



Australian Government

The Treasury

JOINT ECONOMIC FORECASTING GROUP REPORT

ECONOMIC OUTLOOK FOR
2014–15, 2015–16 and 2016–17

March 2015

This report incorporates domestic and international data released up to 10 April 2015.

EXECUTIVE SUMMARY

The Australian economy continued to grow in 2014 and extended its run to 23 calendar years of uninterrupted economic growth, notwithstanding the challenges it faced from a fragile global economy, the unwinding of a once-in-a-century investment boom, and a sharp fall in commodity prices.

The transition away from resources investment to broader-based drivers of growth continues. Mining investment is declining, while household consumption grew at its strongest rate in almost three years in the December quarter and dwelling investment and exports continue to grow strongly.

But Treasury's business liaison program and the latest capital expenditure (CAPEX) survey point to significantly weaker-than-expected non-mining business investment in 2015-16, despite dwellings investment and exports being expected to grow strongly.

Accordingly, the outlook for real GDP growth has been downgraded slightly since MYEFO, with forecast growth of 2 1/4 per cent in 2015-16 and 3 1/4 per cent in 2016-17.

Wage growth remains at historic lows and is expected to continue at around current rates, until a modest pick-up in 2016-17 when economic growth is forecast to have strengthened enough to return to trend. While persistent low wage growth will weigh on household income, it should ameliorate the impact of lower real GDP growth on unemployment, with the unemployment rate still expected to peak at 6 1/2 per cent, though the risk that it will peak at a higher level has increased.

Low forecast wage growth should also ensure domestic price pressures remain well contained. Were it not for higher import prices from the lower dollar, CPI inflation would likely be in the bottom-half of the RBA's target band in 2015-16.

Weak forecast domestic price growth, lower forecast real GDP growth and lower commodity prices have caused a significant write-down to nominal GDP growth. Forecast nominal GDP growth has been downgraded by 1 percentage point to 3 1/2 per cent in 2015-16.

As always there are significant risks to the outlook. If sentiment does not improve, the expected pick-up in non-mining business investment could be further delayed and consumers could become more cautious and scale back spending. On the other hand, especially with significant monetary policy stimulus in place, consumers and firms could spend more strongly than forecast, particularly in 2016-17. Confidence intervals suggest substantial uncertainty around the real GDP forecasts and that there is even more uncertainty around the nominal GDP growth forecasts, reflecting the additional uncertainty around price forecasts.

Table 1: Key domestic and international forecasts

Per cent ^(a)	2013-14		2014-15		2015-16		2016-17	
	Outcomes ^(b)	MYEFO	March JEFG	MYEFO	March JEFG	March JEFG	March JEFG	March JEFG
Real gross domestic product	2.5	2 1/2	2 1/2	3		2 3/4		3 1/4
Nominal gross domestic product	4.0	1 1/2	1 1/2	4 1/2		3 1/2		5 1/4
Consumer price index ^(c)	3.0	2 1/2	1 1/2	2 1/2		2 1/2		2 1/2
Wage price index ^(d)	2.5	2 1/2	2 1/2	3		2 1/2		2 3/4
Unemployment rate ^(e)	6.0	6 1/2	6 1/2	6 1/2		6 1/2		6 1/4
Terms of trade	-3.7	-13 1/2	-11 3/4	-3 3/4		-7		1/4
Major trading partner growth ^(f)	4.2	4 1/2	4 1/2	4 1/2		4 1/2		4 1/4
China ^(f)	7.4	6 3/4	6 3/4	6 1/2		6 1/2		6 1/4
United States ^(f)	2.4	3	3 1/4	3		3		2 3/4
Real GDP forecast comparisons				2 1/4		3		3 1/2
RBA								

Note: Text in blue indicates a forecast upgrade, while red text indicates a forecast downgrade.
(a) Percentage change on preceding year unless otherwise indicated.
(b) Calculated using original data unless otherwise indicated.
Source: ABS Cat. No. 5206.0, 5302.0, 6202.0, 6345.0, 6401.0, unpublished ABS data and Treasury.

(c) Through-the-year growth rate to the June quarter.
(d) Seasonally adjusted, through-the-year growth rate to the June quarter.
(e) Seasonally adjusted rate for the June quarter.
(f) Reported in calendar years (i.e. 2014-15 = 2015)

External Developments and Outlook

The global economy has had a mixed start to 2015. Chinese growth continues to slow, consistent with the outlook at MYEFO, as it transitions to more sustainable growth. While a strong and broad-based recovery has taken hold in the US, transitory factors including activity disruptions during a severe winter may have contributed to weaker growth in the March quarter. Euro area activity remains modest and the Japanese recovery is slower than expected at MYEFO. Iron ore and metallurgical coal prices have fallen in US dollar terms since MYEFO, though the lower Australian dollar has cushioned

the impact in domestic currency terms. Oil prices have also fallen significantly over the past year.

Overall, the outlook for major trading partner growth remains broadly unchanged since MYEFO with growth expected to decline from 4½ per cent in 2015 and 2016 to 4¼ per cent in 2017. Risks to the outlook stem from possible bouts of financial market volatility as the US normalises monetary policy settings, and a worsening of geopolitical tensions. Also China's transition to a more sustainable growth model may not be smooth, posing a downside risk.

Table 2: Key international forecasts^(a)

	2014		2015		2016		2017
	Actual	MYEFO	March JEFG	MYEFO	March JEFG	March JEFG	
China	7.4	6 3/4	6 3/4	6 1/2	6 1/2	6 1/4	
India	7.2	5 1/2	7 1/2	6	7 1/2	7 1/2	
Japan	0.0	1	3/4	3/4	3/4	1/2	
United States	2.4	3	3 1/4	3	3	2 3/4	
Euro area	0.9	1	1	1 1/2	1 1/2	1 1/2	
Other East Asia ^(b)	4.1	4 3/4	4 3/4	4 3/4	4 3/4	5	
Major trading partners	4.2	4 1/2	4 1/2	4 1/2	4 1/2	4 1/4	
World	3.3	3 3/4	3 1/2	4	3 3/4	3 3/4	

Note: Text in blue indicates a forecast upgrade, while red indicates a forecast downgrade.

(a) World, euro area and other East Asia growth rates are calculated using GDP weights based on purchasing power parity (PPP), while growth rates for major trading partners are calculated using export trade weights.

(b) Other East Asia comprises the newly industrialised economies (NIEs) of Hong Kong, South Korea, Singapore and Taiwan and the Association of Southeast Asian Nations group of five (ASEAN-5), which comprises Indonesia, Malaysia, the Philippines, Thailand and Vietnam.

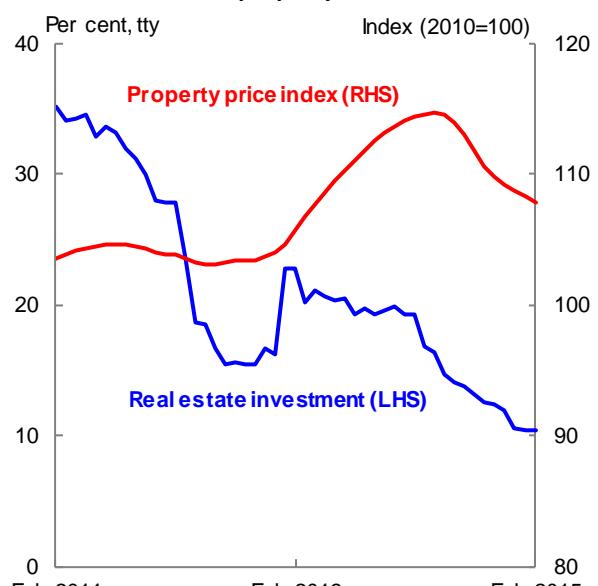
Source: National Statistical Agencies, IMF World Economic Outlook January 2015, Thomson Reuters and Treasury.

Chinese growth moderates...

Chinese growth will continue to moderate to a more sustainable rate, reflecting the transition already underway from investment-led to consumption-led growth. This transition will provide opportunities for Australia's services sector while presenting challenges for our commodity exporters, as our non-rural commodities are used as an input in Chinese investment.

Data released since the start of the year have been broadly consistent with the moderation in growth foreshadowed in MYEFO, though there are concerns that growth is slowing faster than expected. This saw authorities further loosen monetary policy in February. An expected rollout of infrastructure investment and lower oil prices mitigate to a degree ongoing concerns about the slowdown in the property and manufacturing sectors (Chart 1). Authorities remain well placed to use additional monetary and fiscal policy to, if necessary, support growth to achieve the Government's 2015 growth target of 'around 7 per cent' (down from the 2014 target of 7½ per cent).

Chart 1: Chinese property market indicators



Source: CEIC China Database and Treasury.

China's steel industry has taken longer than usual to emerge from the regular shutdown period over Chinese New Year, a sign that the continued strength in infrastructure investment is proving insufficient to offset lower steel demand from the property sector. There is also a concern that last year's record

level of Chinese steel exports may not be sustainable, suggesting further downside risk to the outlook for steel and iron ore prices and, to a lesser extent, volumes over the coming year.

... and Indian growth has been upgraded...

Economic growth in India has been upgraded over the forecast period. If sustained, India could contribute to stronger growth in the region and become a more important trading partner for Australia. India's improved prospects reflect increasing confidence in the new Government's ability to deliver economic reform and ongoing low commodity prices. Recent falls in coal and energy prices have reduced businesses' operating costs and benefited private consumers. They have also contributed to lower than expected inflation, enabling authorities to ease monetary policy to support growth. The upward revision in Indian growth also reflects a boost in measured growth from the adoption of a rebased GDP series by the Indian authorities.

... while advanced economy recoveries are mixed

Over the past year, a strong and broad-based recovery has taken hold in the US, although some indicators suggest a moderation in growth in the March quarter. This is likely to be at least partly due to transitory factors including activity disruptions during a severe winter, though a stronger US dollar may also be weighing on trade and business investment.

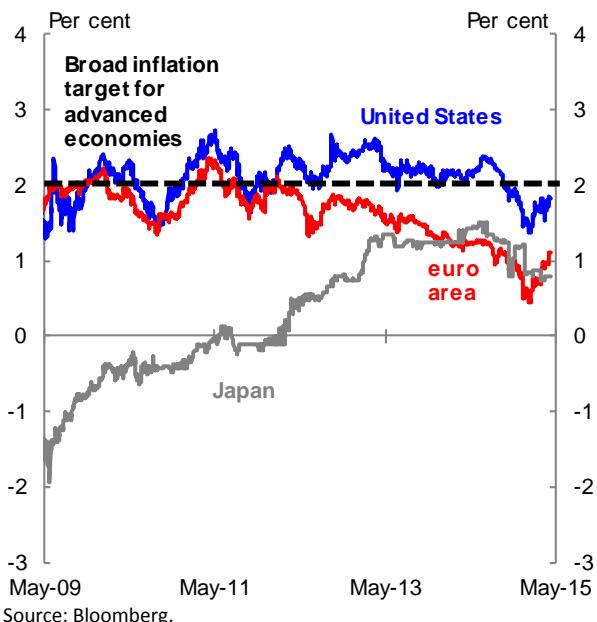
Nevertheless, the fundamentals of the US recovery remain solid. The recovery to date has been led by consumption and business investment, following the prolonged and large fall in business investment following the Global Financial Crisis. A boost to real household incomes, from falling energy prices, has also supported growth. The US economy has added more than 200,000 jobs each month in the twelve months to February this year. Non-farm payrolls in March were weaker than expected, with the slow growth concentrated in the most weather-sensitive sectors of the economy, such as hospitality and construction. The unemployment rate remained at 5.5 per cent in March — the lowest it has been since May 2008.

Reflecting the underlying strength of the recovery, forecast GDP growth for the US has been upgraded to 3½ per cent in 2015 and is unchanged at 3 per cent in 2016. As the recovery has gained momentum, the US Federal Reserve (the Fed) has shifted its focus to the trajectory of interest rate rises going forward.

In the euro area, there are signs that a weaker euro and lower commodity prices are providing a much-needed boost to growth. However, growth remains modest and divergent across the region. The German economy rebounded in the December quarter, to regain momentum lost in the first three quarters of 2014. Spain expanded strongly in 2014, which saw employment pick up and the unemployment rate fall. In contrast, France continues to struggle to record positive growth and Italy has had only one positive quarter of growth since 2011. France and Italy continue to face structural challenges, with reforms urgently needed to boost productivity and growth in the longer-term.

The euro area continues to face very low inflation and low market inflation expectations, partly reflecting prolonged economic weakness. In response, the European Central Bank (ECB) has further eased monetary policy. The marked decline in the euro following the ECB's actions is expected to increase import prices and support growth by boosting exports. Concerns about deflation taking hold in the region remain, but have eased with inflation expectations rising recently in response to the ECB's quantitative easing program (Chart 2).

Chart 2: Inflation expectations for the next five years



Although forecast growth for the euro area is unchanged since MYEFO, downside risks have increased amid renewed concerns about Greece exiting the euro. The euro area remains a critical export market for China, and a slowdown or shock in Europe could have significant implications for Australia through this channel.

In Japan, economic activity has been weaker than expected following the increase in the consumption tax in April last year. Growth looks to have resumed in the December quarter, after declines in GDP in both the June and September quarters.

Going forward, growth should be supported by the Bank of Japan's massive quantitative easing program, fiscal stimulus, low oil prices and the depreciation of the yen. This should see Japanese GDP grow by $\frac{1}{4}$ per cent in 2015 and in 2016. Growth is expected to ease to $\frac{1}{2}$ per cent in 2017, reflecting another scheduled Value Added Tax (VAT) increase.

Key commodity prices have fallen further

Iron ore and coal prices have fallen sharply in US dollar terms since MYEFO. This in part reflects the appreciation of the US dollar against commodity producer currencies. Since costs are in commodity producers' domestic currencies, the stronger US dollar tends to reduce costs and hence commodity prices in US dollars. However more fundamental factors have also been at play in the fall in commodity prices. This includes further signs of weakening steel demand in China, where continued softness in housing investment is weighing on demand for steel and iron ore. At the same time, global iron ore production continues to expand briskly, led by Australian producers who are expected to increase supply by another 10 per cent in 2015.

Reflecting this, the forecast iron ore price is lower than at MYEFO with an assumed price of \$US50/t (FOB) across the forecast period, while the forecasts for metallurgical and thermal coal prices have also been modestly downgraded (see Box 1). Despite the downgrade, iron ore prices have fallen below \$US50/t recently and there is a significant chance iron ore prices could fall further, given the large supply expansions planned for 2015 and the fragility of China's property market. There is also a concern that record Chinese steel exports in 2014 were not supported by genuine international demand, and will therefore decline to more sustainable levels over 2015.

After falling dramatically over the past year, oil prices are currently under \$60 a barrel (Tapis). The sustained drop in oil prices over the past year should stimulate the world and Australian economy (see Box 2). Ample global oil supply and large inventories suggest that oil prices will remain low in the near term.

Interest rates remain low...

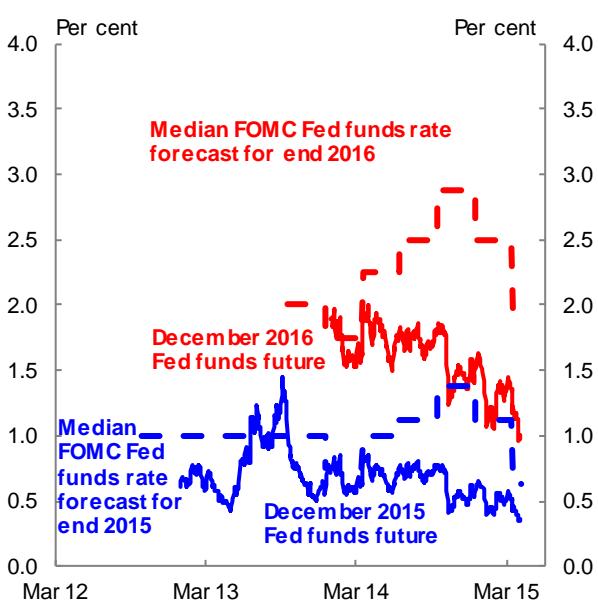
Subdued growth in key economies such as China, the euro area and Japan continues to be reflected in accommodative monetary policy and low global interest rates.

Sentiment in the major global equity and credit markets generally remains strong, supported by an ongoing search for yield given that the returns on 'safe' assets (such as government bonds) continue to be suppressed by easy monetary policy settings in the major advanced economies. To maintain equity and credit market gains, strong and sustained economic growth will be necessary to drive earnings growth and maintain low default rates as central banks — particularly the Fed — start to normalise policy in light of better economic prospects.

With the exception of Greece, euro area government bond yields have fallen further following the commencement of the ECB's quantitative easing program. Many government bond yields in the region have fallen to historic lows, with shorter term yields in some core economies (such as Germany) now below zero.

US Treasury bond yields remain low and markets continue to price in a more modest increase in interest rates over the next couple of years compared to the median forecasts by the Fed policymakers. Even after the Fed recently lowered its policy rate forecasts, markets responded by lowering expectations even further (Chart 3). The gap between FOMC members' rate forecasts and market-based forecasts, despite having narrowed recently, implies that markets could be surprised going forward, potentially leading to volatility as expectations adjust.

Chart 3: Interest rate expectations of the market versus the United States Federal Reserve



Source: Bloomberg.

While the systemic risks from renewed volatility and falls in asset prices would depend on the degree of leverage involved, there could be real economy implications through confidence and wealth channels.

... and the Australian dollar has depreciated

Reflecting US dollar strength and weaker commodity prices, the Australian dollar has depreciated recently falling by around 5 per cent in both US dollar and trade-weighted terms since MYEFO.

This has cushioned the fall in commodity prices in Australian dollar terms with iron ore prices falling by about 25 per cent since MYEFO (compared to a fall of around 30 per cent in US dollar terms) while coal prices have fallen less. The weaker Australian dollar has also led to higher import prices. Higher import prices are weighing down the terms of trade, which is expected to fall by 7 per cent in 2015-16.

Box 1 – Iron ore price developments

Having almost halved over 2014, the iron ore spot price has fallen another 25 per cent since the start of March to be US\$43 per tonne free on board (FOB). Not since 2006 have prices been this low. The extent of the price falls was widely unexpected with Treasury's MYEFO assumption of US\$60 per tonne at the lower end of market expectations at the time.

The price assumption has been revised down to \$50 per tonne across the forecast period. This assumption was settled in early March when the spot price was around \$55 per tonne, but the further price falls over the past month suggest substantial downside risk to this assumption (Chart 4).

Chart 4: Recent spot price developments

Chart has been removed as it contains subscription information.

shift in the Chinese economy away from investment-led growth, with construction activity unlikely to ever again achieve the rates of growth seen in previous years. But it also reflects that authorities remain hamstrung by the financial vulnerabilities associated with previous rounds of credit-driven stimulus, limiting the possibility for a further large, credit-driven expansion in construction investment in the future.

There is growing recognition that authorities will provide less support to property investment than in the past, moderating the growth in the demand for steel. This is reinforcing particular policies aimed at the steel sector, including the recently-announced plans to reduce excess capacity and pollution in the sector. Together, these policies have reportedly been an important factor behind the sharp price falls for both iron ore and metallurgical coal over recent weeks.

The US dollar's appreciation has also played a role in price falls for US dollar denominated commodities. This partly reflects that most commodity producers are located outside the US, so that a US dollar appreciation increases their revenues but has little impact on their costs. Competitive pressures then drive down US dollar commodity prices, while local currency prices remain relatively unchanged.

On the supply side, new low-cost iron ore supply has more than offset lost production elsewhere over the past year, providing little support for prices. Industry reports suggest that Chinese domestic production fell by around 60 millions of tonnes (mt) in 2014 while imports from non-major suppliers fell around 35 mt. This was more than offset by imports from Australia and Brazil, which increased by around 150 mt.

The iron ore sector's success in achieving efficiency gains is also dragging on global prices and has generated something of a downward spiral in costs and prices across the industry.

Looking ahead, both demand and supply factors suggest a price recovery in the iron ore market is unlikely, at least in the near term.

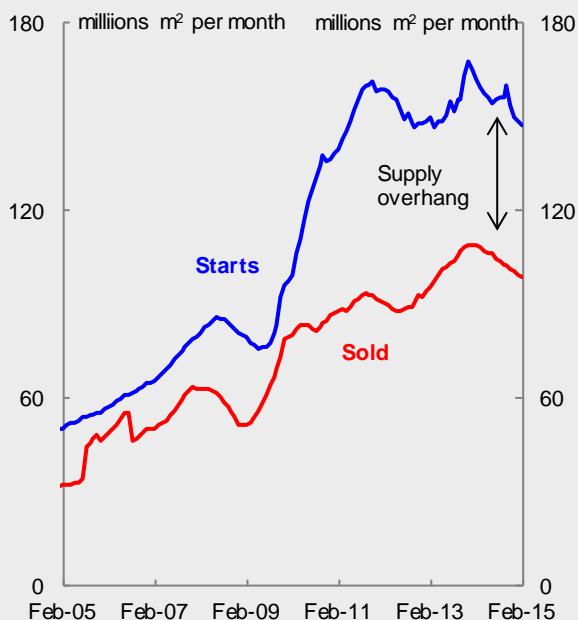
In China, the large supply overhang in the housing market is expected to weigh on construction activity for some time yet, notwithstanding the recent

Unlike last year's supply-driven falls, demand factors have been the more important cause of the recent price collapse. Chinese construction activity, which accounts for about two-thirds of China's steel usage, has continued to ease in 2015 in line with the downswing in the housing market. As a result, Chinese steelmakers have been reluctant to resume production following the shutdown period over Chinese New Year.

In danger of missing their growth target, Chinese authorities have recently instituted a number of policy easing measures including the removal of some previous restrictions on the property sector. Unlike previous easing cycles, the current easing cycle is not yet generating the same lift in residential construction. In part this reflects the inevitable

decision to relax lending requirements for new home purchasers (Chart 5). There are also concerns that record Chinese steel exports in 2014 will prove unsustainable in 2015, leading to a global steel glut unless Chinese steelmakers reduce production. A return in Chinese steel demand from the eventual rebound in the Chinese property sector would provide some price support in 2016 and beyond, as growth in iron ore demand began to catch-up with supply.

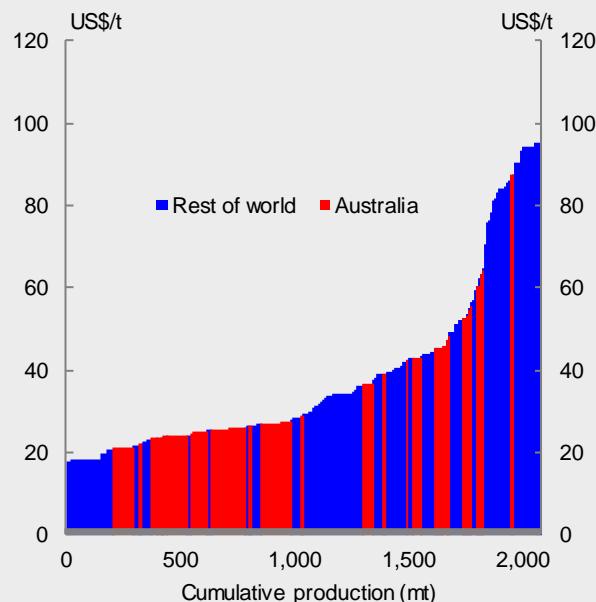
Chart 5: Chinese property supply overhang



In the near-term, further increases in global iron ore supply are expected to weigh on prices. In Australia alone, new low-cost supply is expected to boost export volumes by another 60 mt (almost 10 per cent) in 2015, adding to the extra 140 mt added last year.

If current spot prices were sustained, around one quarter of global iron ore production would be operating at a loss (Chart 6). Australian production is mostly well placed to sustain current price levels, though an increasingly non-trivial portion of production is under pressure. Even assuming that some of these marginal producers exit, their lost output is likely to be more than offset by planned increases in low-cost supply in Australia and Brazil.

Chart 6: 2015 Iron ore mine costs



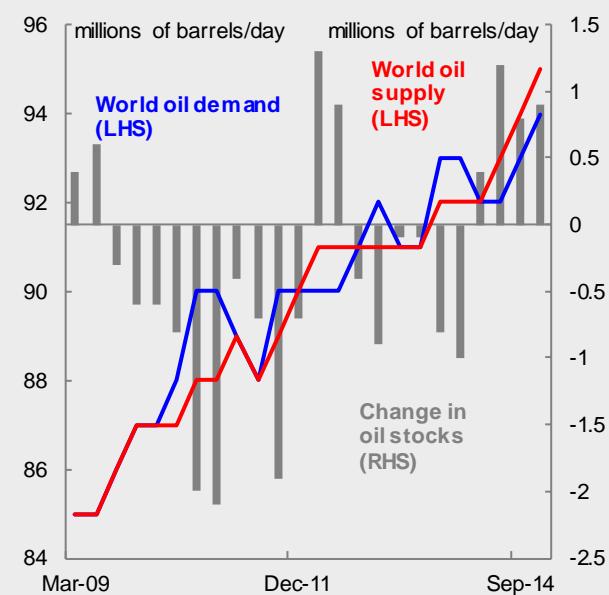
Box 2 – Oil price developments and their effects

The price of oil has roughly halved since last year's Budget, with the Tapis benchmark currently trading under US\$60 per barrel. The sudden price drop over the past year followed a few years of relative stability during which oil prices fluctuated around US\$115 per barrel.

The steep price decline reflects the substantial expansion in global oil supply over recent years, led by the development of 'tight oil' supplies in the US and higher-than-expected production by OPEC members (Chart 7). A weaker outlook for energy demand has also played a role, consistent with downgrades to global growth forecasts over the past year.

Record inventories will likely limit the extent of any price recovery in the near term, although there remains a risk that further supply disruptions in oil-producing regions, due to geo-political developments, could lead to sudden price rises.

Chart 7: World oil markets



Source: International Energy Agency.

The current forecasts assume that the US dollar oil price remains constant across the forecast period at around US\$55 per barrel. In Australian dollar terms, this is only about 20 per cent lower than the MYEFO assumption, but is more than 40 per cent lower than assumed at last year's Budget.

Australian consumers and businesses outside the energy sector are expected to benefit from lower oil prices, and this has been factored into the forecasts.

For households, the fall in direct fuel costs since Budget is expected to have shaved 0.8 percentage points off CPI growth up to the March quarter.

With direct fuel costs representing 2 per cent of spending, the price decline is equivalent to an increase in household income around \$5 billion per year, with part of this saving expected to be diverted into other areas of household consumption. Overall, assuming unchanged household behaviour, consumption would be around 0.5 percentage points higher.

Over time, there will be indirect effects on the economy. Businesses should pass on lower prices for consumers, providing a further boost to household consumption. This in turn should stimulate businesses investment and employment to accommodate this increased demand. Lower costs could also lower inflation expectations and hence wages growth and inflation going forward.

While benefiting the broader economy, sustained lower oil prices are expected to weigh on Australia's energy sector, including the Liquefied Natural Gas (LNG) sector where export prices are contractually tied to oil prices. This has seen most of the LNG sector's expansion plans put on hold in recent months, while exploration expenditure has also been scaled back.

Regardless, the seven large LNG projects currently under construction are all expected to be completed, with Australia still on track to become the world's largest LNG exporter by the end of this decade. That said, lower export prices will weigh on the LNG sector's revenues and profitability, with likely knock-on consequences for government revenues in coming years.

Internationally, lower oil prices should also stimulate growth. IMF and OECD estimates suggest global growth could be boosted by around $\frac{1}{2}$ of per cent in 2015 and a similar amount next year, although other factors led the IMF to downgrade its latest growth outlook for 2015 and 2016.

Domestic Economic Developments and Outlook

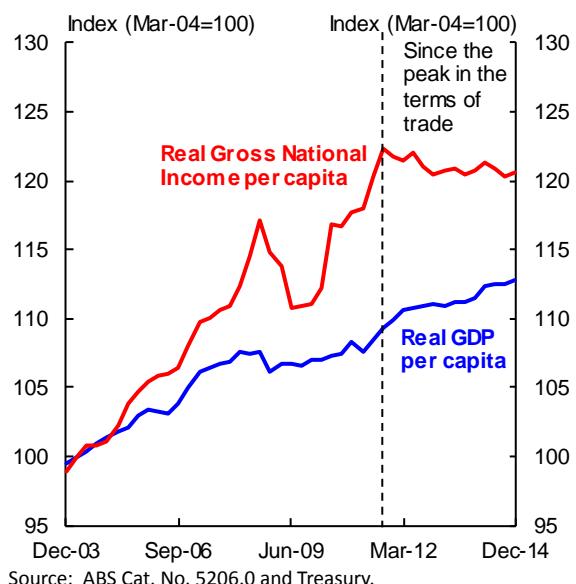
Real GDP growth is below trend...

Real GDP continues to grow at below trend rates, as the economy rebalances away from resources investment and towards resources exports and the non-resources sectors.

Since MYEFO, household consumption and mining exports have grown more strongly than expected. However, rural exports and total business investment have been weaker than expected.

While real GDP per capita has been growing, the fall in the terms of trade over recent quarters has been weighing on real gross national income growth (Chart 8), constraining consumption growth and business investment.

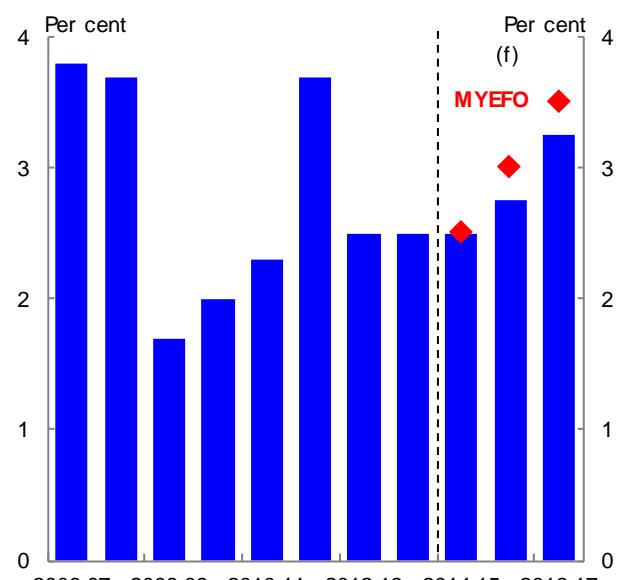
Chart 8: RGNI and GDP per capita



... but is forecast to increase...

GDP growth is forecast to strengthen going forward, as the economy transitions from resources investment led growth towards broader-based drivers of activity (Chart 9). But the outlook is somewhat weaker than at MYEFO, reflecting weaker-than-expected investment intentions. The implied GDP forecasts for calendar years 2015 and 2016 are within the range of consensus forecasts.

Chart 9: Real GDP growth forecasts



... underpinned by strong exports growth...

A key aspect of the move from the investment phase of the resources boom is the rise in export volumes and decreased need for capital related imports. The decline in the exchange rate, associated with the fall in the terms of trade, has also contributed to a decline in imports and a rise in exports.

Export volumes are growing strongly. The transition of the resources boom to its production phase has seen iron ore exports volumes grow strongly, reflecting expansions in production and infrastructure capacity. Given current plans to expand capacity, iron ore exports are expected to continue to increase this year and next, and LNG exports should also increase strongly over the forecast period as projects that are currently under construction begin production.

Rural exports are expected to fall, reflecting declines in crop production from record highs and lower beef exports, partly due to severe drought conditions in Queensland and destocking.

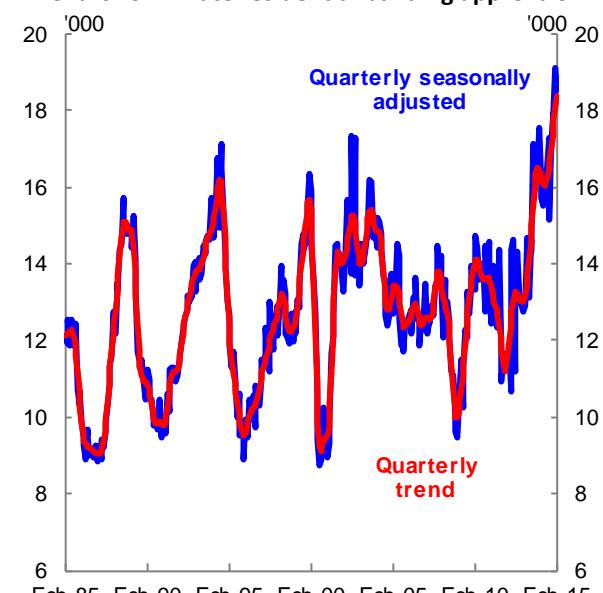
Overall, exports should continue to grow solidly, supported by the lower dollar in the short term and also by the on-going increase in demand for services, including tourism, from the expanding Asian middle class.

Imports have declined, reflecting in part a reduction in resources investment. The fall in the Australian dollar will encourage consumers and businesses to continue switching from imports to domestically produced goods and services with imports expected to decline by 3 per cent in 2014-15 and 1½ per cent in 2015-16.

... and strong dwellings investment growth

Dwelling investment has been growing strongly, supported by low interest rates, rising house prices and robust population growth. While there has been weakness in alterations and additions which may be associated with a shift towards smaller dwellings, the dwelling investment recovery is likely to have some time to run with leading indicators, like approvals, remaining elevated (Chart 10). This points to a significant pipeline of new building activity over the forecast horizon. While softer-than-expected growth in the December quarter has led to a small downgrade in 2014-15 from MYEFO, dwelling investment is forecast to grow by 6½ per cent in both 2014-15 and 2015-16.

Chart 10: Private residential building approvals

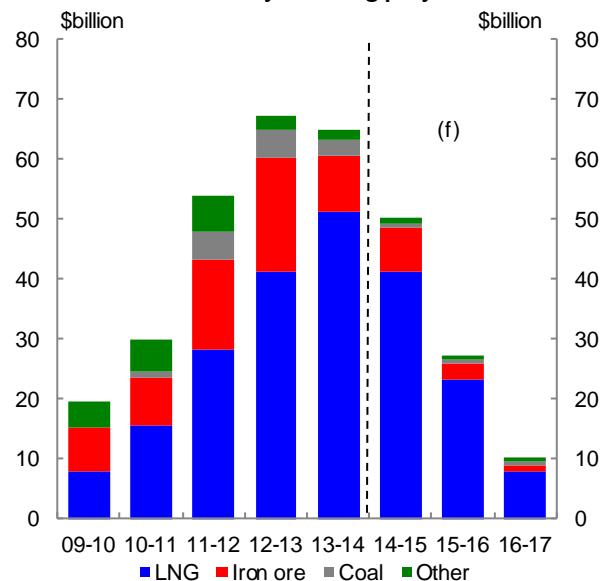


Source: ABS Cat. No. 8731.0.

Business investment is falling...

Business investment continues to fall, reflecting the sharp decline in mining investment as the construction phase of large-scale mining projects, most notably LNG, winds down. Mining investment is expected to decline further. As current projects are completed, few new projects are likely to go ahead given delays in investment plans and further falls in commodity prices (Chart 11). Low commodity prices have also weighed on exploration.

Chart 11: Major mining projects



Note: (f) are forecasts.

Source: Treasury.

Non-mining business investment grew solidly in 2014, albeit less strongly than expected at MYEFO. Investment in the services sector was particularly robust, and non-mining credit growth is showing signs of improvement. While non-mining investment plans remain positive for the rest of 2014-15, the latest capital expenditure (CAPEX) survey data and liaison suggest that many businesses are reluctant to commit to additional investment for 2015-16. Indeed the CAPEX survey suggests a fall in nominal non-mining business investment of 7 per cent in 2015-16, although these initial survey estimates are often unreliable.

Low borrowing costs, a lower dollar and lower fuel costs should encourage investment plans going forward as firms rebuild their capital stocks amid rising rates of capacity utilisation. Reflecting this, real non-mining investment is expected to grow by 3½ per cent in 2015-16, considerably higher than suggested by the CAPEX survey (see Box 3 for more behind the outlook for business investment).

... and public spending is subdued

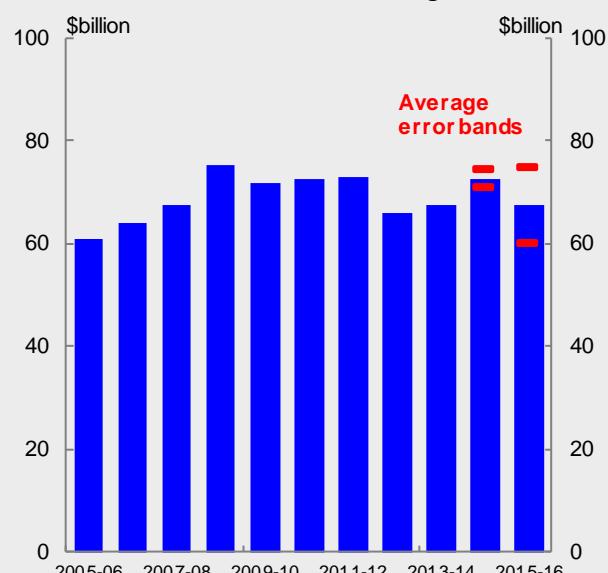
Despite some growth in Commonwealth investment associated with the roll-out of the NBN, public expenditure growth is expected to remain well below its long run average, as all levels of government continue with fiscal consolidation and expenditure restraint.

Box 3 – Outlook for non-mining investment

The outlook for business investment in 2015-16 has weakened since MYEFO, mainly on the back of softer investment plans by non-mining businesses.

The latest ABS capital expenditure (CAPEX) survey included the first estimate of business investment plans for 2015-16. Worryingly, it revealed that non-mining businesses plan to spend less in 2015-16 than this year, though the significant uncertainty around the survey estimates qualify how much weight should be put on this (Chart 12).

Chart 12: Nominal non-mining CAPEX



Note: 2014-15 and 2015-16 have been adjusted using long-run realisation ratios for estimate 5 and 1 respectively. Average error bands are derived using long-run mean absolute percentage error.

Source: ABS Cat. No. 5625.0 and Treasury.

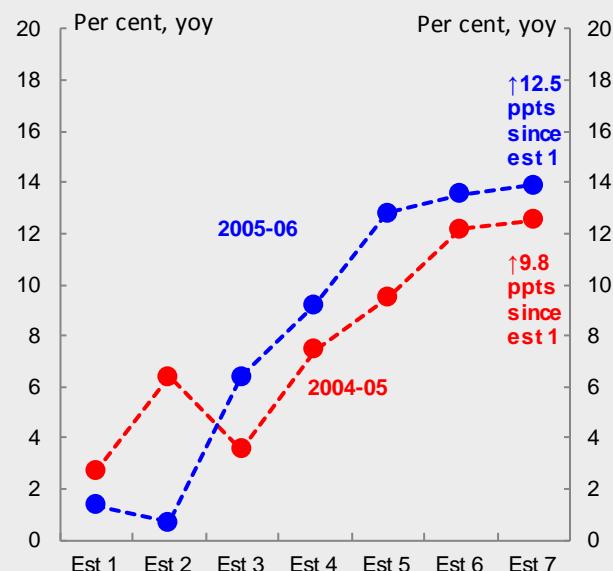
The modest investment plans for 2015-16 could reflect insufficient demand, with business surveys pointing to domestic policy uncertainty affecting household spending and investment decisions.

In this environment, businesses could be adopting a ‘wait and see’ approach, delaying investment plans until they see stronger signs of demand. This ‘wait and see’ strategy is more readily available to businesses in the non-mining economy, where investment can be ramped-up relatively easily with lower planning and lead time.

Indeed, there were several instances in the past where non-mining investment plans were substantially revised up following initially soft intentions. For example, in 2004-05 and 2005-06 actual growth in nominal non-mining investment turned out to be 10 and 13 percentage points higher than the initial expectations

suggested by the CAPEX survey (Chart 13). Notably, these two years shared some key features with the current situation, including relatively low and falling interest rates and increasing rates of capacity utilisation.

Chart 13: CAPEX evolution in 2004-05 and 2005-06



Note: Year on year growth rate estimates have been calculated using a rolling five year realisation ratio average.

Source: ABS Cat. No. 5625.0 and Treasury.

The forecasts assume the current combination of low financing costs and rising capacity utilisation will eventually encourage more bullish investment plans by non-mining businesses, consistent with this experience.

Lower fuel costs and a lower Australian dollar are also expected to encourage investment, especially in fuel-intensive and export-oriented sectors, with non-mining investment expected to grow by 3½ per cent in 2015-16.

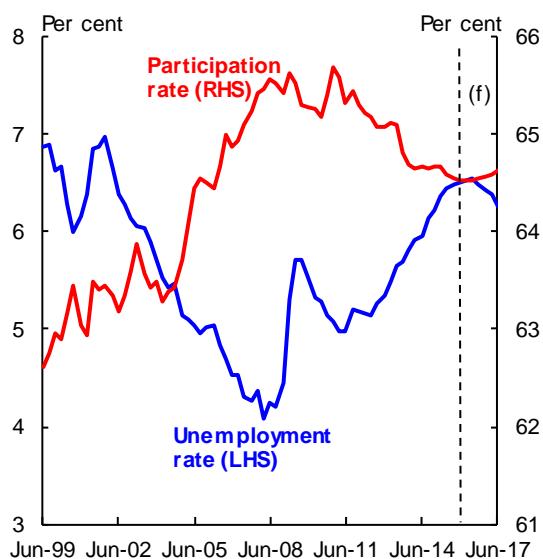
While forecast to grow solidly in 2015-16, there is a material risk that non-mining investment will falter in the way that the CAPEX survey suggests. This concern is reinforced by signs of softening in commercial property, with disappointing building approvals data over the past year and rising office vacancy rates in some markets, pointing to an only modest outlook for non-residential building construction in 2015.

Overall, while the CAPEX survey is a concern, the fundamentals are in place for a pick-up in non-mining investment over the forecast period. Low interest rates, together with the low level of the non-mining capital stock to GDP ratio (reflecting a number of years of weak investment), means conditions are conducive to a pick-up in investment.

Weakness in the labour market

Employment growth has picked up over the past year. However below trend GDP growth continues to mean that employment growth has not been strong enough to keep up with growth in the labour force (which itself has been depressed by low labour force participation). This has led to a slight increase in the unemployment rate (Chart 14).

Chart 14: Unemployment and participation rates



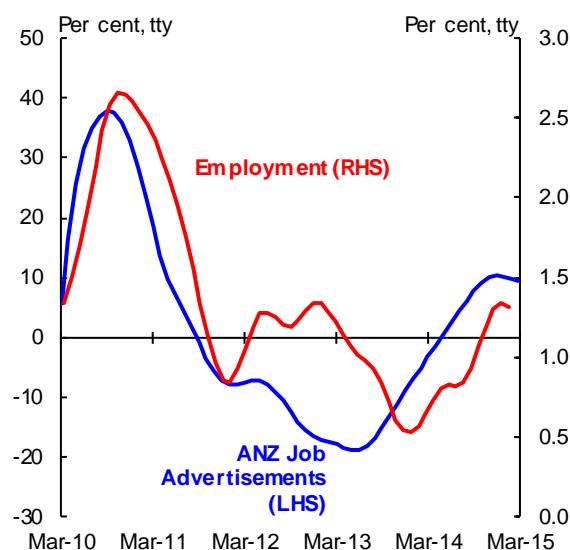
Note: (f) are forecasts.

Source: ABS Cat. No. 6202.0 and Treasury.

While hours worked have also been weak, a number of forward-looking indicators of labour demand, such as job advertisements, vacancies and business survey measures of hiring intentions have picked up a little recently, though they only suggest employment growth roughly consistent with what we have seen (Chart 15).

As GDP growth picks up, the labour market is expected to improve, particularly in 2016-17, with employment growth of 1½ per cent forecast in 2015-16 and 2 per cent in 2016-17. The unemployment rate is expected to peak at 6½ per cent before declining to 6½ per cent in 2016-17 (Chart 14). The implied unemployment rate forecasts for the 2015 and 2016 calendar years are within the range of consensus forecasts.

Chart 15: Job advertisements and employment growth

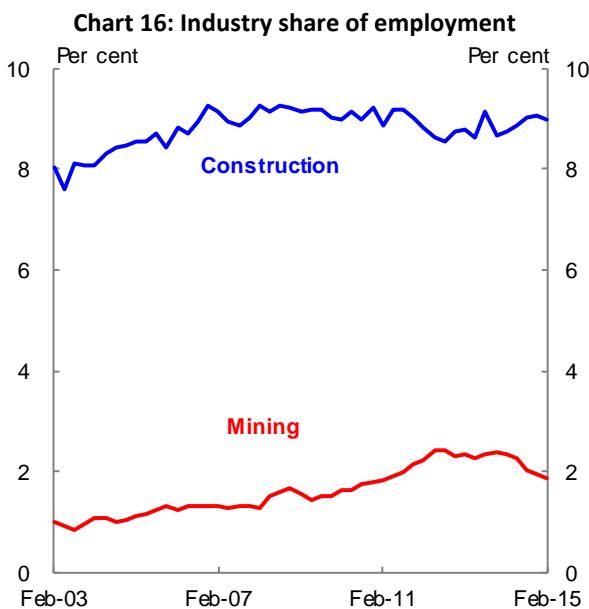


Note: Trend data used. ANZ Job Advertisements series reflects through the year growth based on quarterly data.

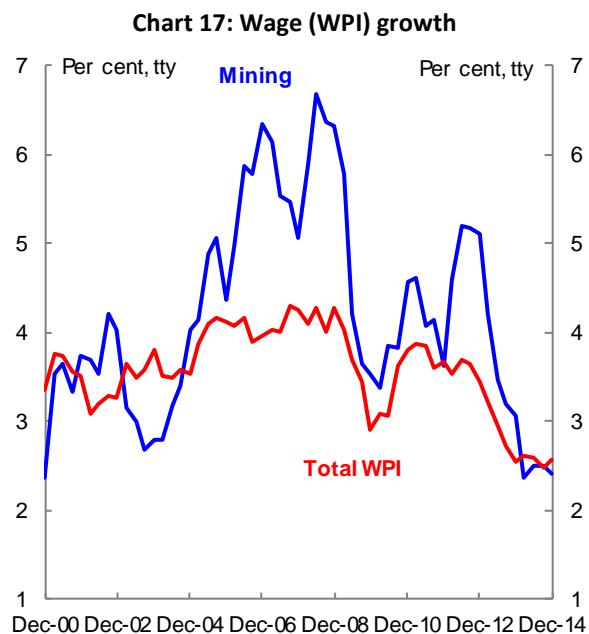
Source: ANZ Job Advertisements, ABS Cat. No. 6202.0 and Treasury.

Wage flexibility helping with the transitions

Wage flexibility is helping the economy to transition. During the early stages of the mining boom, as commodity prices rose and the economy shifted towards resources investment, wages and employment growth in the mining and construction sectors outpaced those seen in the rest of the economy. This increased the share of employment in these sectors. More recently, amid the transition to broader based growth, employment in mining has weakened and growth in mining wages has fallen. Employment has continued to grow in most other sectors, including construction, as dwellings investment has replaced mining construction as a source of economic growth (Charts 16 and 17).



Source: ABS Cat. No. 6291.0.55.003 and Treasury.

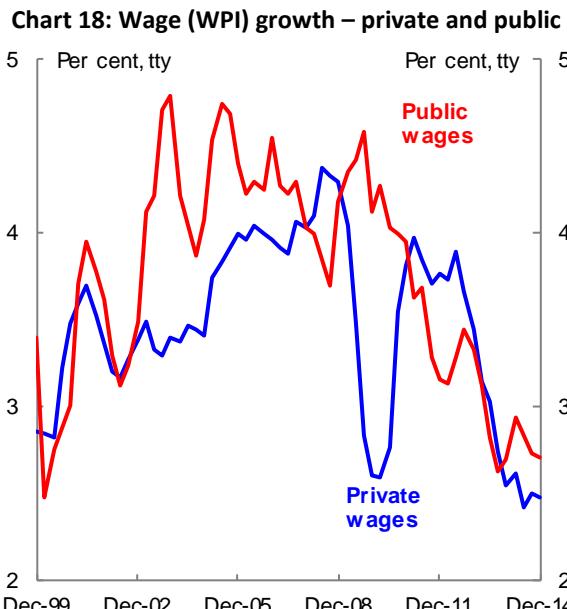


Source: ABS Cat. No. 6345.0 and Treasury.

Subdued wages growth ...

Wage growth continues to be subdued, reflecting the spare capacity in the labour market. The Wage Price Index (WPI) grew at 2.5 per cent in December (tty), its equal lowest rate since the series began in 1997 (Chart 17). This low wage growth is helping to support labour demand and lessening the rise in the unemployment rate due to below trend GDP growth.

There has been weakness in both private and public sector wage growth. This is unlike the Global Financial Crisis, which saw private sector wages grow at substantially lower rates than wages in the public sector (Chart 18).



Source: ABS Cat. No. 6345.0 and Treasury.

Real wages grew in excess of productivity growth while the terms of trade was rising. However since the terms of trade started to decline, real wage growth has been below productivity growth (Chart 19).



Note: Real wage is AENA deflated by the consumption deflator.

Source: ABS Cat. No. 5206.0 and Treasury.

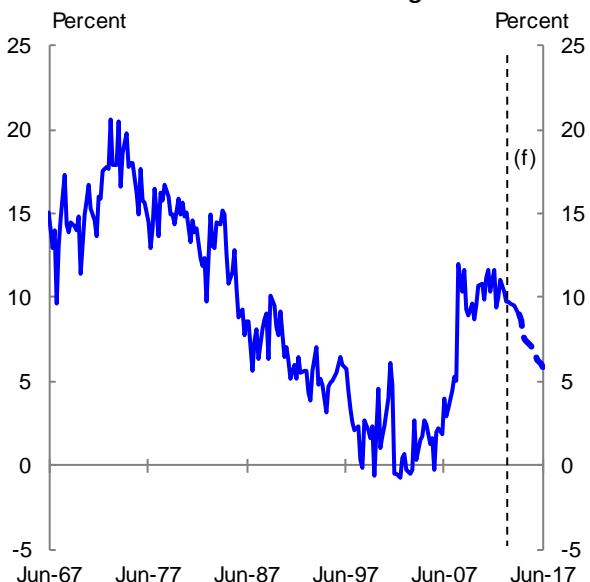
Wage growth is expected to be restrained over the forecast period, consistent with feedback from business liaison that firms are continuing to constrain costs, as well as recent Enterprise Bargaining data.

... weighing down consumption.

Household consumption grew strongly in the December quarter, supported by lower fuel costs and despite measures of consumer confidence being a little below their long-run average.

Looking forward, household income is likely to be constrained by moderate employment growth and subdued wages growth. However, with high net wealth from rising dwelling and equity prices and from saving by consumers during the temporary terms of trade boom, households are well placed to smooth consumption by reducing their saving ratio over the forecast period as the terms of trade declines (Chart 20). While the future trajectory of the saving ratio is uncertain, the heightened risk aversion following the Global Financial Crisis is expected to moderate how far the saving ratio will decline. The expected decline in the saving ratio should enable consumption to grow faster than income, with consumption growth forecast to rise to 3½ per cent, a little below trend, in 2016-17.

Chart 20: Household saving ratio



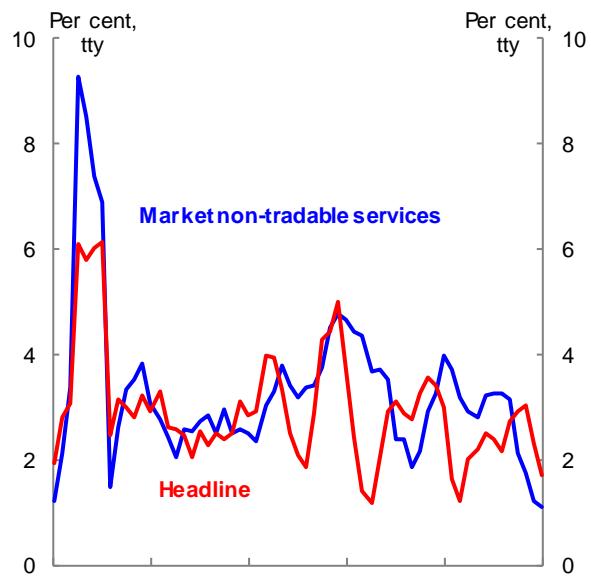
Note: Expressed as per cent of net household disposable income. (f) are forecasts.

Source: ABS Cat. No. 5206.0 and Treasury.

Inflation is subdued

Inflation has been subdued. The GDP deflator has been falling and headline CPI grew by a moderate 0.2 per cent in the December quarter 2014 and by 1.7 per cent through the year (Chart 21). The low inflation outcomes have been due to weak wage growth, the fall in oil prices and the repeal of the carbon tax. Market non-tradeable service CPI inflation, which is particularly affected by wages growth, has declined markedly. Administered price inflation has also fallen after recent strength, due to the repeal of the carbon tax.

Chart 21: CPI inflation



Source: ABS Cat. No. 6401.0.

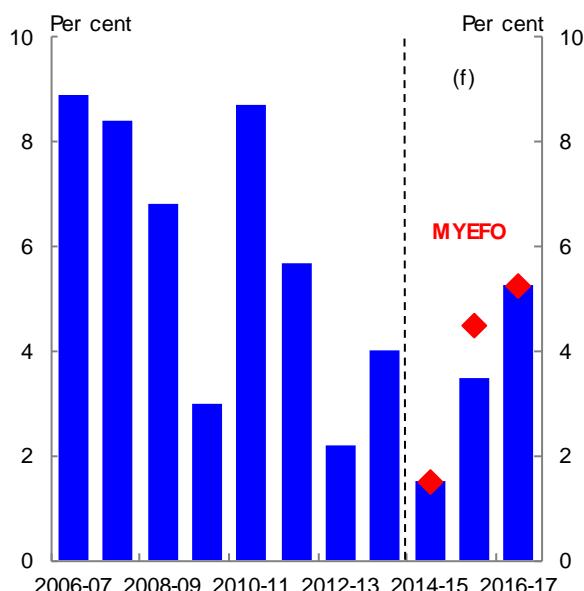
Going forward, consumer price inflation is expected to rise towards the middle of the RBA's target band. While there is an absence of wage pressure, the decline in the exchange rate and the increase in the tobacco excise are expected to contribute positively to CPI inflation.

The GDP deflator is expected to fall in 2014-15, reflecting the substantial forecast decline in export prices, before growing in 2015-16 and 2016-17.

Nominal GDP growth below trend

Nominal GDP growth is expected to remain weak with domestic price growth remaining soft as part of the adjustment in the economy and with the terms of trade continuing to decline, reflecting weaker commodity prices. Nominal GDP is forecast to grow by 3½ per cent in 2015-16 and 5¼ per cent in 2016-17 (Chart 22).

Chart 22: Nominal GDP growth



Note: (f) are forecasts.

Source: ABS Cat. No. 5206.0 and Treasury.

Weaker wages are an important part of the nominal GDP write-down. The National Accounts measure of wages (AENA) grew by 0.2 per cent in the December quarter, well below its average rate of 0.9 per cent. This weakness in the December quarter has negative impacts on wage levels across the forecast period as wages are growing off a lower base. This lower base, in combination with the weaker outlook for wages growth and slightly weaker employment growth, means the forecast for compensation of employees in 2015-16 is about 1.2 per cent or \$10 billion lower than was expected at MYEFO.

Falling commodity prices have also contributed to the write-down to nominal GDP. But the impact is modest, as the lower Australian dollar has cushioned the impact for Australian producers and the price that Australian producers actually receive for their exports has not fallen at the same rate as the spot price.

Downside risks and uncertainty remain

As always, the forecasts are based on a range of assumptions about the evolution of variables such as the exchange rate, interest rate and oil prices. There are also judgements about how developments in one part of the economy affect the rest. If these assumptions or behaviours evolve differently, so will the forecasts.

Apart from these general risks, there are some key risks to the forecasts internationally and domestically. On the international front, a more significant than anticipated moderation in Chinese growth could occur. Also a worsening of geopolitical tensions could lead to

a sustained loss of momentum in key euro area economies.

These scenarios present risks for both the real and nominal sides of the economy. A weaker than expected outlook for the global economy would result in lower demand for our exports. On the nominal side, weaker foreign demand, particularly from China, could affect Australian incomes through lower commodity prices. If deflation were to materialise, this would reduce the price of our imports and weigh on growth in domestic prices and nominal GDP.

The risks are not just limited to those imported from overseas. The domestic economy is currently in transition. These adjustment processes can often be protracted as households and businesses wait for signs that other parts of the economy have improved before lifting their own spending. The forecasts presented here, particularly for household consumption and non-mining business investment, are based on a rise in sentiment encouraging a broad-based boost to activity. A failure of this confidence to rise or a failure of it to translate to greater spending present downside risks to the forecast.

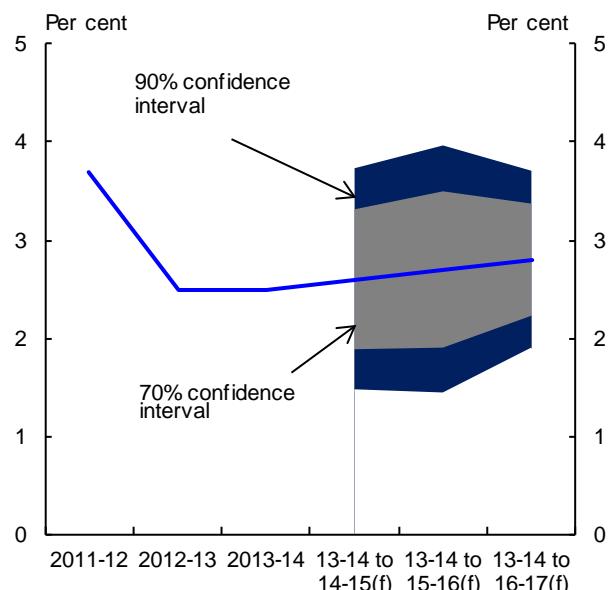
Once the economy starts to recover, it can rebound sharply as pent-up demand sees households and businesses increase their spending rapidly. Especially with substantial monetary policy stimulus in place, there is some upside risk to the forecasts, particularly in 2016-17, if this kind of bounce-back were to materialise.

On the nominal side, the weakness in National Accounts measures of wages stands in contrast to income tax withholding tax collections which, while growing at below average rates, are growing at a faster pace than official statistics imply they should. If National Accounts measures catch-up to tax collection measures, there could be some upside risks to the forecasts for wages growth, domestic prices and nominal GDP.

One way of representing these general and specific uncertainties around the forecasts is to present confidence intervals based on historical forecast errors. Charts 23 and 24 report confidence intervals around average annual real and nominal GDP growth (as average annual GDP growth captures the effects of cumulative growth, which is important for revenue and expense forecasts). Chart 23 suggests that over the two years from 2013-14 to 2015-16 average annual real GDP growth is expected to be around 2.7 per cent,

with the 70 per cent confidence interval from 1.9 to 3.5 per cent. This means, based on past forecast errors, there is a 70 per cent chance that actual GDP growth will fall inside this range.

Chart 23: Confidence intervals around average real GDP growth forecasts



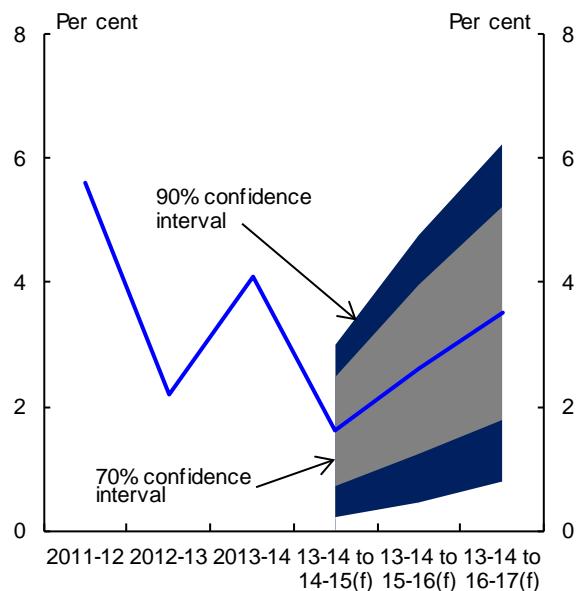
Note: The central line shows outcomes and forecasts (f). Outcomes are shown as annual growth rates. Forecasts are presented using average annualised growth rates from 2013-14. Confidence intervals are constructed using past Budget forecast errors. Further details at <http://www.treasury.gov.au/PublicationsAndMedia/Publications/2013/Estimates-of-uncertainty-around-budget-forecasts>

Source: ABS Cat. No. 5206.0 and Treasury.

There is more uncertainty around forecasts of nominal GDP growth than real GDP growth (Chart 24), reflecting the additional uncertainty around the price forecasts. Over the two years from 2013-14 to 2015-16, average growth in nominal GDP is expected to be 2.6 per cent.

The 70 per cent confidence interval ranges from 1.2 to 4.0 per cent.

Chart 24: Confidence intervals around average nominal GDP growth forecasts



Note: See Chart 23.

Source: ABS Cat. No. 5206.0 and Treasury.

Table 3: Domestic economy forecasts

	2013-14	2014-15	2015-16	2016-17
Per cent ^(a)	Outcomes ^(b)	March JEFG	March JEFG	March JEFG
Real gross domestic product	2.5	2 1/2	2 3/4	3 1/4
Consumption	2.2	2 3/4	3	3 1/4
Dwelling investment	5.1	6 1/2	6 1/2	4 1/2
Total business investment ^(c)	-5.1	-5 1/2	-7	-3 1/2
Mining investment	-7.0	-19	-25 1/2	-29 1/2
Non-mining investment	-3.7	4	3 1/2	6 1/2
Public final demand ^(c)	1.6	1 1/4	1 1/2	1 1/2
Change in inventories ^(d)	-0.3	0	0	0
Gross national expenditure	0.7	1 1/4	1 1/2	2 1/4
Exports	5.8	6 1/2	5 1/2	7
Imports	-1.9	-3	-1 1/2	2 1/2
Net exports ^(d)	1.6	2	1 1/2	1
Nominal gross domestic product	4.0	1 1/2	3 1/2	5 1/4
Prices and wages				
Consumer price index^(e)	3.0	1 1/2	2 1/2	2 1/2
Wage price index^(f)	2.5	2 1/2	2 1/2	2 3/4
GDP deflator	1.5	-1	3/4	2
Labour market				
Participation rate ^(g)	64.7	64 1/2	64 1/2	64 1/2
Employment ^(f)	0.7	1	1 1/2	2
Unemployment rate^(g)	6.0	6 1/2	6 1/2	6 1/4
Balance of payments				
Terms of trade	-3.7	-11 3/4	-7	1/4
Current account balance (% of GDP)	-3.1	-3	-3	-2 1/4
External factors				
Major trading partner growth ^(h)	4.2	4 1/2	4 1/2	4 1/4
Iron ore (\$US/t, FOB) ⁽ⁱ⁾	94	50	50	50
Metallurgical coal (\$US/t, FOB) ⁽ⁱ⁾	111	100	100	100
Thermal coal (\$US/t, FOB) ⁽ⁱ⁾	73	60	60	60
Assumptions				
Exchange rate (AUD/USD) ⁽ⁱ⁾	93	76	76	76
Trade weighted index (TWI) ⁽ⁱ⁾	72	64	64	64
Oil price (Tapis) (\$US/barrel) ⁽ⁱ⁾	115	54	54	54
Cash rate (per cent) ⁽ⁱ⁾	2.50	2.00	1.75	1.75

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

(e) Through-the-year growth rate to the June quarter.

(b) Calculated using original data unless otherwise indicated.

(f) Seasonally adjusted, through-the-year growth rate to the June quarter.

(c) Excluding second-hand asset sales from the public sector to the private sector.

(g) Seasonally adjusted rate for the June quarter.

(d) Percentage point contribution to growth in GDP.

(h) Reported in calendar years (i.e. 2014-15 = 2015)

Source: ABS Cat. No. 5206.0, 5302.0, 6202.0, 6345.0, 6401.0, unpublished ABS data and Treasury.

(i) Level for the June quarter