ECONOMIC OUTLOOK

Real GDP is forecast to grow at around its estimated potential rate of 2¾ per cent in 2019-20 and 2020-21, sustaining solid employment growth and supporting a pick-up in wage growth. Household consumption, business investment, public final demand and exports are all expected to contribute to growth. Dwelling investment is expected to detract from growth, following declines in housing prices and building approvals partly in response to a rebalancing of supply and demand.

The economy is expected to continue to benefit from solid global growth, especially amongst Australia's major trading partners. Global growth strengthened in 2017 and into 2018, with robust labour market conditions driving down unemployment rates in advanced economies. But growth slowed in a number of economies in the second half of 2018. Growth in Australia's major trading partners has outpaced global growth over the past decade and this is expected to continue as growth in the Asian region remains relatively strong. Australia's major trading partners are forecast to grow by 4 per cent in 2019, 2020 and 2021.

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

Household consumption growth is expected to pick up over the forecast period, supported by continued growth in employment, increasing wage growth, historically low interest rates and personal income tax measures.

Non-mining business investment is forecast to record solid growth, supported by historically low interest rates, while mining investment is expected to make its first contribution to real GDP growth in around seven years. Public final demand will contribute to growth, supported by the National Disability Insurance Scheme and infrastructure investment.

Growth in exports in 2019-20 is expected to be supported by major liquefied natural gas (LNG) projects ramping up production and continuing strong demand from Asia for education and travel services. Rural exports are expected to contribute to growth in 2019-20 on the basis of an assumed return to average seasonal conditions after detracting from growth in 2018-19 due to the drought. Export growth is expected to moderate in 2020-21, in line with more modest capacity expansions in the mining sector.

Dwelling investment is expected to detract from growth over the forecast period. Recent falls in residential building approvals have occurred alongside falls in housing prices, which accelerated over 2018 and have continued into 2019. Capital city housing prices have fallen by 9.2 per cent from their most recent peak in September 2017. Price falls have been largest in Sydney and Melbourne over that period, although prices remain around 40 to 50 per cent higher in those cities relative to their 2012 levels.

The labour market is strong, with employment recently growing above its long-run average growth rate. The unemployment rate is at its lowest level in more than seven years and the participation rate is at a near-record high. Solid employment growth is expected to continue and the unemployment rate is forecast to be 5 per cent over the forecast period.

As growth in the economy picks up and spare capacity in the labour market continues to be absorbed, wage growth and inflation are expected to increase. Wage growth, as measured by the Wage Price Index, is expected to pick up to 2¾ per cent through the year to the June quarter 2020 and 3¼ per cent through the year to the June quarter 2021. Consumer price inflation is forecast to be 2¼ per cent through the year to the June quarter 2020 and 2½ per cent through the year to the June quarter 2021.

Nominal GDP is forecast to grow by 5 per cent in 2018-19, 3¼ per cent in 2019-20 and 3¾ per cent in 2020-21. Nominal GDP growth is influenced by the terms of trade, which have been supported in recent months by higher-than-assumed commodity prices, in particular for iron ore and metallurgical coal. The terms of trade are forecast to fall in 2019-20, detracting from nominal GDP growth, as prices of some key commodities are assumed to decline to more sustainable levels. Comprehensive market and industry consultation undertaken by Treasury supports this judgment.

The forecasts reflect technical assumptions for key commodity prices. Since the 2019-20 Budget, the thermal coal spot price has been lower than assumed, but this has been somewhat offset by a higher-than-assumed iron ore price. The oil price, and therefore the LNG price, has also been higher than the Budget assumption. Given short-term volatility and offsetting movements in individual commodity prices, these differences are judged not to give rise to a material change in nominal GDP. The technical assumptions remain unchanged from Budget. Analysis on the effect of commodity price movements on nominal GDP and revenue forecasts is discussed in *2019-20 Budget Statement 2: Economic Outlook* and *2019-20 Budget Statement 7: Forecasting Performance and Scenario Analysis.*

As always there are a number of risks and uncertainties around the forecasts that continue to evolve. These are largely unchanged from those presented in 2019-20 Budget Statement 2.

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

Domestically, uncertainty about the outlook for the housing market, in particular the extent to which housing prices fall further, poses a downside risk to the outlook for both dwelling investment and consumption. A more subdued outlook for household income, or a further tightening in credit conditions, could also constrain household spending amid high levels of household debt. In contrast, faster-than-expected wage or employment growth could lead to household consumption growth being stronger than forecast. There are uncertainties around rural exports given that the outlook will depend on how weather conditions develop. The outlook for commodity prices is a source of significant uncertainty for nominal GDP, but the assumptions for these prices remain prudent.

Table 2 presents the major economic parameters used in preparing the 2019 PEFO. These reflect the best professional judgment of Treasury and are unchanged from those presented in the 2019-20 Budget.

Table 2: Major economic parameters[(a)]

	Outcomes	Forecasts			Projections	
	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
Real GDP	2.8	2 1/4	2 3/4	2 3/4	3	3
Employment	2.7	2	1 3/4	1 3/4	1 1/2	1 1/2
Unemployment rate	5.4	5	5	5	5	5
Consumer price index	2.1	1 1/2	2 1/4	2 1/2	2 1/2	2 1/2
Wage price index	2.1	2 1/2	2 3/4	3 1/4	3 1/2	3 1/2
Nominal GDP	4.7	5	3 1/4	3 3/4	4 1/2	4 1/2

(a) Year-average growth unless otherwise stated. From 2017-18 to 2020-21, employment and the wage price index are through-the-year growth to the June quarter. The unemployment rate is the rate for the June quarter. The consumer price index is through-the-year growth to the June quarter.

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

Detailed forecasts of the economy are prepared for the current financial year, the Budget year and the subsequent financial year. Beyond the forecast period, there is less information on which to prepare detailed forecasts. As such, Australian budgets and other economic statements rely on projections of economic aggregates such as real GDP, nominal GDP and employment growth to underpin budget estimates of receipts and payments. The 2019 PEFO uses the same projection methodology used in budgets and budget updates since the 2014-15 Budget.

That projection methodology assumes spare capacity in the economy at the end of the forecast period is absorbed over the following five years. This is a well-established approach but it is not without drawbacks.

The growth rate of potential GDP is estimated to be 2¾ per cent over the next few years. As spare capacity is absorbed, productivity and labour market variables — including employment and the participation rate — are assumed to converge to their potential levels. To absorb the spare capacity in the economy, real GDP from 2021-22 is projected to grow faster than potential at 3 per cent. By the end of 2025-26, spare capacity is absorbed and real GDP is projected to grow at its potential rate thereafter.

Potential GDP is estimated based on an analysis of underlying trends for population, productivity and participation. In the long run, estimates of participation are affected by demographic factors, including the ageing of the population, while productivity is assumed to grow at its 30-year average rate. The unemployment rate is projected to be 5 per cent, consistent with estimates of the non-accelerating inflation rate of unemployment (NAIRU). Inflation is projected to be 2½ per cent, consistent with the mid-point of the RBA's medium-term target band. The terms of trade are projected to remain flat at around their 2005 level from 2022-23. For a discussion of the sensitivity of the GDP growth projections to estimates of potential output see 2019-20 Budget Statement 7.