tasmania and the Gold Coast, were particularly reliant.

Labour market improvements have also been evident in the number of hours worked by JobKeeper recipients, with the share of those working zero or very low hours (less than one day) declining over the program. For example, for those organisations that took part in the final stage of the program, the share of workers on zero or low hours declined from a peak of 22 per cent in May 2020 to around 11 per cent in March 2021.

As the labour market recovers, transitioning away from job retention schemes (like JobKeeper) towards policies that promote labour reallocation is important. The unwinding of the JobKeeper Payment is not expected to impede the broader economic recovery, which is expected to continue across 2021 and beyond. Early indicators are consistent with these expectations and will continue to be monitored closely.

For further information on the labour market recovery and the JobKeeper transitions, see *Statement 4: The labour market through COVID-19*.

The **unemployment rate** is forecast to fall to 5½ per cent by the June quarter of 2021 and to continue to decline over the forecast period, with rapid falls in the near term expected to moderate as the economic recovery stabilises. Continued policy support and increasing momentum in the economy will see the unemployment rate return to its pre-pandemic level in the December quarter of 2021. Beyond this, in line with continued growth in employment, the unemployment rate is expected to decline steadily, to reach 5 per cent in the June quarter of 2022, before falling further to 4¾ per cent in the June quarter of 2023. This would see the unemployment rate fall within the estimated band for the Non-Accelerating Inflation Rate of Unemployment (NAIRU) by the June quarter of 2022 and reach the bottom of the estimated band by the June quarter 2024.

The unemployment rate has fallen much faster in this recession compared with the recessions of the 1980s and 1990s. In the 1980s, the unemployment rate rose from around 5 per cent to over 10 per cent and took more than eight years to recover. In the 1990s recession the unemployment rate rose from around 6 per cent to over 11 per cent and did not return to pre-recession lows for around ten years. In stark contrast, following this recession, the unemployment rate is forecast to return to pre-pandemic levels in around two years.

The **participation rate** is expected to remain at around 66¼ per cent through to the June quarters of 2021 and 2022, before declining marginally to 66 per cent by the June quarter of 2023. The high participation rate over 2021-22 reflects expectations that continued positive economic conditions will encourage workers to remain in the labour force. A slight decline in the participation rate beyond this reflects the softening cyclical strength in participation as the economy returns towards trend levels of output and employment.

Overall, the outlook for **wage growth** is expected to remain moderate over the forecast period. This reflects both the severe impacts of the pandemic and the continued spare capacity in the labour market in the near term. The wage growth outlook also reflects a modest downwards revision to Treasury's estimate of the NAIRU.²

Growth in wages, as measured by the Wage Price Index (WPI), slowed to just 0.1 per cent in the September quarter of 2020, the lowest quarterly growth on record. Growth in the WPI then recovered to 0.6 per cent in the December quarter of 2020 to be 1.4 per cent higher through the year, partly reflecting a rollback of pay reductions implemented earlier in the year as employers responded to the impact of the pandemic. Modest inflation outcomes however have meant that consumers have maintained purchasing power with real wages growth in line with the 10-year average.

2 Ruberl H, Ball M, Lucas L and Williamson T (2021), 'Estimating the NAIRU in Australia', Treasury Working Paper 2021-01, 29 April 2021.

The WPI is forecast to grow by 1¼ per cent through the year to the June quarter of 2021 and by 1½ per cent through the year to the June quarter of 2022, before rising to 2¼ per cent through the year to the June quarter of 2023. The near-term outlook is consistent with low wage increases in new federal enterprise bargaining agreements and state public sector wage caps that are expected to moderate the outlook for wage growth over the forecast period. Towards the end of the forecast period, the lower unemployment rate and broader economic strength should see wages begin to pick up.

Growth in **consumer prices**, as measured by the Consumer Price Index (CPI), experienced large fluctuations throughout 2020, largely resulting from the impacts of the pandemic and the Government's associated policy response. In June, the CPI fell by 1.9 per cent, the largest quarterly fall in the history of the series. This was driven by the introduction of free childcare, waiving of preschool fees in some cities and a sharp fall in the price of automotive fuel following the significant contraction in global oil prices. The subsequent reinstatement of childcare fees, recovery in fuel prices and increases in tobacco excise saw a strong rebound in the CPI over the second half of 2020, increasing by 2.4 per cent in the six months to December. This strong growth did not continue into 2021, with CPI growing by 0.6 per cent in the March quarter.

Looking forward, CPI growth is expected to peak at around 3½ per cent through the year to the June quarter of 2021 before moderating to 1¾ per cent through the year to the June quarter of 2022. CPI growth is then expected to rise to 2¼ per cent through the year to the June quarter of 2023. Growth in the near term reflects the rebound from the record fall in CPI inflation in the June quarter of 2020, alongside the continued recovery in global oil prices, with some strength being offset by the continued rollout of HomeBuilder grants. However, this near-term strength is expected to be transitory, and underlying inflation is expected to remain subdued, below the RBA's target band of 2-3 per cent in the near term. From the second half of 2021 onwards, CPI growth is expected to strengthen, reflecting a reduction in labour market slack and expected wage growth. Headline inflation is expected to approach the RBA's target band of 2-3 per cent in 2022-23, as the unemployment rate reaches the estimated NAIRU.

Underlying measures of price growth have remained subdued in recent quarters with trimmed mean inflation increasing by 0.3 per cent in the March quarter of 2021 to be 1.1 per cent higher through the year, the weakest annual growth in the history of the series. As the unemployment gap is reduced and the unemployment rate approaches the NAIRU, growth in underlying price measures are expected to strengthen. Further falls in the unemployment rate below the NAIRU will likely see wage and price growth become increasingly sensitive to employment growth. However, the extent to which tightening labour market conditions will flow through into wage and price pressures remains highly uncertain.

There are potential upside risks to the outlook for wages and prices, as stronger labour market conditions could increase upward pressure on wages over the forecast period.

In addition, ongoing international border closures may cause labour shortages and place upward pressure on wages in selected industries.

Outlook for nominal GDP growth

Nominal GDP is forecast to grow by 3¾ per cent in 2020-21, by a further 3½ per cent in 2021-22 and by 2 per cent in 2022-23. The increases in nominal GDP over 2021-22 and 2022-23 are expected to be lower than for real GDP, reflecting a notable decline in the terms of trade. The terms of trade are expected to rise strongly in the near term, by 10 per cent in 2020-21, supported by significant strength in iron ore prices. In line with the prudent approach to forecasting volatile commodity prices, elevated iron ore prices are assumed to decline and the terms of trade are expected to fall by 8 per cent in 2021-22 and by a further 10½ per cent in 2022-23.

Commodity prices remain a key driver of the terms of trade and the inherent volatility in commodity prices remains a key uncertainty in the outlook for nominal GDP. Iron ore prices have remained elevated at around US\$160 per tonne since mid-December 2020, due to strong Chinese demand and unresolved supply disruptions in Brazil. Treasury's industry liaison suggests that in the near term, global iron ore supply is not expected to recover rapidly and the sustained demand for steel production is expected to drive iron ore demand. The iron ore price is assumed to decline to US\$55 per tonne FOB by the end of the March quarter 2022, three quarters later than was assumed in the 2020-21 Budget.

Metallurgical coal prices have also been volatile recently and are modestly higher than recent COVID-period lows. Thermal coal prices have been supported by the continued recovery in global economic activity, the cold winter in East Asia over early 2021 and recent weather-related supply disruptions in Australia. While Chinese restrictions have affected the price of some types of Australian coal, so far, most coal exports have been able to be re-directed to alternative markets. Consultation with market and industry participants, however, has highlighted that there is elevated uncertainty in the coal market, in particular around the duration of the Chinese restrictions on Australian coal, as well as around global environmental policies.

There are upside risks to the outlook for commodity prices as industry consultation suggests that iron ore prices could remain elevated for an extended period of time. Meanwhile, a stronger recovery in steel production outside of China could also provide further support for iron ore and metallurgical coal prices.

Box 2.5: Sensitivity analysis of the iron ore spot price

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 spot price assumption, holding everything else constant.

If the iron ore price was to fall immediately to US\$55 per tonne FOB, rather than by the end of the March quarter of 2022 as assumed, nominal GDP could be around \$11.6 billion lower than forecast in 2020-21 and \$38.1 billion lower in 2021-22. This would result in a decrease in tax receipts of around \$600 million in 2020-21, \$8.3 billion in 2021-22 and, reflecting the timing of company tax collections, around \$3.5 billion in 2022-23 (Table 2.3).

By contrast, if the iron ore price was to remain elevated until the end of the March quarter of 2022, before falling immediately to US\$55 per tonne FOB, nominal GDP could be around \$1.1 billion higher than forecast in 2020-21 and \$48.7 billion higher in 2021-22. This would result in an increase in tax receipts of around \$100 million in 2020-21, \$5.5 billion in 2021-22 and, again reflecting the timing of company tax collections, around \$6.9 billion in 2022-23.

Table 2.3: Sensitivity analysis of movements in the iron ore spot price

| \$billion | Earlier fall to US\$55/tonne FOB ^(a) | | | Later fall to US\$55/tonne FOB | | |
|--------------|---|---------|---------|--------------------------------|---------|---------|
| | 2020-21 | 2021-22 | 2022-23 | 2020-21 | 2021-22 | 2022-23 |
| Nominal GDP | -11.6 | -38.1 | 0.0 | 1.1 | 48.7 | 0.0 |
| Tax receipts | -0.6 | -8.3 | -3.5 | 0.1 | 5.5 | 6.9 |

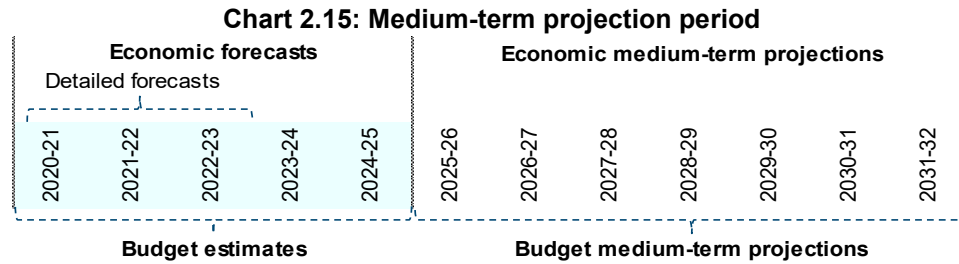
(a) FOB is the free-on-board price which excludes freight costs.

Source: Treasury.

Further details on how movements in commodity prices can affect the economy are detailed in *Statement 8: Forecasting Performance and Sensitivity Analysis*.

Medium-term projections

The fiscal aggregates in this year’s Budget are underpinned by forecasts of economic activity over the Budget forward estimates and projections over the medium term (Chart 2.15).



Source: Treasury.

In the current financial year, the Budget year and the subsequent financial year, more emphasis is placed on detailed forecasts of the expenditure components of economic activity. Beyond this period, estimates are constructed based on expectations for the level of potential output and modelling of the path by which output converges back to this potential level. An output gap exists if actual output is below potential.

A macroeconomic model of the Australian economy is used to help inform the path that the economy takes to close the output gap, accounting for factors such as the nature and level of spare capacity in the economy, the drivers of potential output growth, and the expected path of international trade prices. The model allows for a considered assessment of the path of output beyond the detailed forecast period, including incorporating major policy into the economic forecasts over the budget forward estimates period.

Potential GDP is estimated based on an analysis of trends for population, productivity, and participation. As additional capacity in the economy is absorbed over time (that is, the output gap closes), real GDP converges towards its potential level and the unemployment rate converges towards the estimate of the NAIRU. On the nominal side, key non-rural commodity export prices are projected based on cost curve analysis. Domestic prices return over time to the mid-point of the RBA’s inflation target band.

Overall, the outlook for the level of nominal GDP over the forecast and medium-term projection period has strengthened, reflecting a faster-than-expected recovery to date, a higher level of potential GDP over the medium term and stronger actual and updated commodity export prices assumptions. Potential GDP over the medium term is projected to remain below its expected pre-pandemic level. The terms of trade are projected to return to and remain around their 2006-07 level from 2025-26.

The faster-than-anticipated recovery in output and the labour market means that spare capacity continues to be reduced. Spare capacity in the labour market is expected to be absorbed by the end of 2022-23. From this point onwards, real GDP is projected to be primarily driven by potential GDP growth.

Potential GDP growth is estimated to fall below 2 per cent per annum in the near term before rising to average around 2¾ per cent per annum over the medium term to 2031-32.

Treasury has recently updated its approach to estimating the NAIRU, resulting in a lower NAIRU estimate that lies within the band of 4½ to 5 per cent. A lower NAIRU is consistent with the international experience prior to the pandemic of low unemployment with little to no inflation.

The trend participation rate has been revised up over the forward estimates and through the medium term. This primarily reflects improved expectations for labour-force participation for females, particularly full-time prime working age and older females.³

Labour productivity growth depends on both trends in underlying productivity⁴ and the productive capital stock. Underlying productivity growth is assumed to converge over a 10-year period to the average growth rate in labour productivity over the 30 years to 2018-19 of 1.5 per cent per annum. Increases in underlying productivity lead to complementary increases in the productive capital stock, but this takes time due to costs of adjustment.

³ Gustafsson L (2021), 'Australian labour force participation: historical trends and future prospects', Treasury Working Paper 2021-02, 29 April 2021.

⁴ Underlying productivity is also known as labour augmenting technical change.

