Part 2: Economic Outlook

Overview

The Australian economy is slowing in expected ways, given high but moderating inflation, higher interest rates and global economic uncertainty. Inflation is higher than target but is moderating alongside a clear pickup in wage growth. The labour market continues to perform well, with a low unemployment rate and strong employment growth. Risks, particularly internationally, are weighted to the downside but the Australian economy faces these challenges from a position of strength.

The outlook for the global economy remains highly uncertain and inflation continues to be a major challenge around the world. More persistent global inflation, Russia's invasion of Ukraine, the Hamas-Israel conflict, an ongoing adjustment in China's property sector and the lagged effects of sharp global monetary tightening all pose downside risks to growth. While some key economies have shown greater-than-expected resilience, global growth is still expected to moderate over the next two years as persistent inflation and higher interest rates weigh on economic activity.

Global growth is expected to slow from 3.4 per cent in 2022 to 3 per cent in 2023 and 2024 before a modest pick-up to 3¼ per cent in 2025. As at the 2023–24 Budget, global growth over the next two years is expected to be the weakest in over two decades, excluding the Global Financial Crisis and the pandemic.

While global inflationary pressures have eased overall since the second half of 2022, fuel prices have recently driven volatility in headline inflation in a number of advanced economies and inflation in many countries is taking longer to return to target than previously anticipated. Financial markets expect that most advanced economies have reached or are close to the peak in their tightening cycle, however interest rates are expected to remain near current levels until mid–2024. The Hamas-Israel conflict, Russia's ongoing invasion of Ukraine and additional production cuts by OPEC+ pose upside risks to global fuel prices and global inflation.

The Australian economy has not been immune from these challenges, with higher interest rates and high but moderating inflation impacting households. Inflation is still elevated and above target, but it has fallen broadly in line with expectations since the annual peak in 2022. This downward trend is expected to continue as easing supply constraints and weaker domestic activity reduce underlying price pressures across the economy.

In the near term, higher global oil prices and the continued pass-through of cost pressures will apply upward pressure to headline inflation, which has been revised up to 3¾ per cent through the year to the June quarter 2024. Elevated fuel prices directly added ¼ of a percentage point to annual inflation in the September quarter 2023. The oil price has since fallen but remains volatile, given ongoing global conflicts.

These developments have not changed the broader outlook for inflation, with the headline rate still projected to return to target within 2024–25 and forecast to be 2¾ per cent in the June quarter 2025. While Australia's inflation trajectory is similar to the experience of major advanced economies, inflation peaked later and lower than in most of these economies.

The Government's cost-of-living measures are directly reducing headline inflation and providing targeted relief to household budgets. Increases to child care subsidies, Commonwealth rental assistance and electricity rebates were estimated to reduce headline inflation by ½ of a percentage point in the September quarter 2023. The Government's cost-of-living policies are expected to reduce annual headline inflation by ¾ of a percentage point in the June quarter 2024.

Nonetheless, the impact of higher interest rates and elevated but moderating inflation on households is expected to weigh on economic activity in the near term. Economic growth is expected to slow from 3.1 per cent in 2022–23 to 1¾ per cent in 2023–24. Household consumption growth has slowed materially in response to elevated inflation and higher interest rates. Dwelling investment, which is highly sensitive to interest rates and remains subject to labour and material shortages, was also weaker than expected in the first half of 2023.

The Australian economy is well placed to navigate these challenges. Continued public and business investment momentum and the ongoing recovery in the international student and tourism sectors are helping to offset weakness in the household sector. These developments, combined with a resilient and dynamic labour market, are flowing through to a modest upgrade to GDP growth this financial year relative to the 2023–24 Budget.

The labour market has remained highly resilient to date, with over 600,000 additional people employed over the past 18 months. Participation also remains at record highs, and the unemployment rate has recorded its longest consecutive run below 4 per cent since monthly records began. Australia's labour market has outperformed major advanced economies with faster employment growth over the past 18 months, and a higher participation rate and employment-to-population ratio.

Given its strong starting position, the labour market is forecast to perform well compared to pre-pandemic averages even as conditions soften. Leading indicators suggest some slowing in the labour market is underway, with job advertisements and vacancies moderating from recent peaks and the underemployment rate rising from early-2023 lows. The unemployment rate is expected to rise modestly, reaching 4¼ per cent in the June quarter 2024. Broader labour market indicators, such as hours worked and the participation rate, are also expected to weaken. The unemployment rate is expected to peak at 4½ per cent in the June quarter 2025, unchanged from Budget. This remains low by historical standards and is only ¼ of a percentage point above Treasury's estimate of the Non-Accelerating Inflation Rate of Unemployment (NAIRU).

Annual wage growth has picked up to 4 per cent, the fastest rate of annual growth since 2009. This reflects recent labour market strength, as well as the Fair Work Commission determinations on the minimum wage and the Aged Care Work Value Case. Wage growth is expected to remain around 4 per cent until the end of 2023–24, before easing as the labour market softens and inflation normalises. As there is no evidence of a wage-price spiral and medium-term inflation expectations remain well anchored, this outlook is consistent with a return of inflation to target within 2024–25, with headline inflation forecast to reach 2¾ per cent by the June quarter 2025.

The economy is expected to regain momentum in 2024–25 as inflation subsides and growth in household disposable incomes improves. With inflation moderating, positive annual real wage growth is expected to return in early 2024 and will support real household disposable incomes. This is expected to support household consumption and drive a recovery in economic growth to 2¼ per cent in 2024–25.

There are substantial risks to the economic outlook. Further global instability and a re-tightening of oil markets stemming from escalations in Russia's invasion of Ukraine or the Hamas-Israel conflict pose upside risks to global inflation and downside risks to growth. As a large commodity exporter, Australia is also exposed to the risk of a sharper downturn in China's property sector that leads to commodity price volatility. Globally, the cumulative effects of monetary policy tightening could induce a larger-than-expected economic contraction and rise in unemployment, as well as the re-emergence of banking sector stress.

Heightened global inflationary pressures could contribute to more persistent domestic inflation, which would dampen household spending through further reductions in real incomes. Over the past decade, productivity outcomes in most advanced economies, including Australia, have been weak, and price pressures may be more persistent if this continues. As the global and domestic economies navigate the current environment, there remains a risk that further temporary shocks add to the anticipated cyclical slowdown and inflation challenge facing the Australian economy.

International economic outlook

The outlook for the global economy remains highly uncertain and inflation remains a key challenge in many economies. Russia's invasion of Ukraine, the Hamas-Israel conflict, China's property sector downturn and the lagged effects of sharp monetary tightening all pose downside risks to economic activity.

Key economies have diverged over 2023. The outlook for the euro area and United Kingdom remains weak, given higher peaks in headline inflation and weaker external demand. China's rebound after the removal of pandemic restrictions has also been more subdued than expected, as a deeper and more protracted decline in the property sector weighs on the broader economy.

In contrast, activity in some advanced economies – particularly the United States – has been stronger than previously expected. Growth has remained resilient despite sharp rises in interest rates over the past two years, labour markets have remained tight and banking sector stresses have so far been successfully contained.

Momentum in the global economy is expected to remain subdued as above-target inflation and higher interest rates weigh on activity. Global growth is forecast to slow from 3.4 per cent in 2022 to 3 per cent in 2023 and 2024, before edging up slightly to 3¼ per cent in 2025 as lower inflation and more accommodative policy rates support activity. Forecast global growth in 2023 and 2024 continues to represent the weakest two years in two decades, outside of the pandemic and global financial crisis.

Australia's major trading partners are forecast to grow by 3½ per cent in 2023. Growth is expected to slow to 3¼ per cent in 2024, unchanged since Budget, primarily due to weaker growth in China. A pick-up to 3½ per cent is expected in 2025 as moderating inflation leads to increases in real household incomes and policy interest rates begin to become more accommodative.

In the past two years, the global economy has experienced the most severe inflationary episode in decades. Despite recent volatility in oil prices, global headline inflation has fallen sharply as energy and food spot prices have retreated from their 2022 peaks and supply chain bottlenecks have unwound. However, core inflation in most major advanced economies has declined more gradually and remains above central banks' targets due to the continued pass-through of earlier shocks and ongoing strength in labour markets.

Inflation in advanced economies is expected to gradually decline over the forecast period. However, the normalisation of inflation rates is expected to take longer than previously anticipated for several economies. A return to central banks' targets is not anticipated in most advanced economies until at least 2025. Nonetheless, financial markets expect that most central banks have reached or are close to the peak in their tightening cycles, with policy rates in several advanced economies judged to be sufficiently restrictive to bring about further declines in inflation.

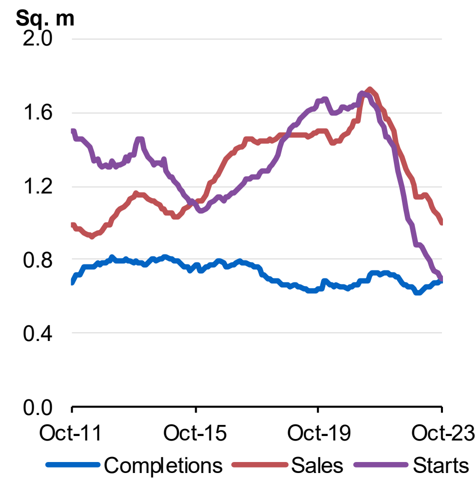
Risks to the international outlook remain tilted to the downside. Recent movements in global oil and energy prices contributed to volatility in headline inflation in several economies. Sustained increases in global commodity prices would add further pressure to global inflation, complicating the decisions of central banks. Despite resilience in some advanced economies to date, a larger-than-anticipated contraction in global economic activity and rise in unemployment rates could still materialise as the full effects of cumulative monetary policy tightening flow through. Renewed banking sector stress could emerge in an environment of heightened interest rates, particularly among small US institutions that are highly exposed to commercial real estate. Weaker-than-expected growth in China as the downturn in the property sector undermines consumer confidence could also weigh on global growth. As a commodity exporter, Australia is exposed to the associated risk of a sharp correction in key commodity prices.

China's economy is forecast to grow by 5¼ per cent in 2023, and 4½ per cent in 2024 and 2025. This represents a downward revision of ½ of a percentage point in 2023. China's post-pandemic rebound has been more subdued than expected due to a deeper and more protracted decline in the property sector, weak household and business confidence, and waning global demand.

Formerly a key growth driver, the property sector's downturn was precipitated by policy-driven efforts to limit financial risks and bring activity in line with slowing underlying demand. However, the downturn exposed weak fundamentals as credit restrictions forced developers to halt projects (Chart 2.1). With most new properties paid for in advance, demand has fallen due to buyers' fears that projects may not be delivered. Despite signs of a tentative recovery in early 2023, the correction has deepened, leading more developers to default and undertake lengthy debt restructuring.

The structural downturn in property is weighing on China's broader economy. The property sector is linked to a substantial amount of household wealth and local government revenue. Its downturn has exacerbated fragile consumer confidence (Chart 2.2) and stretched local government finances. While authorities have provided targeted support, aiming to ensure delivery of pre-sold apartments, they appear resolute that the sector should play a smaller role in the economy going forward. Though pockets of strength in infrastructure and manufacturing have helped to soften property's drag, its transition will continue to weigh on China's growth in the next two years.

Chart 2.1: China property sector activity indicators



Source: National Bureau of Statistics, China; Refinitiv.

Chart 2.2: China consumer confidence index

Source: National Bureau of Statistics, China; Refinitiv.

Note: Data is in billions, 12-month sums.

In the longer-term, growth in China's economy is expected to gradually slow as demographics and diminishing returns to investment lead China to become more reliant on productivity improvements to drive growth.

The **United States** is forecast to grow by 2½ per cent in 2023, 1½ per cent in 2024 and 1¾ per cent in 2025. The US achieved stronger-than-expected growth in the first 3 quarters of 2023. Strong employment growth and falling inflation have boosted consumption, and government tax incentives have stimulated business investment. Additionally, banking sector stresses from earlier in the year have so far been successfully contained. Combined, these factors see the growth outlook for 2023 upgraded by 1½ percentage points. Growth is still expected to slow in 2024, albeit less so than expected at Budget, as higher interest rates weigh on activity.

US policy interest rates are expected to be higher for longer than expected at Budget due to the stronger near-term outlook for growth. As such, forecast growth in 2025 has been downgraded by ½ of a percentage point. Moderating inflation despite resilient growth has widened the path to a soft landing since Budget. However, the outlook remains highly uncertain as inflation could prove more persistent than expected and the cumulative monetary policy tightening since early 2022 may have a stronger impact than anticipated.

Euro area GDP is forecast to grow by ½ per cent in 2023, ¾ per cent in 2024 and 1¾ per cent in 2025. Banking sector stresses have receded, allowing the region to grow more strongly than expected through the first half of 2023. However, high core inflation has led to further policy rate increases that, alongside weak external demand and a contracting manufacturing sector, will weigh on growth in 2023 and 2024. An anticipated easing in inflation and less restrictive policy rates are expected to support a recovery in 2025.

The **United Kingdom** is forecast to grow by ½ per cent in 2023 and 2024 and 1¾ per cent in 2025. Tighter monetary policy and high energy costs have weighed on growth in the UK. However, the containment of banking stresses and resilience in the labour market and services consumption have contributed to an improved outlook for growth in 2023. While higher than in all other major advanced economies, easing inflation should support real wage and consumption growth. There remains a risk that persistent inflation, high interest rates and weaker external demand weigh more heavily on the services sector and labour market.

Japan is forecast to grow by 1¾ per cent in 2023 and by 1 per cent in 2024 and 2025. Japan has experienced stronger-than-expected growth in 2023, driven by the easing of pandemic-related regulations, expansionary monetary policy and strong growth in net exports reflecting a recovery in inbound tourism and auto shipments amidst easing supply constraints and a depreciating yen. Although conditions for Japan's exporters will become tougher as the pace of recovery overseas slows, the economy is expected to grow strongly by recent historical standards.

Other East Asia is forecast to grow by 3¼ per cent in 2023 and by 4 per cent in 2024 and 2025. Economies in the region have recovered from pandemic-related shocks, but the recovery has been uneven. Going forward, growth will be impacted by high interest rates, relatively high levels of government debt relative to GDP, and reduced capacity for government spending. Externally, the region will also be impacted by tight financial conditions and slowing global growth, especially the slowdown in China.

India is forecast to grow by 7 per cent in 2023 and by 6½ per cent in 2024 and 2025. Growth in 2023 has been upgraded by 1½ percentage points due to unexpected strength in the first 3 quarters of the year. The strong growth through the year to the September quarter reflects higher government consumption and investment. This is despite weak monsoon season rainfall and a historically dry August harming crop yields, raising food inflation, and leading to the government placing restrictions on food exports.

Table 2.1: International GDP growth forecasts(a)

	Outcome	Forecasts (Calendar years)		
	2022	2023	2024	2025
Australia	3.9	2	1 ¾	2 ¼
China	3.0	5 ¼	4 ½	4 ½
India	6.6	7	6 ½	6 ½
Japan	0.9	1 ¾	1	1
United States	1.9	2 ½	1 ½	1 ¾
Euro area	3.4	½	¾	1 ¾
United Kingdom	4.3	½	½	1 ¾
Other East Asia (b)	4.5	3 ¼	4	4
Major trading partners	3.0	3 ½	3 ¼	3 ½
World	3.4	3	3	3 ¼

a) World and Other East Asia growth rates are calculated using GDP weights based on purchasing power parity (PPP). Growth rates for major trading partners are calculated using Australian goods and services export trade weights.

b) Other East Asia comprises Indonesia, Malaysia, the Philippines, Thailand, Vietnam and Singapore, along with Hong Kong, South Korea and Taiwan.

Source: National statistical agencies, IMF, Refinitiv and Treasury.

Domestic economic outlook

Elevated inflation, higher interest rates and a volatile international environment are all placing pressure on the Australian economy. The economy has shown significant resilience in the face of these challenges with continued labour market strength and a pick-up in wage growth. In 2022–23, economic growth was broad-based at 3.1 per cent, supported by consumption, returning international students and significant investment from both businesses and the public sector. This was broadly in line with Budget expectations of 3¼ per cent. Economic growth is expected to moderate to 1¾ per cent in 2023–24 before recovering to 2¼ per cent in 2024–25.

Household budgets remain under pressure from elevated but moderating inflation and higher interest rates. Growth in household consumption has softened in recent quarters. Many households, particularly those facing higher housing costs, have adjusted their consumption and savings behaviour. Financial markets and market economists see the current cash rate of 4.35 per cent as at or near its peak. This is higher than the 3.85 per cent peak assumed at Budget, and the higher cash rate profile will act as an additional drag on consumption and dwelling investment over coming quarters.

The near-term weakness in the household sector is being partly offset by stronger-than-expected business investment and a recovery in tourism and international education enabled by the reopening of international borders.

New business investment grew by 8.2 per cent in 2022–23, the fastest rate since 2011–12, supported by continued investment in non-dwelling construction projects and demand for new machinery and equipment. The level of business investment is expected to remain elevated through 2023–24 and 2024–25, though the pace of growth is expected to fall back from recent highs. This activity will be underpinned by a solid pipeline of non-dwelling construction projects, particularly on commercial buildings, electricity transmission, generation and supply, and a few significant LNG projects.

Inflation has peaked and is moderating as expected, with inflation still projected to return to the target band within 2024–25 and reach 2¾ per cent in the June quarter 2025. While annual inflation is easing, several factors are adding to price pressures in the near term. Higher global oil prices, in particular, have been flowing through to petrol prices and added ¼ of a percentage point to annual inflation in the September quarter. Targeted cost-of-living policies are helping to alleviate some of these near-term inflationary pressures and are estimated to reduce annual inflation by ¾ of a percentage point in the June quarter 2024.

Cyclical conditions are expected to improve in 2024–25, led by consumption and dwelling investment. Growth in real household disposable incomes is expected to pick-up in 2024–25 and drive a recovery in household consumption. Market economist expectations are taken as a technical assumption on the forward path of the cash rate. The assumption includes interest rate cuts, which are expected to reinforce a rebound in dwelling investment in 2024–25, spurred by strong housing demand.

The labour market remains resilient, with employment growing by over 400,000 through the year to October 2023 and the unemployment rate lifting only slightly to 3.7 per cent. Recent data has begun to show some moderation in response to the cyclical slowdown; this is expected to continue over the coming year broadly in line with the Budget outlook. The unemployment rate is expected to modestly rise over the next two years to reach 4½ per cent by the June quarter 2025, but remain below pre-pandemic levels. Easing labour market conditions are also expected to result in falls in the participation rate and an increase in broader measures of labour market slack such as the underemployment rate.

The recent strength in labour market outcomes is flowing through to wage growth, with nominal wage growth up by 4 per cent over the year to the September quarter 2023, the fastest rate of growth since 2009. The Fair Work Commission's Annual Wage Review and Aged Care Work Value Case have also had a positive impact on wage growth in the near term. Annual real wage growth is expected to resume in early 2024 for the first time since early 2021.

There are substantial risks to this outlook. It remains uncertain how sensitive aggregate household consumption will be to cyclical conditions. Households that built up significant savings buffers through the pandemic may support spending in the near term through a lower savings rate, but many households are facing acute budget pressures and spending has been weaker-than-expected to date. Inflation could also be more persistent, which would further weigh on household budgets.

Table 2.2: Domestic economy – detailed forecasts[a]

	Outcomes	Forecasts			
	2022-23	2023-24		2024-25	
		Budget	MYEFO	Budget	MYEFO
Real gross domestic product	**3.1**	**1 1/2**	**1 3/4**	**2 1/4**	**2 1/4**
Household consumption	5.0	1 1/2	1/2	2 1/2	2
Dwelling investment	-3.9	-3 1/2	-2	-1 1/2	1
Total business investment[b]	8.2	2 1/2	2 1/2	2	- 1/2
By industry					
Mining investment	1.6	2	5	1 1/2	-5
Non-mining investment	10.4	2 1/2	2	2	1
Private final demand[b]	4.1	1	3/4	2 1/4	1 1/2
Public final demand[b]	2.4	1 1/2	2 1/2	2	3/4
Change in inventories[c]	-0.2	0	- 1/2	0	1/4
Gross national expenditure	3.4	1	3/4	2 1/4	1 1/2
Exports of goods and services	6.8	6	7 1/2	3 1/2	5
Imports of goods and services	9.3	4	4 1/2	3 1/2	3
Net exports[c]	-0.1	1/2	1	0	3/4
Nominal gross domestic product	9.8	1 1/4	4 1/4	2 1/2	2 1/4
Prices and wages					
Consumer price index[d]	6.0	3 1/4	3 3/4	2 3/4	2 3/4
Wage price index[d]	3.6	4	4	3 1/4	3 1/4
GDP deflator	6.6	- 1/4	2 1/2	1/4	0
Labour market					
Participation rate (per cent)[e]	66.9	66 1/4	66 3/4	66 1/4	66 1/4
Employment[d]	3.2	1	1 1/2	1	1
Unemployment rate (per cent)[e]	3.6	4 1/4	4 1/4	4 1/2	4 1/2
Balance of payments					
Terms of trade[f]	-0.5	-13 1/4	-6 1/4	-8 3/4	-9 3/4
Current account balance (per cent of GDP)	1.1	-2 1/2	1/2	-3 1/2	-2
Net overseas migration[g]	510,000	315,000	375,000	260,000	250,000

a) Percentage change on preceding year unless otherwise indicated.
b) Excluding second-hand asset sales between the public and private sector.
c) Percentage point contribution to growth in GDP.
d) Through-the-year growth rate to the June quarter.
e) Seasonally adjusted rate for the June quarter.
f) Key commodities are assumed to decline from elevated levels over four quarters to the end of the September quarter 2024: the iron ore spot price is assumed to decline from a September quarter 2023 average of US$105/tonne to US$60/tonne; the metallurgical coal spot price declines from US$264/tonne to US$140/tonne; the thermal coal spot price declines from US$144/tonne to US$70/tonne. All prices are in free-on-board (FOB) terms.
g) Net overseas migration is forecast to be 255,000 in 2025–26 and 235,000 in 2026–27. The figure for 2022–23 consists of three quarters of preliminary estimates and one quarter of forecasts.

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 60 and a $US exchange rate of around 65 US cents. Interest rates are informed by the Bloomberg survey of market economists. World oil prices (Malaysian Tapis) are assumed to remain around US$96/barrel

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

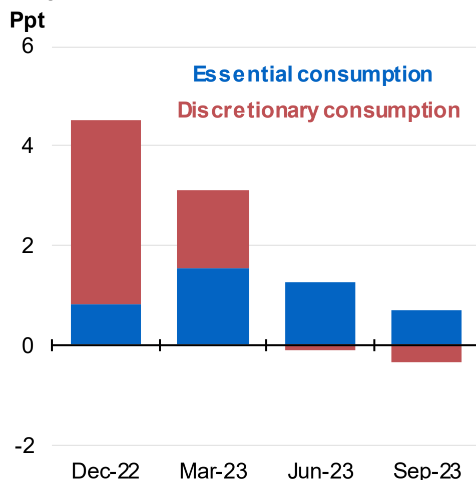
Household consumption

Elevated inflation and higher interest rates are constraining household budgets. Growth in household consumption has softened in recent quarters, with households prioritising spending on essential items (Chart 2.3). Household consumption rose 0.1 per cent in the June quarter 2023 and was flat in the September quarter 2023. Recent data indicates that this weakness has continued in recent months and consumption is expected to remain subdued in 2023–24, growing only ½ per cent.

While aggregate household savings remain positive, many are saving less of their incomes in response to elevated inflation and higher interest rates. The household saving ratio has fallen in recent quarters and is expected to average 2 per cent in 2023–24, its lowest annual level since 2007–08. It is also likely that some households are needing to draw upon previously accumulated savings to support their consumption and service mortgage costs.

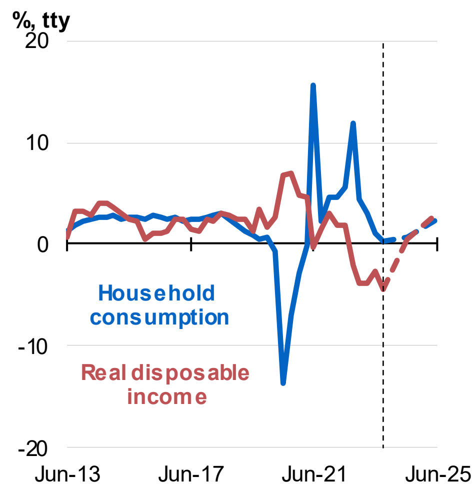
Households' financial position will improve as inflation subsides and wage growth picks up. This is expected to drive a recovery in household consumption, with 2 per cent growth forecast in 2024–25 (Chart 2.4).

Chart 2.3: Contribution to consumption growth, through the year



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

Chart 2.4: Consumption and real income growth



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

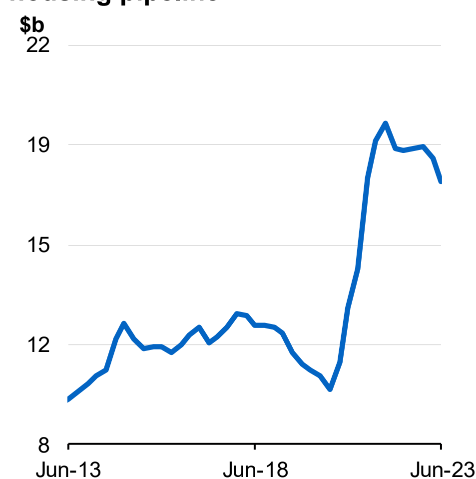
Dwelling investment

Constrained household budgets, higher interest rates and elevated construction costs are also weighing on the demand for new dwelling investment. Dwelling investment is expected to contract by 2 per cent in 2023–24, following a 3.9 per cent fall in 2022–23.

Capacity constraints, including labour and material shortages, have constrained dwelling investment in recent quarters. However, recent data suggests that these constraints are easing, allowing the pace at which the sector works through the significant backlog of detached housing to pick up (Chart 2.5).

Dwelling investment is forecast to recover, rising by 1 per cent in 2024–25, led by increased demand for housing, tight supply and improving asset returns (Chart 2.6). The projected rebound in activity is expected to be concentrated in medium and high-density dwellings.

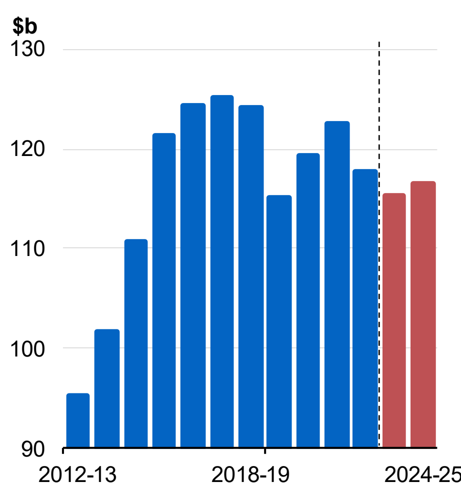
Chart 2.5: Real value of detached housing pipeline



Source: ABS Building Activity; unpublished ABS data and Treasury.

Note: Data is original. Nominal pipeline of residential work is deflated by dwelling prices.

Chart 2.6: Dwelling investment



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

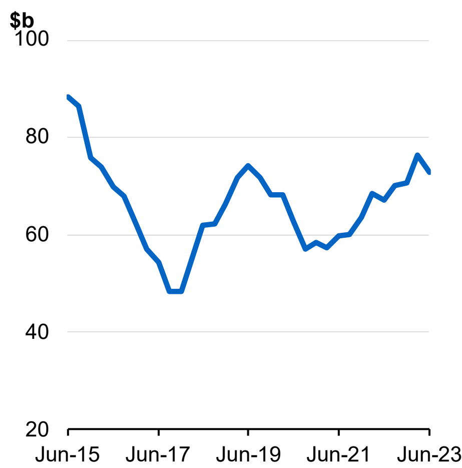
Business investment

New business investment grew strongly in 2022–23, supported by an improvement in the supply of new machinery and equipment, capital goods, and activity progressing on non-dwelling construction projects. The level of new business investment is expected to remain elevated above pre-pandemic levels.

Solid capital expenditure intentions underpinned by strong business balance sheets, and elevated levels of capacity utilisation are forecast to drive a 2½ per cent increase in investment in 2023–24. A solid pipeline of non-dwelling construction projects, particularly large mining projects, will also support growth. Investment is expected to unwind by ½ per cent in 2024–25 as this pipeline gets worked through (Chart 2.7). The possibility that firms delay or cancel projects in response to economic headwinds continues to present a downside risk to investment.

The non-mining sector is expected to drive business investment over the coming years, growing by 2 per cent in 2023–24 and by a further 1 per cent in 2024–25. The pipeline of non-residential construction projects remains elevated. Activity will be focused on commercial buildings, such as data centres and warehouses, and the generation, transmission and distribution of electricity which includes a growing number of renewable energy projects. Mining investment is expected to increase by 5 per cent in 2023–24 as work continues on significant LNG projects. Activity is expected to normalise in 2024–25, falling by 5 per cent, with expenditure concentrated on maintaining existing production capacity (Chart 2.8).

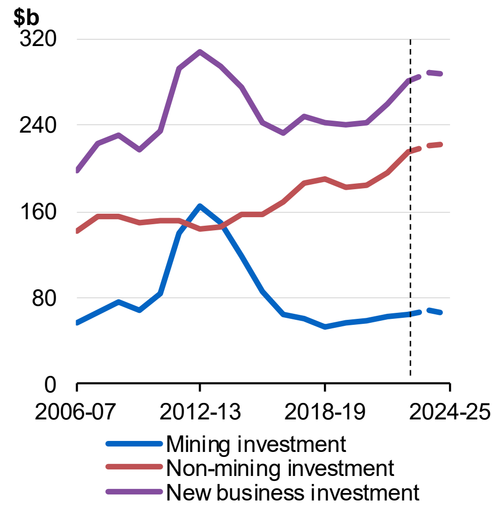
Chart 2.7: Real value of non-dwelling construction pipeline



Source: ABS Building Activity, ABS Engineering Construction, ABS Australian National Accounts: National Income, Expenditure and Product and Treasury.

Note: Nominal pipeline of non-dwelling construction work is deflated by non-dwelling construction prices.

Chart 2.8: Business investment by component

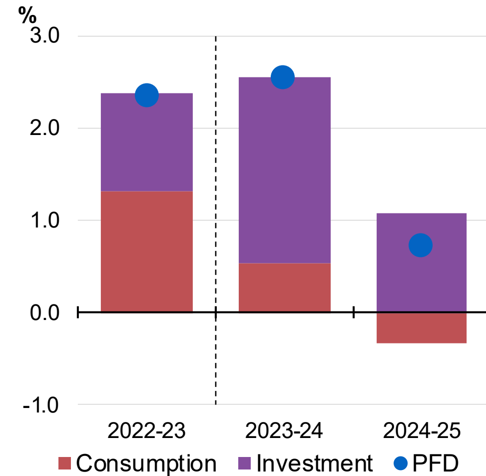


Source: ABS Australian National Accounts: National Income, Expenditure and Product and Treasury.

Public final demand

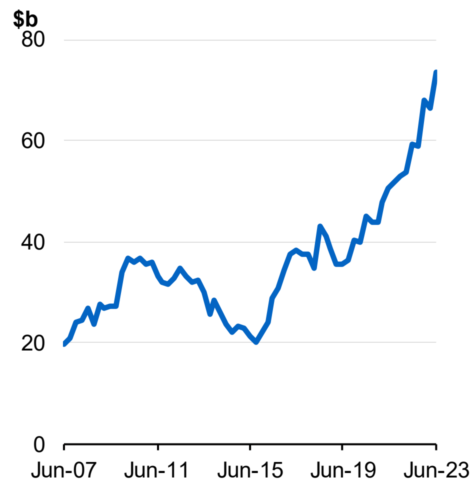
Public final demand is forecast to increase by 2½ per cent in 2023–24, driven by an increase in public investment across different levels of government and targeted cost-of-living policies to support households (Chart 2.9). As capacity constraints ease, activity in the near term will be underpinned by work progressing on public infrastructure projects that are currently underway (Chart 2.10). The Government has made changes to the Infrastructure Investment Program to ensure deliverability and ease capacity constraints, while refocussing on nationally significant infrastructure. Growth in public final demand is expected to moderate to ¾ per cent in 2024–25.

Chart 2.9: Contributions to growth in public final demand



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

Chart 2.10: Public investment pipeline



Source: ABS Building Activity, Engineering Construction and Australia National Accounts: National Income, Expenditure and Product.

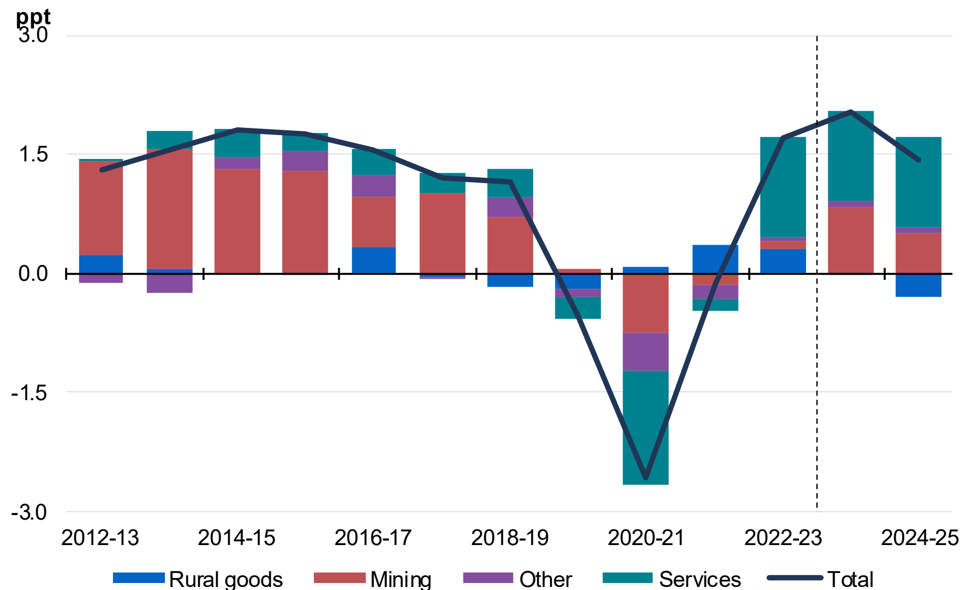
Net exports

Net exports are expected to make a stronger contribution to real GDP growth over the next two years than was expected at Budget, adding a total of 1 percentage point in 2023–24 and ¾ of a percentage point in 2024–25. This upgrade reflects a more robust outlook for services exports driven by the ongoing recovery in international demand for higher education services.

Services will underpin growth in total exports, which are expected to increase by 7½ per cent in 2023–24 and by 5 per cent in 2024–25. Strong mining exports from improved production conditions are also expected to support export growth in the near term (Chart 2.11).

Imported goods volumes have remained elevated since the pandemic, with recent strength attributable to strong vehicle imports as supply constraints resolve. Goods imports growth is expected to evolve in line with domestic demand, with growth easing in 2023–24 before recovering in 2024–25. The ongoing recovery in tourism imports is expected to support growth in imports of 4½ per cent in 2023–24 and 3 per cent 2024–25.

Chart 2.11: Contribution of export components to GDP growth



Source: ABS Australian National Accounts: National Income, Expenditure and Product; Balance of Payments and International Investment Position, Australia and Treasury.

Note: 'Other' includes exports of non-commodity goods and additive differences due to rebasing of volume change measures.

Inflation

Annual inflation peaked in late 2022, and is now moderating with the unwinding of price shocks, including from pandemic-related disruptions and Russia's invasion of Ukraine. These global factors were exacerbated by domestic events, including floods across Eastern Australia. Annual inflation eased to 5.4 per cent in the September quarter 2023, well below its peak of 7.8 per cent in the December quarter 2022 and in line with Budget expectations. This outcome was driven by both the continued easing of goods inflation as well as the Government's measures to deliver cost-of-living relief.

Goods inflation has been moderating throughout 2023, as global supply chain disruptions eased and demand for goods normalised. The pick up in services inflation has lagged that of goods inflation. Services inflation is close to its peak and is expected to normalise over the next two years.. Higher fuel prices are also contributing to higher inflation in the near term, with the outlook in 2024–25 broadly unchanged.

Headline inflation is now expected to fall to 3¾ by June quarter 2024, ½ of a percentage point higher than expected at Budget. The primary driver of this upgrade is the recent rise in global oil prices. While oil prices have subsequently retreated, movements in oil prices and the exchange rate this year have added to near-term petrol prices and inflationary pressures (Box 2.1).

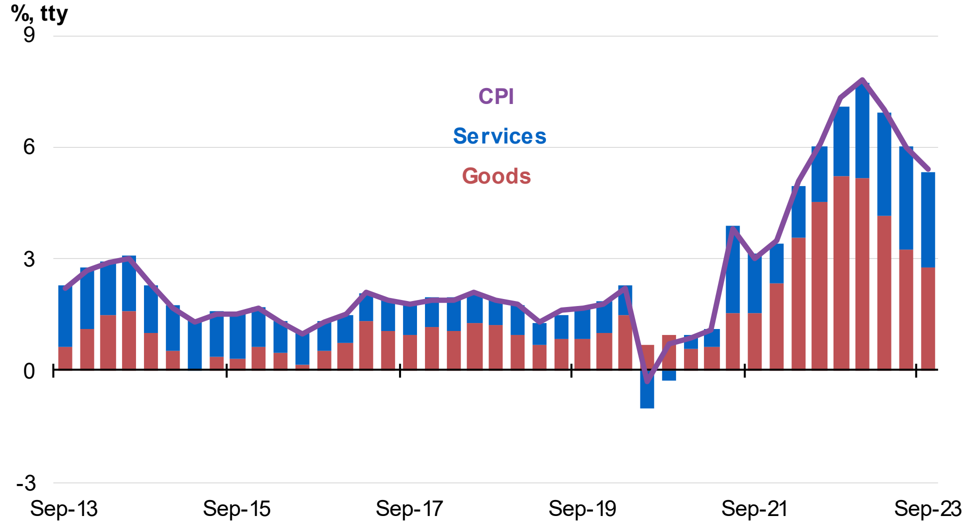
The rental market has remained very tight, with national vacancy rates at near-record lows of around 1 per cent. Annual growth of advertised rental prices remained at 8.1 per cent in November, slightly easing from its September quarter 2022 peak of 9.6 per cent. Growth in rental costs is expected to remain elevated in the next few years as increases in advertised rents flow through to existing lease agreements when they are renewed. Demand for housing has increased sharply following the pandemic, driven by a fall in average household size and the reopening of international borders. Conversely, material and labour constraints affecting the residential construction sector are delaying new dwelling completions. This is limiting the capacity for housing supply to keep up with demand.

Cost-of-living relief measures are helping to offset these developments by directly reducing headline inflation. Electricity rebates, increases in child care subsidies and Commonwealth Rent Assistance are estimated to have reduced annual inflation in the September quarter 2023 by ½ of a percentage point. The Government's cost-of-living measures are estimated to reduce annual inflation by ¾ of a percentage point in the June quarter 2024.

Inflation is expected to continue easing and to gradually return to the target band within 2024–25 and reach 2¾ per cent in the June quarter 2025. Goods disinflation will continue to drive down headline inflation, while services inflation is expected to moderate as rental price growth eases and slowing domestic activity reduces price pressures across the economy.

However, the outlook for inflation is highly uncertain, and it could remain more persistent than currently anticipated. Recent global events have demonstrated how domestic inflationary pressures can be driven by the uncertain global environment. In addition, El Niño, typically associated with dry weather conditions, pose an upside risk to food inflation. Disruptions to normal rainfall patterns or a greater likelihood of natural disasters may disrupt production which would put upward pressure on inflation.

Chart 2.12: Goods and services inflation



Source: ABS Consumer Price Index and Treasury.
Note: Contributions are approximations as they are back-cast prior to the September quarter 2023 using the 2023 CPI expenditure weights, and use rounded analytical series contributions.

Box 2.1: Global oil price impact on domestic inflation

Global oil prices have been volatile since Budget, peaking at around 16 per cent above the Budget assumption in US-dollar terms in September. While oil prices have subsequently retreated, movements this year have added to near-term petrol prices and inflationary pressures. The volatility is a result of ongoing oil production adjustments across major exporters, as well as heightened risks associated with current global conflicts. Additionally, as oil is traded in US dollars, movements in the Australian-US dollar exchange rate also impact the price paid locally. Since Budget the Australian dollar has depreciated by around 3.1 per cent against the US dollar.

Oil prices primarily impact domestic inflation via the cost of fuel. Increases in fuel prices have both direct impacts on domestic inflation, via the price households pay at the bowser, and indirect impacts, from an increase in transportation costs and intermediate input costs across the economy.

Treasury estimates that around half of the impact of an increase in global oil prices on domestic inflation is through a direct increase in automotive fuel prices for households. The rest of the impact is a result of indirect passthrough, with higher fuel prices for businesses flowing into final prices. Analysis of the CPI indicates that a sustained 15 per cent rise in oil prices in Australian dollars on average adds around ¼ of a percentage point to domestic inflation through the direct channel, and ¼ of a percentage point via the indirect channel. However, the timing and magnitude of the pass-through is uncertain and sector specific.

Oil prices have moderated recently but there is risk of further price spikes. A regional escalation of the Hamas-Israel conflict that impacts major oil exporting nations presents upside risks to global oil prices and the near-term domestic inflation outlook. The recently announced OPEC+ output cuts, which are in addition to earlier cuts, could also put upward pressure on prices. An increase in inflation resulting from such a shock would decrease households' real incomes and may reduce their consumption, weighing on domestic economic activity.

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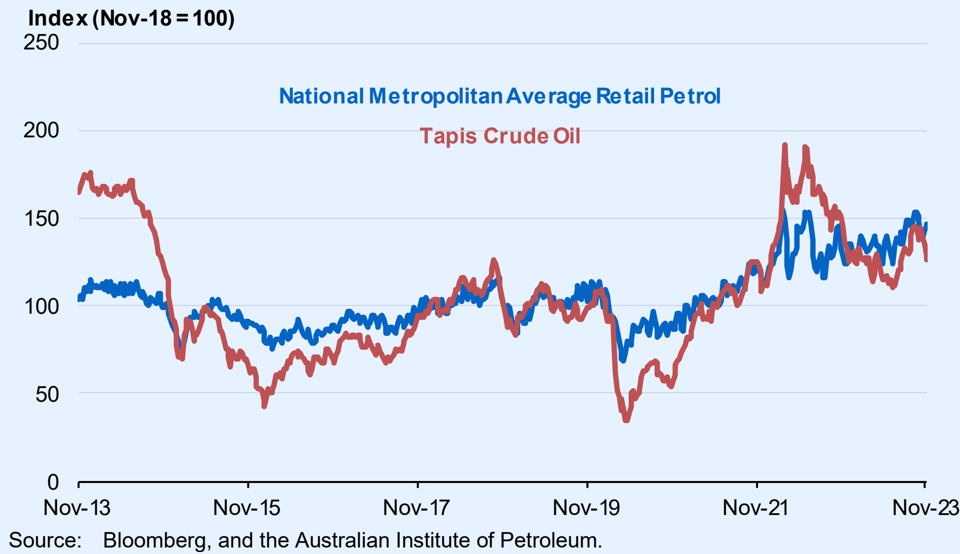
Box 2.1: Global oil price impact on domestic inflation (continued)

Chart 1: Tapis crude oil and national metropolitan average petrol prices



Source: Bloomberg, and the Australian Institute of Petroleum.

The labour market

The labour market has shown resilience, with the unemployment rate remaining below 4 per cent across 2023. Despite moderating economic growth, tight conditions in the labour market are taking time to unwind. The labour market has readily absorbed recent increases in labour supply associated with strong population growth and record-high participation, with many new workers filling job opportunities (Chart 2.13). These conditions have lifted prospects for cohorts who traditionally face barriers to employment. Female participation reached a new record high in October 2023, and while youth unemployment has risen, it remains low compared to its pre-pandemic levels.

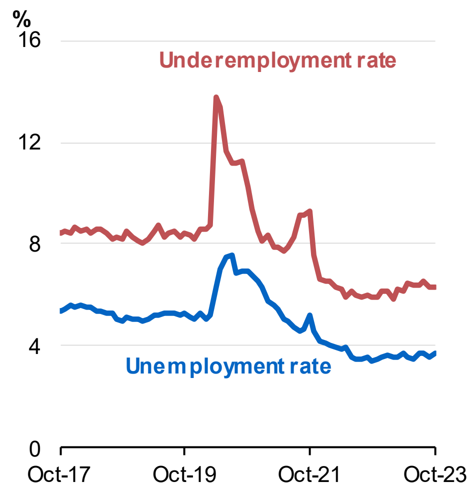
Conditions in the labour market are expected to gradually ease over the coming year. This is consistent with leading indicators, including job advertisements and vacancies. In addition, firms have started to reduce average hours worked by employees which is coinciding with a slight increase in the underemployment rate (Chart 2.14).

The continued softening in the labour market is expected to see the unemployment rate gradually rise to 4½ per cent in the June quarter 2025 and the participation rate fall slightly from record highs reflecting the delayed pass-through of weaker economic conditions. Even with this pick-up, an unemployment rate at this level is low by historical standards and only ¼ of a percentage point above Treasury's estimate of the NAIRU.

Chart 2.13: Participation rate

Source: ABS Labour Force, Australia.

Chart 2.14: Unemployment and underemployment rate



Source: ABS Labour Force, Australia.

Reflecting these tight labour market conditions, nominal wage growth has picked up, rising by 4 per cent through the year to the September quarter 2023, the fastest annual nominal wage growth since 2009. Wages are expected to continue to grow by 4 per cent through the year to the June quarter 2024. Most of the pick-up in wages over 2023–24 is anticipated to be driven by public and private enterprise agreements, which lag awards and individual arrangements due to negotiation times. Wage growth forecasts take into account administered decisions including the Fair Work Commission's Annual Wage Review determination and work value case for the aged care industry. Growth in market sensitive wages, such as those set via individual arrangements, are expected to ease in response to a softening in the labour market.

There is no sign of a wage-price spiral developing in Australia and medium-term inflation expectations are well anchored. Moving through 2024–25, wage growth is expected to soften as the labour market loosens in response to weaker demand. Nominal wage growth is expected to ease to 3¼ per cent in the June quarter 2025.

With inflation moderating and wages picking up, positive annual real wage growth is expected to return in early 2024. This is broadly in line with expectations in the Budget.

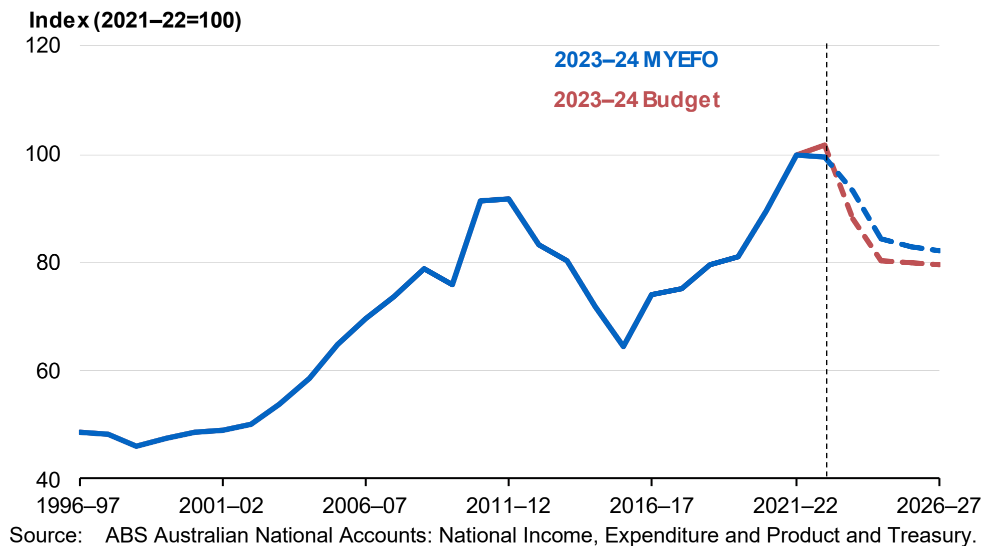
Outlook for the terms of trade

Australia's terms of trade, the ratio of export to import prices, are forecast to decline by 6¼ per cent in 2023–24 (Chart 2.15). This is driven by the assumption that bulk commodity prices trend towards their long-run anchors over four quarters, consistent with Budget.

The terms of trade are also sensitive to the exchange rate, as mining exports are denominated in US dollars. Mining export values and prices have been upgraded since the Budget to align with the current Australian-US dollar exchange rate assumption of 0.65, down from 0.67 at Budget. The recent depreciation in the exchange rate has been driven by higher interest rates in the United States relative to Australia. While recent weakness in the Australian dollar has supported mining export earnings, an upward correction in the exchange rate could weigh on the value of mining export earnings and tax receipts.

Overall, key commodity prices are assumed to return to their long-run fundamental levels by the end of the September quarter 2024. The Tapis oil price assumption, which affects both export and import prices, has been updated from US$87/barrel to US$$96/barrel. Oil prices have fallen in recent weeks but remain highly volatile, with upside risks posed by ongoing global conflict and renewed production cuts by major oil producers.

Chart 2.15: Terms of trade



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

Outlook for nominal GDP

Nominal GDP is expected to grow 4¼ per cent in 2023–24. This reflects underlying growth in economic output as well as strength in domestic consumption and investment prices. Nominal GDP growth is then expected to slow to 2¼ per cent in 2024–25 as solid output growth and continued growth in domestic prices are offset by a fall in the terms of trade.

Medium-term projections

The fiscal aggregates in MYEFO are underpinned by economic forecasts over the Budget estimates period and projections over the medium term.

Treasury uses a macroeconometric model of the Australian economy for its forecasts and projections beyond the detailed forecast horizon of 2024–25. The model informs how the economy returns to its trend level of output, known as potential GDP, following short-term fluctuations of the business cycle.

Potential GDP is estimated based on an analysis of trends for population, productivity, and participation. Changes in these trends have decreased the level of potential GDP over the projections compared with the Budget.

Since Budget, the level of population (aged over 15) has been revised up by ¼ per cent on average over the medium term. The trend participation rate is largely unchanged.

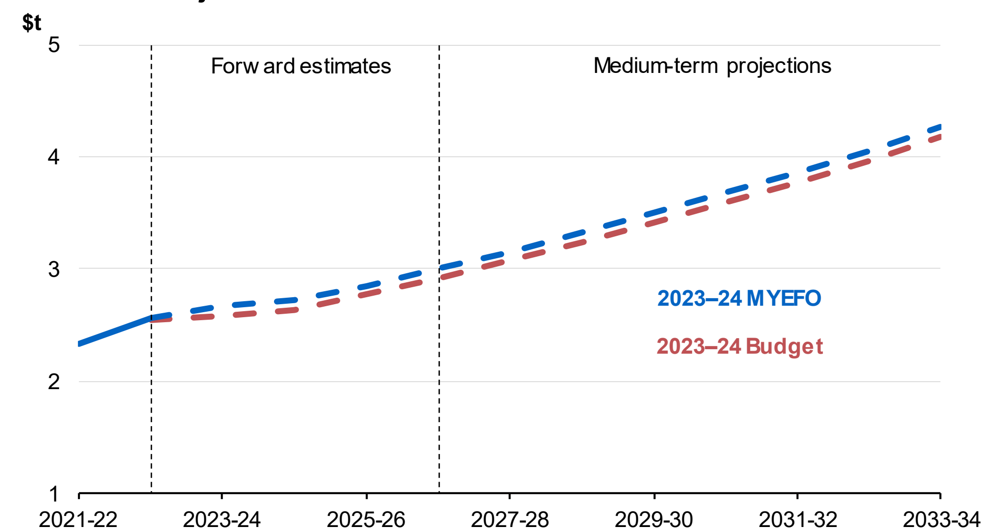
The upgrade in the size of the workforce has been more than offset by a lower estimated level of trend productivity, reflecting continued weak underlying productivity growth, which pre-dated COVID-19 related disruptions that are largely expected to unwind. In the long run, productivity is assumed to grow at 1.2 per cent per annum, unchanged from the assumption in the Budget.

The unemployment rate settles at the NAIRU assumption of 4¼ per cent by the June quarter 2027 and remains at that rate over the projections.

Domestic price growth converges over time to the midpoint of the RBA target band of 2.5 per cent. The terms of trade are projected to remain around their 2024–25 level over the medium term, with key commodity prices being at levels consistent with their long-term fundamentals. Nominal wage growth converges to 3¾ per cent, reflecting the outlook for labour productivity growth and inflation.

The level of nominal GDP over the projections is higher than at Budget, reflecting the combination of a higher domestic price level and a lower exchange rate assumption (Chart 2.16).

Chart 2.16: Projected nominal GDP



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