STATEMENT 2: ECONOMIC OUTLOOK

This statement presents the economic forecasts that underlie the Budget estimates.

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Recent natural disasters will reduce Australia's economic growth in the first half of 2011, but the negative macroeconomic impacts are expected to be temporary. Australia's medium-term fundamentals remain strong, with the economy forecast to grow at an above-trend rate in 2011-12 and 2012-13, supported by strong economic conditions in the region. Robust growth in emerging Asia has pushed Australia's terms of trade towards historical highs, underpinning an extremely strong outlook for resources investment and exports. Strong real GDP growth is expected to drive solid growth in jobs and reduce unemployment. With the unemployment rate already low, price and capacity pressures are likely to emerge. However, conditions will remain uneven across the economy, with the appreciation of the Australian dollar and legacy effects from the global financial crisis (GFC) weighing heavily on some sectors. The key risks to Australia's economic outlook arise from fragilities in the international economy, with recent events in Japan and rising world oil prices adding to existing concerns.

OVERVIEW

The recent natural disasters in Australia, Japan and New Zealand will reduce Australia's economic growth in early 2011. Combined, these natural disasters are expected to detract around ¾ of a percentage point from Australia's economic growth in 2010-11, with real GDP likely to have contracted in the March quarter. While it will take many years for the affected communities to recover from these tragic events, the negative impacts on Australia's economic growth are expected to be temporary, with the resumption of activity and commencement of reconstruction expected to add to real GDP growth from 2011-12.

More broadly, the Australian economy is in a strong position and the outlook is favourable, with above-trend real GDP growth forecast over the next two years. Employment has grown strongly with over 300,000 jobs created over the past year and the unemployment rate has fallen to around 5 per cent. Underlying inflation has moderated and is currently at around decade lows. Beyond the short-term impact of the natural disasters, Australia's real GDP growth is forecast to strengthen to 4 per cent in 2011-12 and 3¾ per cent in 2012-13, led by record levels of investment in the resources sector.

The favourable outlook for the Australian economy is supported by improving global conditions, although the international recovery remains uneven following the GFC and risks remain elevated. The world economy continues to recover and fears that growth would not be sustained have receded. Financial conditions have also improved, and global risk aversion and financial market volatility have moderated, notwithstanding ongoing concerns in some European countries. Looking ahead, the recovery in advanced economies is forecast to consolidate, while growth in the large emerging economies is expected to moderate to more sustainable rates. Accordingly, the global economy is expected to grow 4¼ per cent in 2011 and 4½ per cent in 2012, down from 5 per cent growth in 2010.

However, global economic conditions remain unbalanced. Output in the major advanced economies is still well below potential and, while economic growth has strengthened, it is not yet sufficient to make substantial inroads into high unemployment. This is at a time when governments in some major advanced economies are under pressure to make credible commitments towards medium-term fiscal consolidation, leading to difficult policy trade-offs. By contrast, after sustaining strong growth through the global recession, the large emerging market economies are now confronting significant capacity pressures.

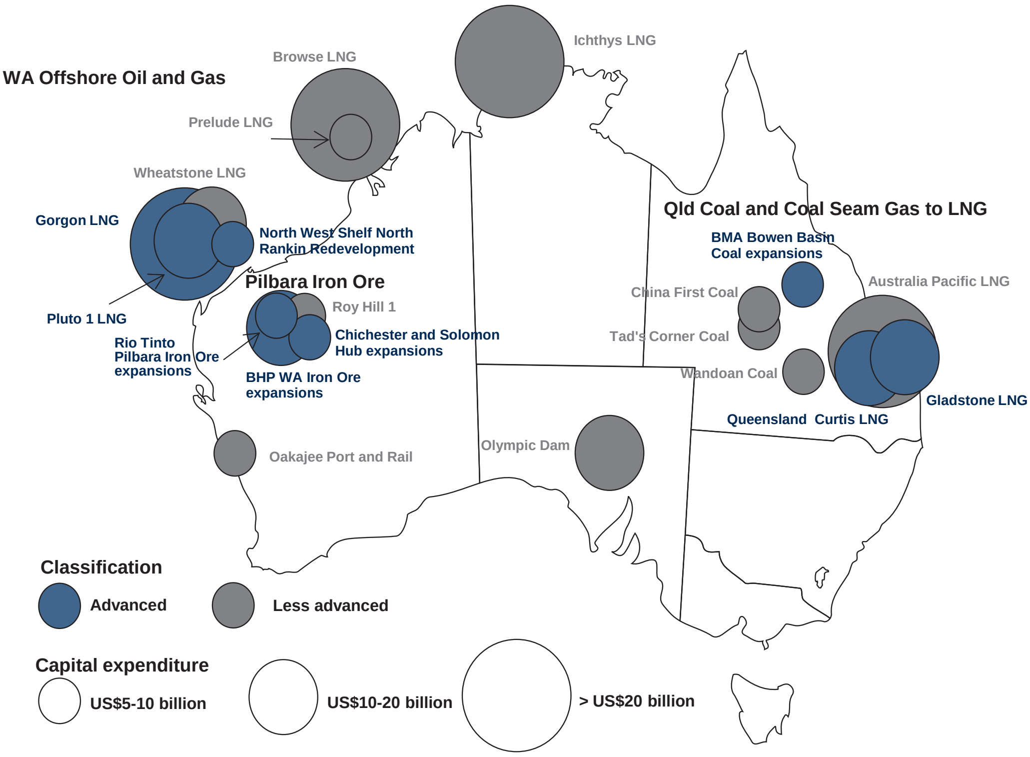
While gaining traction, the global economic recovery also remains vulnerable. Uncertainty about the speed and strength of the Japanese recovery, compounded by the ongoing nuclear situation, and rising world oil prices are adding to existing fragilities. While financial conditions have improved in recent months, the potential for sovereign debt concerns in the euro area to affect the broader European financial sector and cause contagion effects beyond Europe remains a key risk. Failure to develop a credible medium-term response to the unsustainable US fiscal position also poses a threat to the sustainability of the global recovery. Inflationary pressures continue to build in emerging market economies, driven by reduced spare capacity and compounded by rising food and oil prices. While oil prices have not returned to their July 2008 peaks, a further significant and sustained increase could pose broader risks to global growth in the context of a fragile global recovery.

Notwithstanding these risks, strong growth in China (now Australia's largest export market), India and in the other emerging economies of Asia is expected to underpin strong demand for Australian exports. Australia's major trading partners grew by a record 6.6 per cent in 2010, albeit from a low base, and are expected to grow by a robust 4½ per cent in 2011 and 5 per cent in 2012. This will continue to boost demand for Australia's non-rural commodities and further support Australia's terms of trade.

Sustained high prices for Australia's key non-rural commodity exports are driving record investment intentions in the mining sector and strong forecast growth in commodity exports. New engineering construction is expected to grow 56 per cent over the next two years, underpinned by large liquefied natural gas (LNG) projects, driving new business investment to 50-year highs as a percentage of GDP. The surge in investment will expand the economy's capacity over time, with previous investment in mine and transport infrastructure underpinning a forecast increase in the volume of non-rural commodity exports of over 20 per cent over the next two years.

Forecast growth in mining investment is well-supported by projects that are already at an advanced stage and by the longer term outlook for global resources demand (Chart 1). While cyclical fluctuations in global growth will have implications for commodity prices, investment decisions are taken over longer time horizons and are underpinned by projections of the growing resource needs of the large emerging market economies over a period of decades. In value terms around two-thirds of the large mining projects included in the economic forecasts have received final investment approval, with the majority of these already under construction.

Chart 1: Selected major resource projects



Note: ABARES defines advanced projects as either 'committed' or 'under construction' and less advanced projects as those undergoing a feasibility (in some cases, pre-feasibility) study, or that have not yet been subject to a final investment decision since the completion of a feasibility study.
Source: Indicative estimates based on ABARES, company reports and other publicly available information.

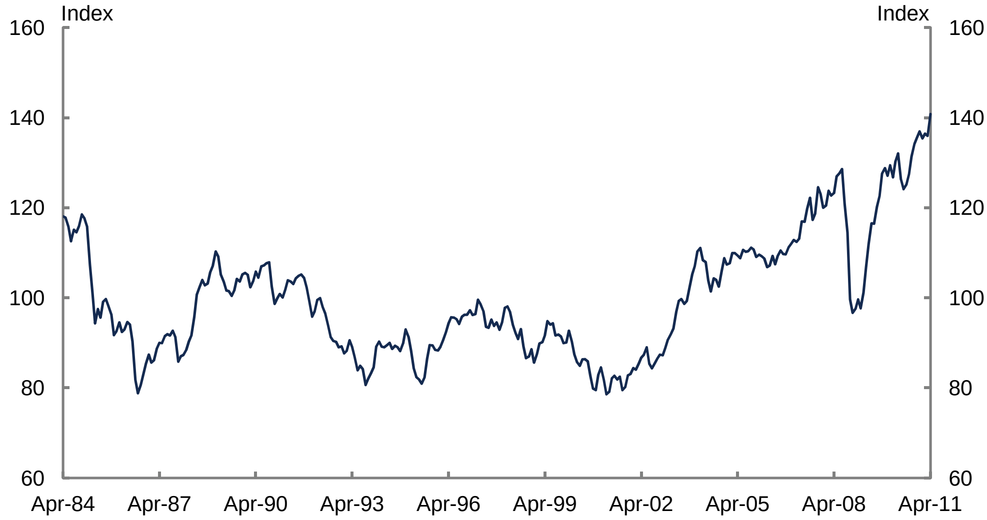
The medium-term outlook is for Australia's terms of trade to decline as the global supply of iron ore and coal increases. Still, the rapid pace of economic development in emerging Asia, and the prospect that strong resources-intensive investment in China and India will continue for many years to come, underpin expectations that the decline in Australia's terms of trade will be gradual. One consequence of the increasing concentration of Australia's trade in non-rural commodity exports to China and India is that Australia's economic outlook is now more sensitive to developments in those two countries.

Australia's high terms of trade are supporting strong national incomes and growth in the broader economy. However, conditions are expected to remain challenging in those sectors that are not benefitting — either directly or indirectly — from the resources boom. Australia's high terms of trade, strong growth relative to other advanced economies and tightened macroeconomic policy settings have seen the

Australian dollar appreciate to post-float highs. In real trade-weighted terms, the exchange rate is currently around 40 per cent above its post-float average, reducing the competitiveness of trade-exposed sectors of the economy (Chart 2).

Chart 2: Real trade-weighted exchange rate

(Post-float average = 100)



Source: RBA.

The high exchange rate and withdrawal of fiscal and monetary policy stimulus are helping to moderate inflationary pressures as the economy returns to full capacity. However, these same factors are also bearing down on activity and profits in some sectors. For many businesses, these challenges are compounded by more cautious household spending behaviour and greater difficulty accessing credit following the GFC. The mining investment boom is also increasing competition for labour and other inputs, raising cost pressures for some businesses. Therefore, while the Australian economy is expected to grow at an above-trend rate over the next two years, conditions are likely to remain uneven across the economy.

Consistent with the strong outlook for real GDP growth, employment growth is expected to remain solid over the forecast period and the workforce participation rate is expected to remain at around record highs. The unemployment rate is forecast to fall gradually from around 5 per cent currently to 4½ per cent in the June quarter of 2013 as the economy approaches capacity. Underlying inflation is expected to remain contained but increase steadily, as the labour market tightens, to 3 per cent by the June quarter of 2013. Headline inflation will be higher in the short-term due to the increase in world oil prices and the impact of the recent floods and Cyclone Yasi on fruit and vegetable prices.

While Australia's economic outlook is favourable, the significant risks to the global recovery noted earlier would, if they eventuated, have serious negative implications for economic growth. The adjustment in the economy as the mining sector expands, adding to capacity pressures and placing additional strains on other sectors, is a source of further uncertainty in the forecasts. Australia's high terms of trade also present risks. While the terms of trade are expected to remain at historically high levels, the prospect of heightened volatility and large adjustments become more significant the further prices for Australia's key non-rural commodity exports are away from sustainable long-run levels.

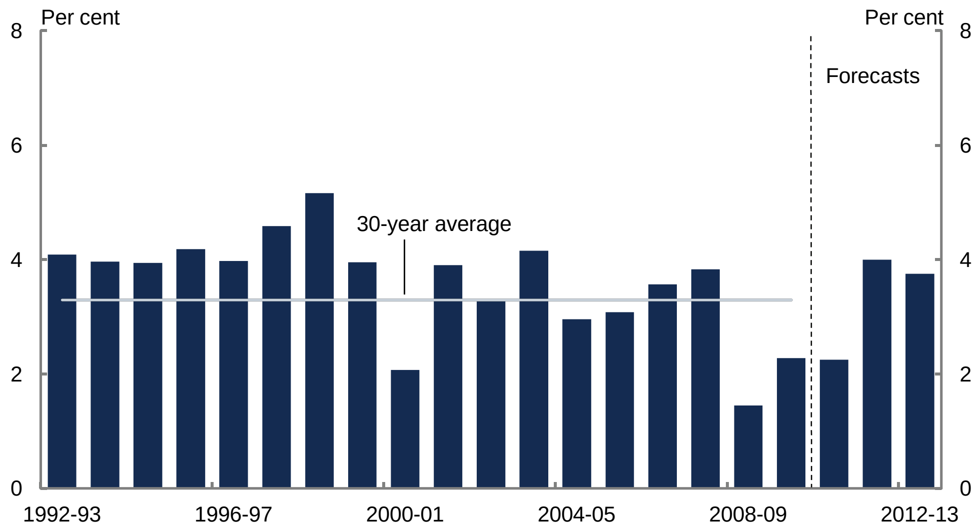
Notwithstanding Australia's positive medium-term outlook, these risks, especially those to the global economy, heighten the importance of Australia continuing to pursue robust macroeconomic and structural policies. Fiscal consolidation will ensure that the Government is not compounding the pressures of a strengthening economy and that Australia is well prepared for any eventuality.

Summary of forecasts

The **world economy** is forecast to grow 4¼ per cent in 2011 and 4½ per cent in 2012 as strong growth in emerging market economies moderates slightly and the recoveries in a number of advanced economies gather momentum.

Australia's real GDP is forecast to grow 4 per cent in 2011-12 and 3¾ per cent in 2012-13 (Chart 3). The main drivers of economic growth are expected to be business investment and commodity exports.

Chart 3: Growth in real GDP



Source: ABS cat. no. 5206.0 and Treasury.

Household consumption is expected to grow moderately in the context of a buoyant labour market and solid growth in household disposable income, with consumers remaining cautious following the GFC. Household consumption is expected to increase 3½ per cent in both 2011-12 and 2012-13.

Dwelling investment is expected to be subdued, with forecast growth of 1½ per cent in 2011-12 and 3 per cent in 2012-13, dampened by tighter credit conditions and ongoing supply constraints.

New business investment is forecast to grow by a strong 16 per cent in 2011-12 and 14½ per cent in 2012-13, underpinned by record capital expenditure in the mining sector, while non-residential building investment is expected to remain subdued.

Public final demand growth is expected to decline sharply over the next two years, reflecting the conclusion of fiscal stimulus in line with the Government's fiscal consolidation strategy. This is notwithstanding reconstruction spending by the Commonwealth and State governments following the recent natural disasters.

Exports are forecast to grow a solid 6½ per cent in 2011-12 and 5½ per cent in 2012-13 as domestic production of non-rural commodities expands to meet global demand. However, the high Australian dollar is expected to weigh on growth in exports of manufactures and services, notwithstanding the improved global outlook.

Imports are forecast to increase strongly over the next two years, driven by robust domestic demand and the high Australian dollar. While import growth is expected to be broad-based, the largest contribution is expected to come from an increase in capital goods imports required for major resource projects.

The **terms of trade** are forecast to reach their highest sustained levels in 140 years, based on strong price rises for Australia's key non-rural commodity exports. This reflects increased global commodity demand and significant supply disruptions — particularly to Queensland's metallurgical coal exports, due to the floods. The terms of trade are expected to decline gradually over 2011-12 and 2012-13, driven by a modest decline in non-rural commodity prices as increased global supply comes on line.

The **current account deficit** is expected to narrow sharply in 2010-11, reflecting the expected increase in the terms of trade, and then widen in 2011-12 and 2012-13, reflecting strong growth in import volumes and the expected gradual fall in the terms of trade. The trade balance moved into surplus in 2010-11 and is expected to remain in surplus over the next two years. The net income deficit is expected to widen over 2011-12 and 2012-13, as rising export earnings generate increased equity income outflows.

Employment is forecast to grow 1¾ per cent through the year to the June quarters of both 2012 and 2013, in line with strengthening economic growth. The **unemployment rate** is forecast to fall, reaching 4¾ per cent by the end of 2011-12 and 4½ per cent by the end of 2012-13. The participation rate is expected to remain at around record highs of 66 per cent.

Wages growth returned to trend in 2010, and is expected to increase as the labour market tightens. The wage price index is expected to grow 4 per cent through the year to the June quarter of 2012 and 4¼ per cent through the year to the June quarter of 2013.

Underlying inflation is expected to increase steadily from 2½ per cent through the year to the June quarter of 2011 to 3 per cent through the year to the June quarter of 2013. Following an initial spike associated with the recent natural disasters, **headline inflation** is also expected to be 3 per cent through the year to the June quarter of 2013.

Nominal GDP is forecast to grow 6¼ per cent in 2011-12 and 5¾ per cent in 2012-13, reflecting strength in real GDP growth and the gradual forecast decline in the terms of trade.

Table 1: Domestic economy forecasts[(a)]

	Outcomes(b)	Forecasts		
	2009-10	2010-11	2011-12	2012-13
Panel A - Demand and output(c)				
Household consumption	2.1	3	3 1/2	3 1/2
Private investment				
Dwellings	2.1	2 1/2	1 1/2	3
Total business investment(d)	-4.9	4 1/2	16	14 1/2
Non-dwelling construction(d)	-8.2	8	18 1/2	17 1/2
Machinery and equipment(d)	-4.8	2	17 1/2	14
Private final demand(d)	0.7	3	6	6
Public final demand(d)	7.0	3 1/2	1 1/4	-1 1/4
Total final demand	2.1	3	4 3/4	4 1/2
Change in inventories(e)	0.3	0	0	0
Gross national expenditure	2.4	3 1/4	4 3/4	4 1/4
Exports of goods and services	5.2	4	6 1/2	5 1/2
Imports of goods and services	4.9	9	10 1/2	8 1/2
Net exports(e)	0.1	-1	-1	- 3/4
Real gross domestic product	**2.3**	**2 1/4**	**4**	**3 3/4**
Non-farm product	2.3	2	4	3 3/4
Farm product	1.5	13	1	-3
Nominal gross domestic product	2.3	8	6 1/4	5 3/4
Panel B - Other selected economic measures				
External accounts				
Terms of trade	-4.4	19 1/4	- 1/4	-3
Current account balance (per cent of GDP)	-4.1	-2	-4	-5 1/4
Labour market				
Employment (labour force survey basis)(f)	2.4	2 3/4	1 3/4	1 3/4
Unemployment rate (per cent)(g)	5.2	5	4 3/4	4 1/2
Participation rate (per cent)(g)	65.3	66	66	66
Prices and wages				
Consumer price index(h)	3.1	3 1/4	2 3/4	3
Gross non-farm product deflator	0.2	6	2 1/4	2
Wage price index(f)	3.0	4	4	4 1/4

(a) Percentage change on preceding year unless otherwise indicated.
(b) Calculated using original data unless otherwise indicated.
(c) Chain volume measures except for nominal gross domestic product which is in current prices.
(d) Excluding second-hand asset sales from the public sector to the private sector.
(e) Percentage point contribution to growth in GDP.
(f) Seasonally adjusted, through-the-year growth rate to the June quarter.
(g) Seasonally adjusted rate in the June quarter.
(h) Through-the-year growth rate to the June quarter.

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 78 and a US$ exchange rate of around 107 US cents. Interest rates are assumed to move broadly in line with market expectations. World oil prices (Malaysian Tapis) are assumed to remain around US$132 per barrel. The farm sector forecasts are based on average seasonal conditions in 2012-13.

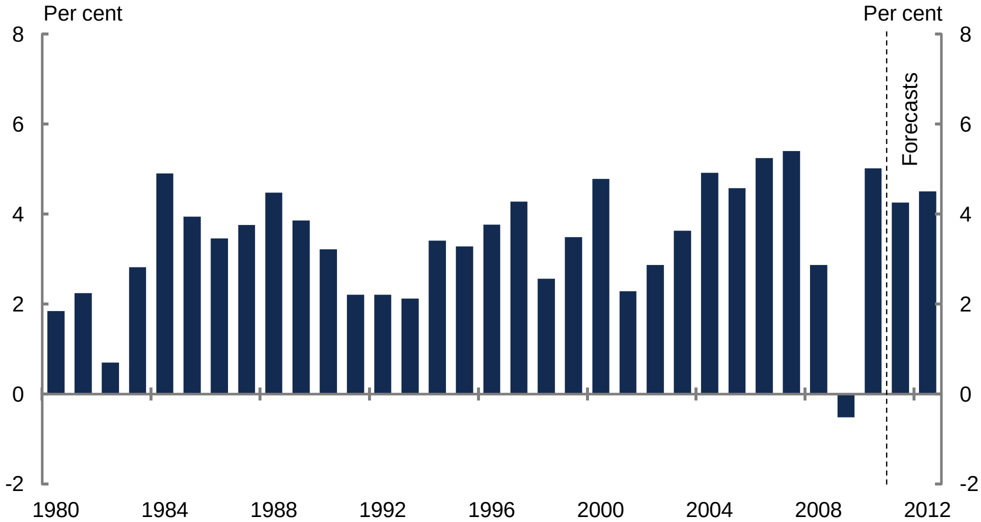
Source: Australian Bureau of Statistics (ABS) cat. no. 5206.0, 5302.0, 6202.0, 6345.0, 6401.0, unpublished ABS data and Treasury.

THE OUTLOOK FOR THE INTERNATIONAL ECONOMY

The global economic recovery is gaining momentum, but remains uneven and subject to significant downside risks. The recovery in the United States is consolidating, while robust growth in emerging market economies is continuing. Global financial conditions have also improved, notwithstanding the shocks from the earthquake in Japan and unrest in the Middle East and North Africa. However, output in the major advanced economies is still well below potential following the GFC, while the large emerging market economies are confronting significant capacity pressures. The strength and sustainability of the global recovery remains vulnerable due to ongoing stresses in European sovereign debt markets, enduring weaknesses in financial sector balance sheets, fiscal consolidation pressures in many of the major advanced economies, a build-up of inflationary risks in emerging market economies and rising oil prices.

The global economy is expected to grow 4¼ per cent in 2011 and 4½ per cent in 2012, slightly lower than the stronger-than-expected 5 per cent growth recorded in 2010 (Chart 4).

Chart 4: World GDP growth



Source: IMF *World Economic Outlook* April 2011, Thomson Reuters and Treasury.

Australia's major trading partners (MTPs) are forecast to grow 4½ per cent in 2011, and 5 per cent in 2012 (Table 2) following 6.6 per cent growth in 2010, the strongest rate in more than 20 years. The easing in MTP growth in 2011 reflects, in part, the economic impact of the Japanese earthquake, and more generally an expected moderation in the rapid expansion in emerging Asia that occurred during the initial phase of the recovery. The Japanese earthquake is expected to detract around ¼ of a percentage point from MTP growth in 2011 and, through the reconstruction, add ¼ of a percentage point to MTP growth in 2012 (see Box 1).

Table 2: International GDP growth forecasts(a)

	Actuals	Forecasts	
	2010	2011	2012
United States	2.9	3	3
Euro area	1.8	1 1/2	1 1/2
Japan	3.9	1/4	2 1/2
China(b)	10.3	9 1/2	9
India(b)	10.4	8 3/4	8 1/4
Other East Asia(c)	7.6	5	5
Major trading partners	6.6	4 1/2	5
World	5.0	4 1/4	4 1/2

(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) Production-based measure of GDP.
(c) 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* April 2011, Thomson Reuters and Treasury.

Developments in the United States and China, which are in different phases of their economic cycle, will largely determine the shape and durability of the global recovery. In the United States, macroeconomic policy remains highly accommodative, while in China the government is attempting to reduce inflationary pressures and overheating.

The outlook for the United States economy has solidified in recent months, with private consumption playing a larger role in the recovery. Extraordinary monetary policy accommodation continues to provide support to the economy. The fiscal package enacted in December 2010, based largely on tax cuts, will also play a role in supporting growth in 2011 by encouraging consumer spending. Following growth of 2.9 per cent in 2010, the United States economy is expected to continue to grow slightly above trend at 3 per cent in both 2011 and 2012, supporting a gradual fall in the unemployment rate.

A key uncertainty for the United States recovery is the potential for an extended period of high oil prices or continued lacklustre employment growth to dampen incomes growth and private consumption. Although the unemployment rate has fallen since November 2010 and employment growth has improved recently, there are still around 7 million fewer people employed than before the crisis. Unemployment is likely to remain significantly above pre-crisis levels over the forecast period, weighing on recovery prospects. Further, although conditions in the United States housing market are stabilising and are unlikely to detract much more from growth, bloated inventories and weak house price growth will continue to restrain housing activity. Additionally, the wind-down of stimulus and efforts to consolidate the fiscal position will be a drag on growth in 2012 and beyond.

The Chinese economy has continued to grow strongly, with GDP growth of 10.3 per cent in 2010. Despite a wind-down of the Government's fiscal stimulus program and a tightening of monetary conditions, investment contributed over half (5.6 percentage points) of this growth and now makes up around half of GDP.

In 2011, the Chinese economy is forecast to grow 9½ per cent, before moderating slightly to 9 per cent in 2012. Domestic demand is expected to make a stronger contribution to growth, while net exports are expected to make a small positive contribution to growth in 2011 and 2012, as they did in 2010.

Consumption is expected to contribute more to growth than in the past, as China seeks to redirect growth away from investment by slowing credit expansion and moderating activity in the property sector. China's 12th Five Year Plan, which outlines key economic and social objectives for the next five years, is focused on restructuring China's economic model towards internal sources of growth.

Overall, Chinese Government policy continues to be supportive of growth. The key risks to the short-term outlook are centred on controlling inflation and managing inflation expectations. Inflation is being driven by high food prices and excess liquidity. Despite recent increases in the reserve requirement ratio and interest rates, further tightening is likely, with the attendant risk of an overcorrection.

While the global outlook has improved, it is exposed to shocks and a number of key downside risks remain. Sovereign debt problems are most pressing in Europe. Greece and Ireland have already received European Union-IMF rescue packages, and Portugal reached an agreement on a rescue package in early May with the EU and IMF. Each of these countries is undergoing large-scale fiscal consolidation and implementing broad-ranging structural reforms. However, market concern over the sustainability of the debt burden remains, as does the potential for contagion to the European banking sector.

The United States and Japan also face the challenge of addressing the longer-term sustainability of their public finances. In the near term, considerable uncertainty shrouds the ultimate form of long-term fiscal consolidation in the United States, while in Japan the near-term focus will be on funding recovery and reconstruction from the earthquake. In both countries, credible long-term consolidation plans have yet to be agreed.

Another significant risk to the global recovery is the inflationary pressure building in emerging economies. In fast-growing emerging economies, spare capacity has been significantly reduced and inflationary pressures have been building for some time. Rapid capital inflows and rising food and oil prices are accentuating these pressures, adding impetus to the need for policy tightening. Measures are being taken, with monetary authorities in a number of these economies increasing interest rates since the start of 2011. However, as the pressure on authorities to further tighten policy increases, it will be crucial that inflationary pressures are reduced while avoiding a sharp slowing of growth. Given that emerging economies have driven the global recovery to date, a sharp slowing in these economies would not bode well for the global recovery.

Resurgent demand for oil, and improving confidence in the strength of the global recovery, underpinned rising oil prices during 2010. Disruptions to oil supply due to the unrest in the Middle East and North Africa in recent months have pushed oil prices to well over US$100 per barrel. In addition, the damage to Japan's nuclear power capacity from the recent earthquake may also result in an increase in oil and gas demand from Japan, the world's third-largest consumer of oil, as well as from other economies reassessing their use of nuclear power.

A significant and sustained oil price rise would pose a significant risk to the global economic outlook. Recent work by the IMF estimates that a temporary rise in oil prices to an average of US$150 per barrel for 2011 could reduce the level of advanced economies' real GDP by ¾ of a per cent in 2012 from its current projections. In emerging economies, the effect is estimated to vary widely across regions, from GDP losses of close to ¾ of a per cent in Asia and ½ of a per cent in Latin America, to GDP gains in the Middle East and North Africa and in the Commonwealth of Independent States.

While the balance of risks is to the downside, there are also upside risks to the global recovery. There is potential for a rapid improvement in sentiment and a subsequent surge in investment and activity more broadly, financed from the substantial levels of liquidity sitting idle with banks and corporates, particularly in the United States but also in Japan. A continuation of the recovery in equity markets would also reduce some of the need for continued deleveraging.

Box 1: Japanese earthquake

The magnitude-9.0 Tohoku earthquake in March 2011 was the most powerful in Japan's recorded history. On top of the tragic loss of human life, the earthquake and associated tsunami and nuclear emergency have had a significant impact on the Japanese economy.

Japanese GDP is expected to decline sharply in the first half of 2011, with industrial production in March falling 15.3 per cent. Reconstruction activity will add to GDP growth later this year and in 2012.

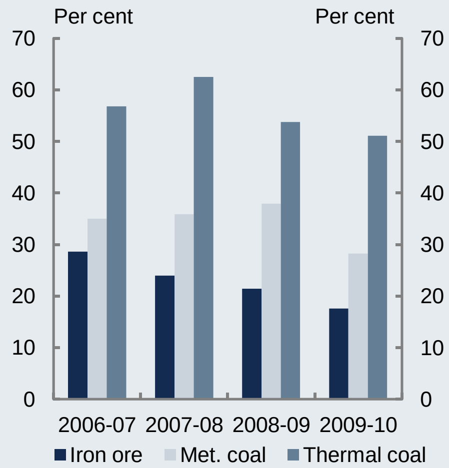
Japan's productive capacity was reduced significantly in the immediate area of the disasters, with structural damage estimated at ¥16-25 trillion ($180-300 billion) — far more than the 1995 Kobe quake. Damage extended to key ports and power plants, particularly the Fukushima Daiichi nuclear power plant. Other parts of Japan have also been affected by power shortages, disruptions to supply chains and falls in consumer confidence particularly associated with concerns about radiation leaking from the damaged nuclear power plant.

Short-term global economic impacts are expected to be material, given that Japan accounts for around 6 per cent of world GDP. Japan is a key producer of high-end intermediate goods, such as electronics parts, which are crucial to closely-integrated global supply chains.

The disruption to Japanese production and damage to port infrastructure are expected to reduce Japan's short-term demand for Australia's (non-rural) commodity exports (Chart A), reducing Australia's real GDP growth in 2010-11 by up to ¼ of a percentage point.

Chart A: Selected Australian commodity exports to Japan

(per cent of total value exported)



Source: ABS customised report.

Australian earnings from exports to Japan are expected to be reduced by around $2 billion in 2010-11, primarily reflecting disruptions to commodity shipments and the short-term effect on commodity prices. Australian exporters whose products were earmarked for Japan may be forced to find alternative customers in the near term, causing delays to exports. Spot prices for Australia's key non-rural commodity exports fell after the earthquake amid expectations of a short-term reduction in Japanese demand, but have since rebounded.

Japan's reconstruction efforts are likely to boost Australia's export earnings from 2011-12 through higher world commodity prices.

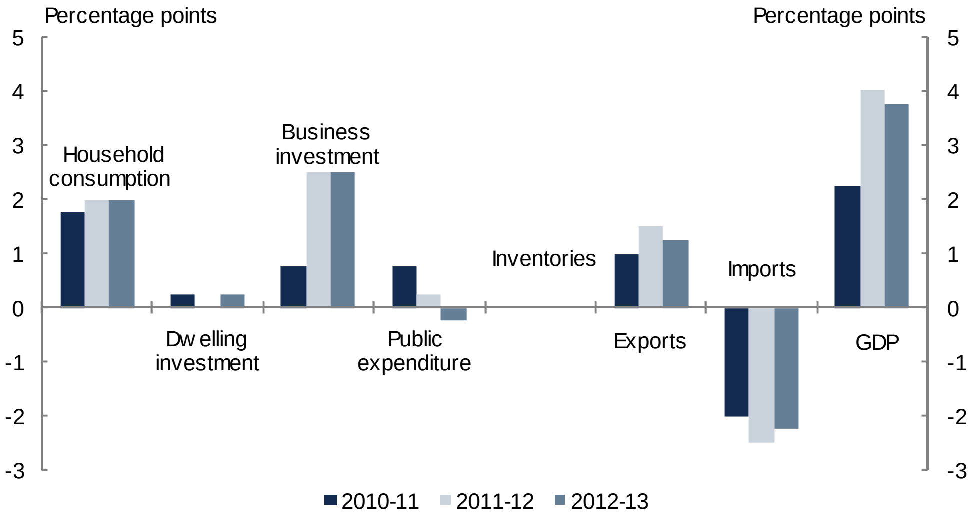
The outlook for the domestic economy

Demand and output

The recent natural disasters in Australia, Japan and New Zealand are expected to detract ¾ of a percentage point from Australia's economic growth in 2010-11 (see Box 1, Box 2). This, combined with recent weakness in household demand, has driven a 1 percentage point downgrade in forecast real GDP growth since the *Mid-Year Economic and Fiscal Outlook 2010-11* (MYEFO) to 2¼ per cent in 2010-11. However, the macroeconomic impact of these natural disasters is expected to be temporary and the medium-term outlook remains strong, with real GDP forecast to grow 4 per cent in 2011-12 and 3¾ per cent in 2012-13. The strong growth outlook is underpinned by unprecedented growth in resources investment and strong growth in non-rural commodity exports, which are surging in response to high global prices for Australia's bulk commodity exports (Chart 5).

The strong expected growth in the overall economy masks some significant divergences between sectors, with conditions outside of mining and related industries expected to remain challenging. Tighter macroeconomic settings and credit conditions, heightened consumer caution and the high Australian dollar are all weighing heavily on some sectors, particularly retailing, manufacturing and tourism.

Chart 5: Contributions to real GDP growth



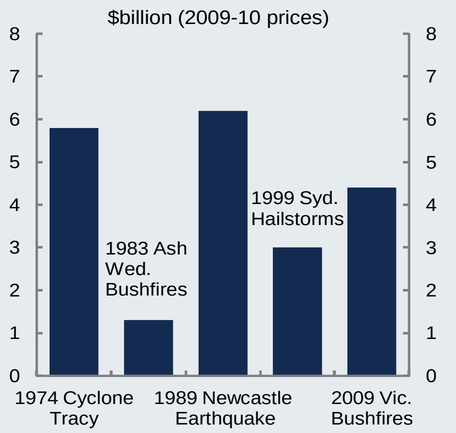
Note: Business investment and public expenditure are adjusted for second-hand asset sales from the public sector to the private sector.
Source: ABS cat. no. 5206.0 and Treasury.

Box 2: Impact of recent Australian floods and cyclones

The flooding across eastern Australia, followed by Cyclone Yasi, has had a significant impact on economic activity — disrupting coal production, destroying agriculture, reducing activity in the tourism and retail sectors, and damaging infrastructure.

In economic terms, it is estimated that the recent floods were the most costly natural disaster in Australia's history, larger than the 1989 Newcastle Earthquake and Cyclone Tracy (Chart A).

Chart A: Estimated economic impact of previous natural disasters



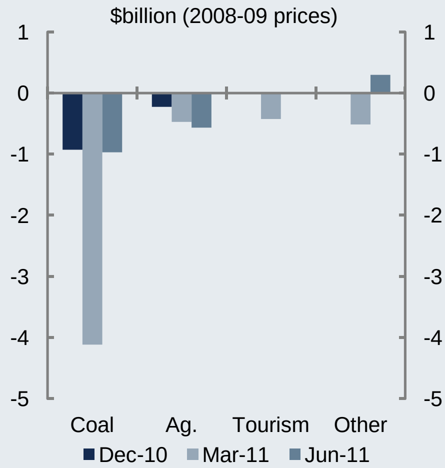
Source: Economic Costs of Natural Disasters in Australia, Bureau of Transport Economics, 2001; 2009 Victorian Bushfires Royal Commission, final report.

The direct negative impact of the recent natural disasters is expected to be largely confined to the first half of 2011 — reducing real production by $9 billion and real GDP growth by ½ of a percentage point in 2010-11, and leading to temporary price rises for affected rural and non-rural commodities.

In 2011-12, reconstruction and the resumption of economic activity are expected to add to real GDP growth.

Reduced coal production from Queensland is the largest direct impact, with production losses estimated to be around 25 million tonnes (around $6 billion in real terms — Chart B).

Chart B: Estimated impact of recent floods and Cyclone Yasi on real economic activity



Source: Treasury.

Floodwaters covered and damaged key rail lines and inundated a large number of coal pits. While much of the affected rail infrastructure is now fully operational, ongoing de-watering of coal mines means that mine production will take time to return to full capacity. The impact on export earnings is expected to be partly offset by higher prices — with contract prices for metallurgical coal in the June quarter around 50 per cent higher than for the previous quarter. Prices are expected to return to around pre-flood levels when production capacity is restored.

Box 2: Impact of recent Australian floods and cyclones (continued)

For the rural sector, the floods and Cyclone Yasi led to significant losses and quality downgrades to a range of agricultural products — with the total real production impact estimated to be $1.9 billion (with Queensland accounting for the majority of this). This has led to what is expected to be temporary price rises for a number of agricultural products — most notably, bananas. It is estimated that these price rises will add around ½ a percentage point to inflation over the March and June quarters. Around two-thirds of this increase is expected to be unwound by the end of the September quarter — consistent with the experience of previous natural disasters of this sort.

Household consumption

Household consumption growth has moderated since the onset of the GFC. While the labour market has strengthened, household incomes have grown solidly and consumer confidence is around its long-term average, consumers continue to be cautious. This follows a period prior to the mid-2000s where growth in household consumption had exceeded growth in household incomes, supported by strong growth in both housing market and sharemarket returns. Since the crisis, the household saving ratio has risen sharply to around 20-year highs, coinciding with slower growth in household credit (Box 3).

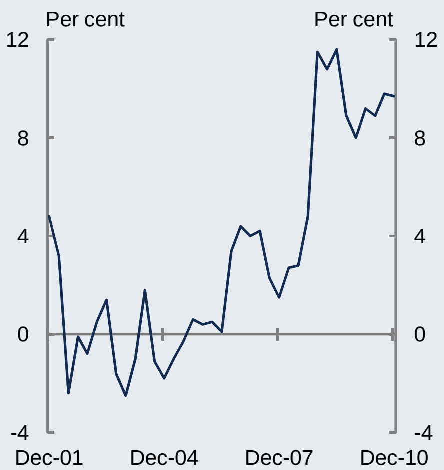
Household consumption growth is expected to increase steadily over the next two years, supported by strengthened household finances and increasingly favourable economic conditions. With household consumption forecast to grow broadly in line with household income, the household saving ratio is expected to remain at around its current level. Household consumption growth is forecast to be 3 per cent in 2010-11, before rising to 3½ per cent in both 2011-12 and 2012-13.

Box 3: Consumer caution

Australian households have been more cautious in their approach to spending and borrowing since the GFC, even as economic conditions have strengthened.

Household saving was negative in the mid-2000s, with consumption exceeding disposable income (Chart A). Household consumption growth has moderated though since the GFC. With solid growth in disposable income, this has seen the household saving ratio rise to around 10 per cent.

Chart A: Household saving ratio

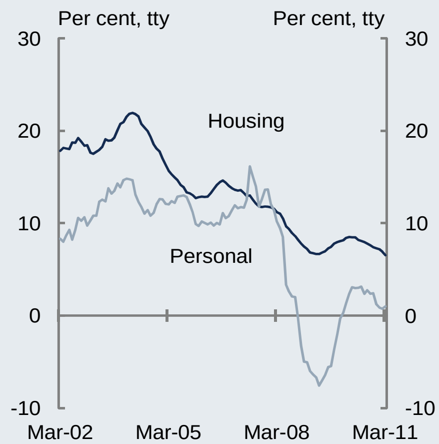


Source: ABS cat. no. 5206.0.

The boost in household saving has accompanied a substantial reduction in household credit growth from the double-digit rates seen in much of the past decade. The slowdown in credit growth has been broad-based, with annual growth in housing credit and personal credit each more than 6 percentage points below their 10-year averages (Chart B). Lower credit growth has seen a stabilisation in the household sector's debt-to-asset and debt-to-income ratios, after two decades of increases. The household debt-to-asset ratio was 19.1 per cent in December 2010, down from a high of 20.6 per cent in March 2009.

Higher saving and subdued credit growth have enabled a rebuilding of household balance sheets following the decline in household net worth caused by the GFC. This changed behaviour may reflect the subdued recovery in household wealth and a heightened awareness among Australians of the risks associated with high rates of indebtedness, having witnessed the severe impact of the GFC in other advanced economies.

Chart B: Household credit growth



Source: RBA.

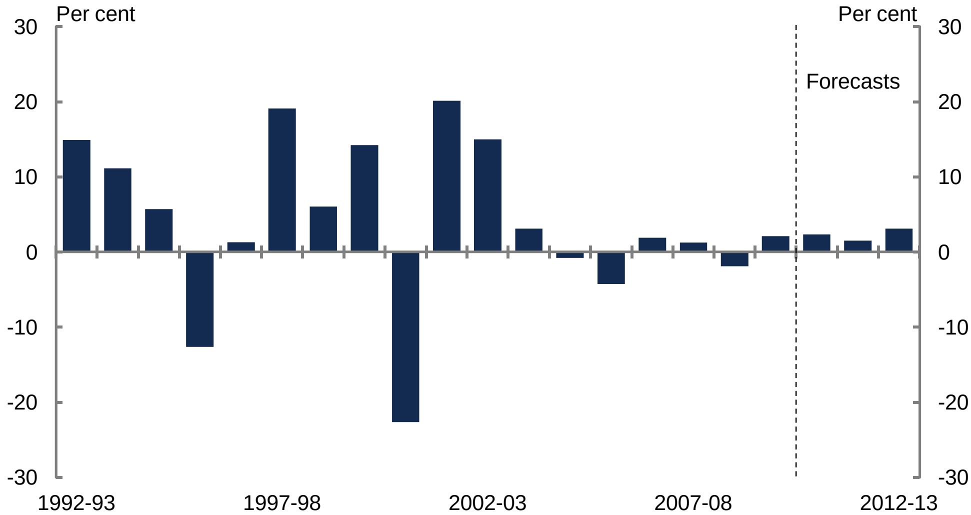
While putting near-term pressure on some sectors such as retail, these developments will ultimately benefit the Australian economy. Sturdier balance sheets will buffer households from economic shocks; and a smaller contribution of household spending to domestic demand growth will create room for rising investment in the resources sector, helping to moderate price and wage pressures.

Dwelling investment

Households also remain cautious with respect to their dwelling investment decisions, with tighter credit conditions further weighing on activity in this sector. In the short term, forward indicators are pointing to continued weakness, with housing finance for new dwellings and dwelling approvals falling in recent months. In the medium term, demand for housing is expected to be supported by low unemployment, solid growth in household incomes and past strength in population growth. However, ongoing supply constraints associated with planning and approval processes and land release restrictions are expected to continue to weigh on dwelling investment growth.

Dwelling investment is forecast to grow 1½ per cent in 2011-12, and 3 per cent in 2012-13 (Chart 6). There has been little growth in the supply of new dwellings in Australia since 2002-03.

Chart 6: Growth in dwelling investment



Source: ABS cat. no. 5206.0 and Treasury.

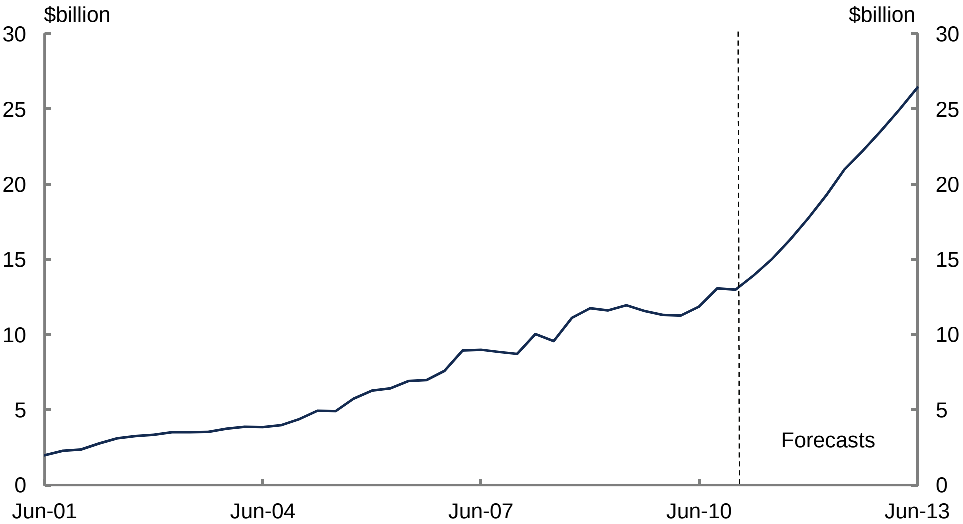
Business investment

Business investment is rapidly gaining momentum, with sustained high prices for Australia's key non-rural commodity exports driving record investment intentions in the mining sector. New business investment is expected to grow 16 per cent in 2011-12, and 14½ per cent in 2012-13, underpinned by strong growth in both engineering construction, and machinery and equipment investment. Non-residential building investment is expected to remain modest over the next two years. New business investment is expected to reach 50-year highs as a share of GDP by the end of 2012-13.

The mining sector is expected to be the key driver of business investment over the next two years, with continuing strong global demand for Australia's mineral resources and record levels of profitability underpinning an unprecedented pipeline of investment activity. The ABS *Private New Capital Expenditure and Expected Expenditure* (CAPEX) survey suggests that mining investment will reach a record $76 billion in 2011-12. Mining investment is also expected to remain at high levels over subsequent years, with the Australian Bureau of Agricultural and Resource Economics and Sciences (ABARES) estimating that the current pipeline of resources investment is over $380 billion (see Box 4).

The expected surge in new engineering construction investment is well underway with growth of 12.4 per cent through the year to the December quarter of 2010. New engineering construction investment is forecast to grow a further 56 per cent over the next two years, led by the LNG sector and with strong support from the iron ore and coal sectors (Chart 7). Over the past year, the oil and gas industry has committed to more than $30 billion in additional investment, including a number of world-first coal seam gas-to-LNG projects in Queensland.

Chart 7: New engineering construction (value)



Source: ABS cat. no. 5206.0 and Treasury.

New machinery and equipment investment fell in 2010, in part due to businesses bringing forward investment into 2009 to take advantage of the Small Business and General Business Tax Break. However, the recent CAPEX survey points to strong growth in investment during the remainder of 2010-11 and 2011-12, led by mining-related activity and supported by the resumption of maintenance and replacement spending in other sectors. Investment in new machinery and equipment is forecast to grow 17½ per cent in 2011-12 and 14 per cent in 2012-13.

Investment in new non-residential building is expected to recover modestly in 2011-12 and 2012-13. Non-residential investment declined during the second half of 2010 as Building the Education Revolution activity wound down. While declining vacancy rates and modest growth in building approvals in recent months suggest the sector is stabilising, conditions remain relatively weak with activity still below pre-crisis levels. Investment in the sector is expected to grow 2½ per cent in 2011-12 and 8 per cent in 2012-13, largely supported by growing demand for office space associated with strong employment growth.

Box 4: Mining boom mark II

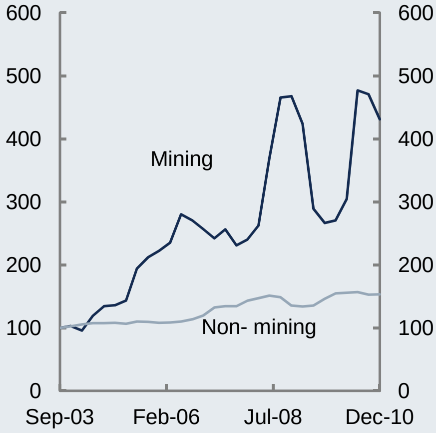
The Australian economy is in the early stages of the biggest investment boom on record, generating substantial benefits.

The rapid industrialisation and urbanisation of emerging Asia, particularly China, is expected to sustain strong growth in resources demand for some time. Strong demand for commodities is supporting prices for Australia's key non-rural commodity exports and the terms of trade. In 2010-11, the terms of trade are expected to reach their highest sustained levels in 140 years on the back of substantial price rises for coal and iron ore.

High prices for non-rural commodities are generating a significant supply response, both in Australia and overseas. From 2011-12, the terms of trade are expected to decline gradually as growth in the global supply of non-rural commodities starts to outpace demand. That said, with demand for Australia's key commodity exports expected to remain strong, the terms of trade are likely to remain well above historical levels for an extended period.

Australia's high terms of trade have supported strong growth in national incomes, particularly in the mining industry (Chart A). Mining's share of total company profits has more than doubled since the start of the boom, notwithstanding a large temporary decline during the GFC.

Chart A: Business profits



Source: ABS cat. no. 5676.0 and Treasury.

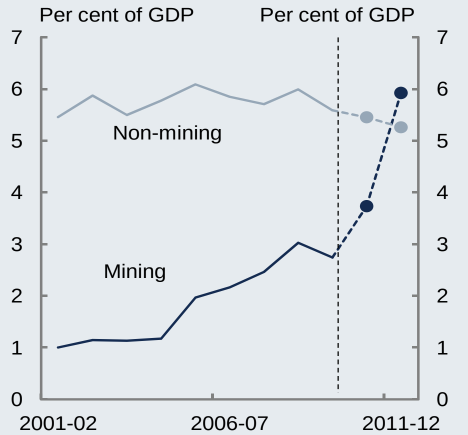
Record mining profitability and the prospect of continued strong demand for our non-rural commodities is reflected in the massive forward pipeline of mining investment.

Mining investment has risen from $12 billion in 2003-04 to an estimated $56 billion in 2010-11. This is a precursor to an even larger surge over coming years as a range of large resource projects ramp up, led by the LNG sector. Mining investment is expected to reach record highs as a share of GDP over the next two years (Chart B).

The surge in mining investment will lead to a substantial increase in mining capacity and exports. The annual value of real non-rural commodity exports is anticipated to increase by around $25 billion over the next two years to more than $203 billion in 2012-13. This would see non-rural commodity

Box 4: Mining boom mark II (continued)

Chart B: Mining and non-mining investment intentions



Note: Estimates for 2010-11 and 2011-12 are from the ABS CAPEX survey, and based on long-run average realisation ratios.
Source: ABS cat. no. 5625.0 and Treasury.

exports increase from around 10 per cent of GDP in 2009-10 to around 13 per cent of GDP in 2012-13.

The high level of mining investment will also significantly increase the demand for labour. While mining is more capital intensive than other industries, employment demand is still expected to be strong. Over the past year, 27,700 jobs have been created in the mining industry, which now employs over 200,000 people. While small as a share of total employment, the mining sector's employment share has almost doubled to 1.8 per cent since 2003-04.

Mining investment will also draw heavily on the construction sector, with around $63 billion planned to be spent on buildings and structures in 2011-12.

This represents around 70 per cent of planned private non-dwelling construction in 2011-12, adding to demand for skilled construction workers and placing pressure on a tightening labour market.

The current mining boom (mark II) is a continuation of the boom that started in the mid 2000s (mark I), but it has some key differences.

The starting point of the economy is now different, with the economy operating closer to full capacity at the start of mining boom mark II, indicating less room for above-trend growth without generating price and wage pressures.

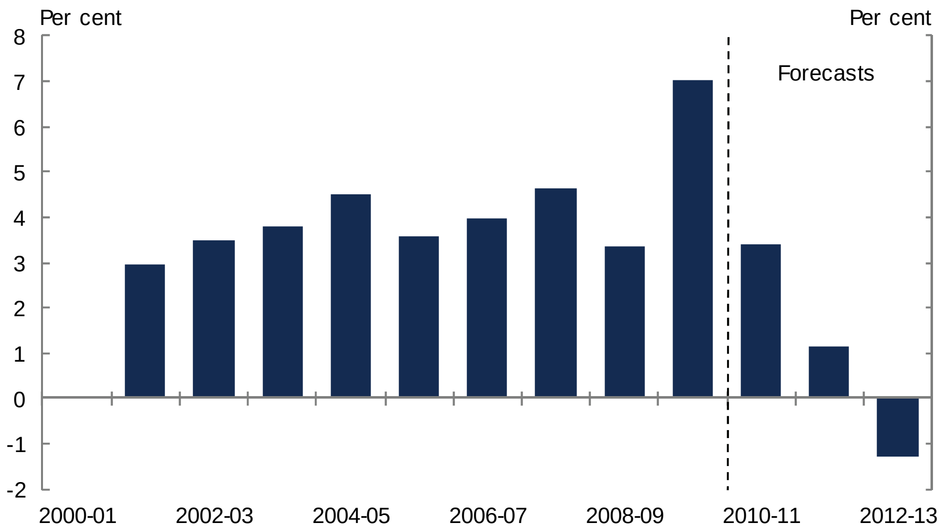
Consumers are behaving more cautiously, notwithstanding strong employment and incomes growth. Access to credit is tighter, both for consumers and businesses. Policy settings are tighter and the exchange rate is higher. These forces have seen the emergence of a patchwork economy, with a substantial divergence between the performance of the mining and non-mining related sectors of the economy.

The other key difference is that, compared with mark I, throughout which the terms of trade continued to rise strongly, the terms of trade are now around expected peaks, with gradual declines in prospect. While levels are expected to remain elevated, the strong growth in incomes and Government revenues that occurred in mark I are unlikely to be repeated in mark II. Further details on the impacts on revenue can be found in Budget Statement 5.

Public final demand

Public final demand growth is expected to decline sharply over the next two years, notwithstanding additional spending associated with post-disaster rebuilding efforts. Public final demand is expected to grow 3½ per cent in 2010-11, underpinned partly by reconstruction activity, and 1¼ per cent in 2011-12, before declining 1¼ per cent in 2012-13 (Chart 8). This decline reflects the conclusion of the Australian Government's fiscal stimulus as well as fiscal consolidation across all levels of government. The withdrawal of the fiscal stimulus is expected to reduce GDP growth by around 1 percentage point in 2010-11 and by ½ of a percentage point in 2011-12.

Chart 8: Growth in public final demand



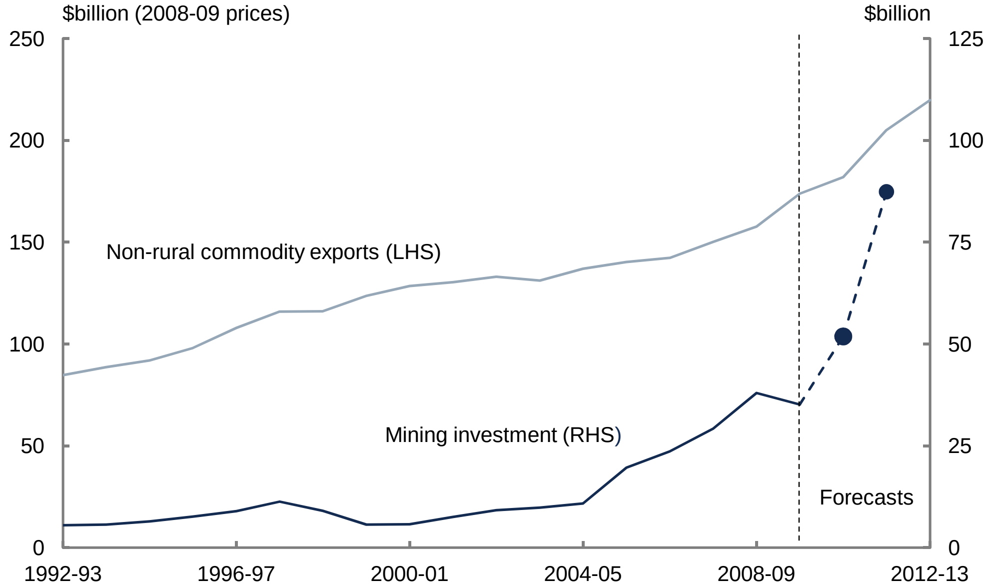
Source: ABS cat. no. 5206.0 and Treasury.

Exports and imports

Aggregate export volumes are forecast to increase 4 per cent in 2010-11, 6½ per cent in 2011-12 and 5½ per cent in 2012-13, driven by a significant expansion of production capacity in the resources sector.

Non-rural commodity exports are expected to grow strongly as ongoing expansions to mine and infrastructure capacity facilitate greater export volumes to meet global demand (Chart 9). Mine and port capacity expansions in Western Australia are expected to boost iron ore exports, while coal infrastructure expansions in Queensland are expected to boost both metallurgical and thermal coal exports. Coal exports will continue to suffer in the near term due to the disruption to mining operations and rail infrastructure caused by the severe flooding in Queensland. However, with the exception of a few smaller mines, coal production is expected to return to around full capacity by the September quarter 2011. Recent disasters in Japan also reduced demand for Australia's non-rural commodity exports but this is expected to be temporary, with reconstruction activity likely to add to demand for Australia's non-rural commodities. Non-rural commodity exports are expected to grow 4½ per cent in 2010-11, 12½ per cent in 2011-12 and 7 per cent in 2012-13.

Chart 9: Mining investment intentions and non-rural commodity export volumes



Note: Estimates for 2010-11 and 2011-12 for mining investment are from the ABS CAPEX survey, and based on long-run average realisation ratios.
Source: ABS cat. no. 5302.0 and 5625.0 and Treasury.

Rural exports are expected to increase 13½ per cent in 2010-11 and remain at a high level over the next two years, in line with a strong outlook for farm production. The growth in 2010-11 largely reflects favourable seasonal conditions for the winter crop, partly offset by subsequent crop losses arising from the floods and Cyclone Yasi. The major impact of these disasters is expected to be a significant downgrade to crop quality. A bumper summer crop is also expected in 2011-12, with recent rainfall increasing the availability of irrigation water and improving sub-soil moisture. In 2012-13, farm production is expected to decline slightly, under an assumption of a return to more normal seasonal conditions.

Exports of elaborately transformed manufactures (ETMs) are expected to increase a little over the next two years, but remain below pre-crisis levels. While demand is expected to rise in line with strong forecast growth in Australia's major trading partners, the high exchange rate is expected to continue to weigh on ETMs export growth. ETMs exports are expected to be flat in 2010-11, decline by ½ of a percentage point in 2011-12, but increase by 4 per cent in 2012-13.

Exports of services are also not expected to recover to pre-crisis levels over the next two years, again largely due to the strength of the Australian dollar. Tourism exports are expected to remain weak, as are education-related exports. Services exports are expected to fall ½ of a per cent in 2010-11 and 3½ per cent in 2011-12, before growing 1½ per cent in 2012-13.

Imports are expected to grow strongly over the next two years, driven by strengthening domestic demand and a high Australian dollar. While growth is expected to be relatively broad-based, the largest contribution is expected to come from capital goods imports. This reflects the expected ramp up of construction activity on major resource projects, particularly in the LNG sector where more than two-thirds of capital investment comprises imported products. Import volumes are forecast to grow 9 per cent in 2010-11, 10½ per cent in 2011-12 and 8½ per cent in 2012-13.

Terms of trade

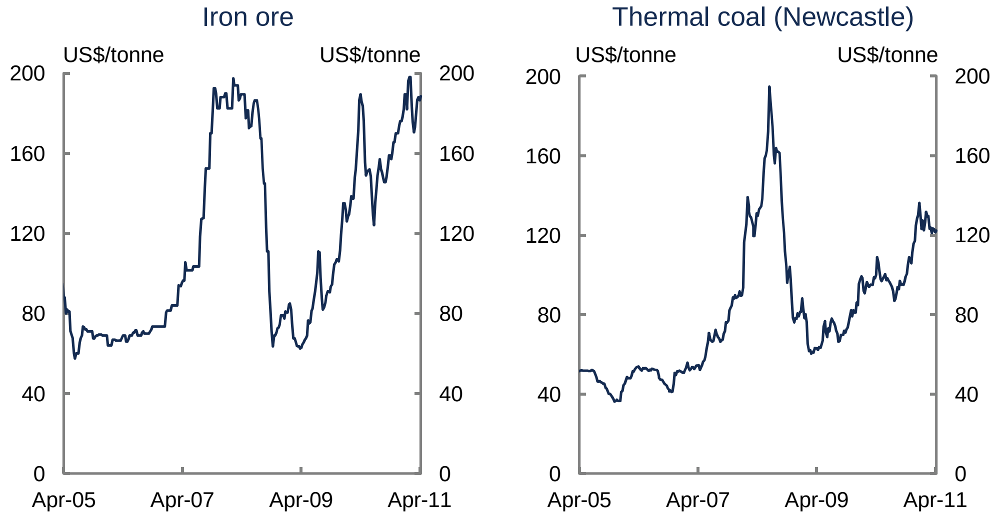
The terms of trade are forecast to increase 19¼ per cent in 2010-11, underpinned by strong increases in the prices of Australia's key non-rural commodity exports, before declining gradually over 2011-12 and 2012-13 as increasing global commodity supply starts to match growth in demand (Chart 10).

Chart 10: Terms of trade

Source: ABS cat. no. 5206.0 and Treasury.

Prices for Australia's non-rural commodity exports have increased significantly in 2010-11, reflecting ongoing strong global demand, coupled with supply disruptions in Australia and abroad. Iron ore spot prices have increased by more than 50 per cent since mid-2010, reflecting strengthening global demand and weather-related disruptions to global supply (Chart 11). The Queensland floods severely disrupted both the production and transportation of coal — leading to strong price rises, particularly for metallurgical coal. Contract prices for metallurgical coal for the June quarter 2011 are around 50 per cent higher than for the previous quarter. Coal prices are expected to decline as affected supply is restored.

Chart 11: Bulk commodity prices



Source: Bloomberg and Global Coal.

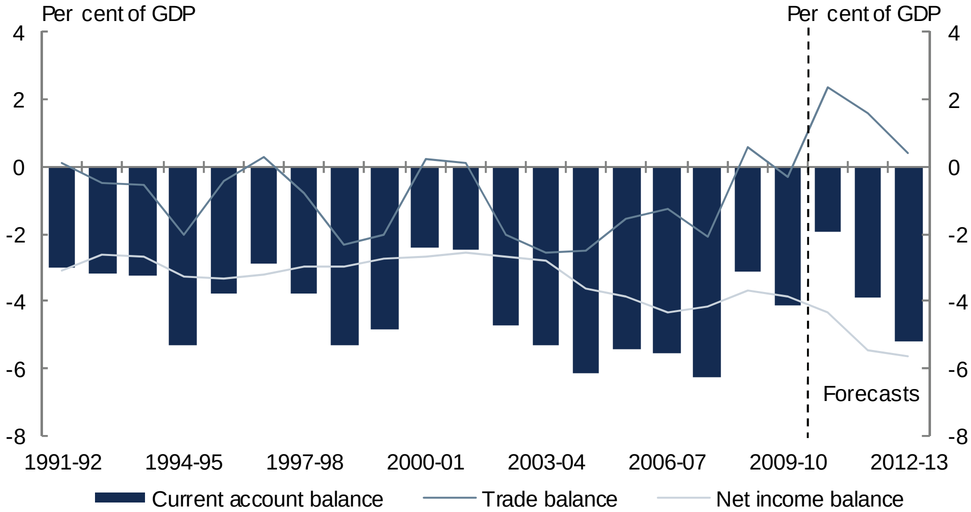
The terms of trade are forecast to decline gradually over the next two years, but remain at historically high levels. Global commodity demand is expected to continue to grow solidly, driven by strong economic growth in emerging Asia, coupled with reconstruction activity in Japan following the earthquake. However, increasing global supply is expected to begin to weigh on commodity prices over the next two years, with further gradual commodity price declines projected over the medium term. The terms of trade are forecast to fall ¼ of a per cent in 2011-12 and 3 per cent in 2012-13, largely reflecting a modest fall in non-rural commodity prices.

Current account balance

The current account deficit is expected to narrow to 2 per cent of GDP in 2010-11, the smallest deficit as a share of GDP since 1979-80. The trade balance is expected to move from a deficit of 0.3 per cent of GDP in 2009-10 to a surplus of 2½ per cent of GDP in 2010-11, largely reflecting a strong rise in non-rural commodity prices and volumes. With a large share of mining profits repatriated to overseas investors, a wider net income deficit is expected to more than offset the trade surplus, leaving the current account in deficit.

The current account deficit is expected to widen to 4 per cent of GDP in 2011-12 and to 5¼ per cent of GDP in 2012-13, as non-rural commodity prices fall slightly and import volumes increase strongly (Chart 12). From a saving and investment perspective, the widening of the current account deficit reflects the expected increase in national investment, driven by record high capital expenditure intentions in the mining sector. National saving will be supported by the Australian Government's fiscal consolidation and an expectation that household saving will remain elevated.

Chart 12: Current account balance



Source: ABS cat. no. 5206.0 and 5302.0 and Treasury.

Labour market

The labour market has strengthened over the past year and this is expected to continue in 2011-12 and 2012-13 (Box 5).

Employment has grown well above trend over the past year with over 300,000 jobs created. The unemployment rate has declined below 5 per cent and the participation rate has increased to around record levels. While employment growth slowed in the aftermath of the recent natural disasters, the impact is expected to be temporary, with labour demand indicators pointing to a rebound in coming months. Employment is expected to grow 1¾ per cent through the year to the June quarter of both 2012 and 2013.

Labour force participation has increased over the past year, notwithstanding the demographic drag associated with the first of the post-War baby boomers turning 65. This reflects the return of job seekers previously discouraged during the downturn and also the trend rise in the participation of females and older workers. The national participation rate is expected to remain at around record highs of 66 per cent over the next two years, before commencing a long gradual decline associated with the ageing of the population.

The unemployment rate is expected to continue declining, reflecting the strong growth in employment. The unemployment rate is expected to fall to 4¾ per cent in the June quarter of 2012 and then to 4½ per cent in the June quarter of 2013.

Box 5: The Australian labour market and the global financial crisis

Unlike most advanced economies, the Australian labour market was remarkably resilient during the GFC and, following a short period of weakness, has since strengthened. Over the past 18 months, employment has grown strongly, the unemployment rate has fallen steadily, and the participation rate has reached record highs. The long-term unemployment rate remains low and continues to decline.

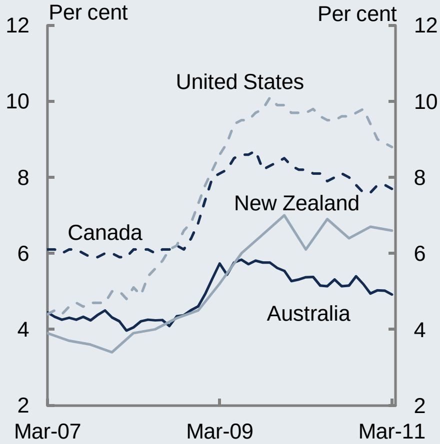
In the lead up to and during the GFC, the unemployment rate rose by a total of around 1¾ percentage points (from 4.0 to 5.8 per cent) in Australia, compared with around a 2¾ percentage point rise in Canada, a 3½ percentage point rise in New Zealand and a 5¾ percentage point rise in the United States (Chart A). Not only was the increase in Australia's unemployment rate relatively modest, but the subsequent recovery has been substantial, with the unemployment rate falling to 4.9 per cent as at March 2011, lower than all the major advanced economies except Japan.

Australia's record on unemployment during the GFC is all the more impressive in the context of the increase in labour force participation that has occurred over this period.

After a short decline during the downturn, Australia's participation rate rebounded strongly, reaching a record high of 66.0 per cent in November 2010. Since March 2007, Australia's participation rate has increased around ¾ of a percentage point, compared with no change in New Zealand, a ½ of a percentage point decrease in Canada and a 2 percentage point decrease in the United States (Chart B).

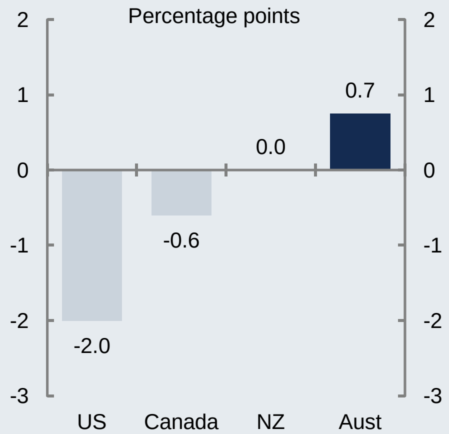
In Australia, this reflects the return of previously discouraged job seekers, as well as a trend increase in the participation of females and older workers. The participation rate of those aged 55+ has increased by around 4 percentage points since March 2007.

Chart A: Unemployment rates



Note: New Zealand data are quarterly.
Source: ABS cat. no. 6202.0, national statistical agencies and Thomson Reuters.

Chart B: Participation rates (change since March 2007)

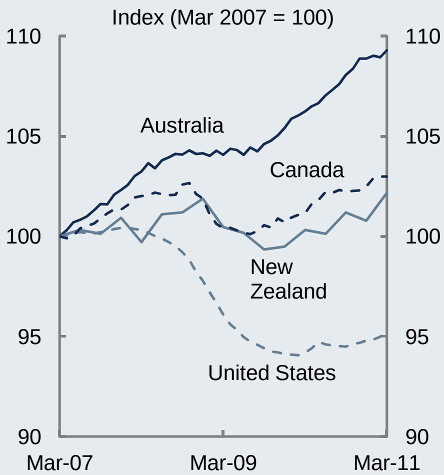


Note: New Zealand data are quarterly.
Source: ABS cat. no. 6202.0, national statistical agencies, Thomson Reuters and Treasury.

Box 5: The Australian labour market and the global financial crisis (continued)

The decline in the unemployment rate at a time of increasing labour force participation reflects an impressive increase in employment. Since March 2007, employment has increased by around 9¼ per cent in Australia compared with around 3 per cent in Canada, 2¼ per cent in New Zealand and a decrease of 4¾ per cent in the United States (Chart C). Whereas Australia has added around 750,000 jobs since the end of 2007, there are 7.2 million fewer jobs in the United States.

Chart C: Employment



Note: New Zealand data are quarterly.
Source: ABS cat. no. 6202.0, national statistical agencies, Thomson Reuters and Treasury.

Australia's success during this episode reflected the relative shallowness of our domestic downturn and the flexibility of our labour market. In Australia, much of the labour market adjustment occurred through reduced hours worked and lower wages growth rather than through the large-scale job losses that occurred in many other advanced economies.

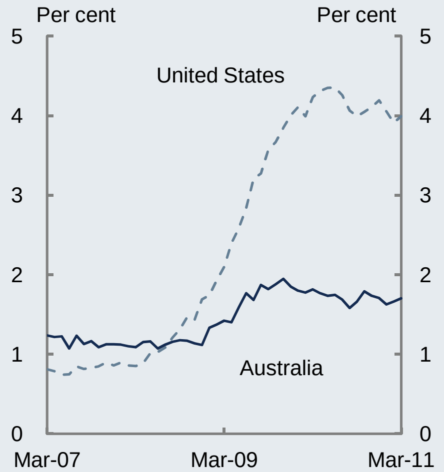
By limiting job losses, Australia also significantly reduced the economic and social costs associated with large scale longer-term unemployment.

In Australia, the long-term unemployment rate, defined for the purpose of international comparison as the proportion of the labour force that has been unemployed for six months or more, increased by much less than it did in the United States and started to decline earlier.

In the lead up to and during the GFC, the long-term unemployment rate rose by a total of 1 percentage point (from around 1 to 2 per cent) in Australia compared with around 3¾ percentage points in the United States (Chart D).

Australia's long-term unemployment rate has fallen over the past 18 months and now is a relatively low 1.7 per cent compared with 4.0 per cent in the United States.

Chart D: Long-term unemployment rates



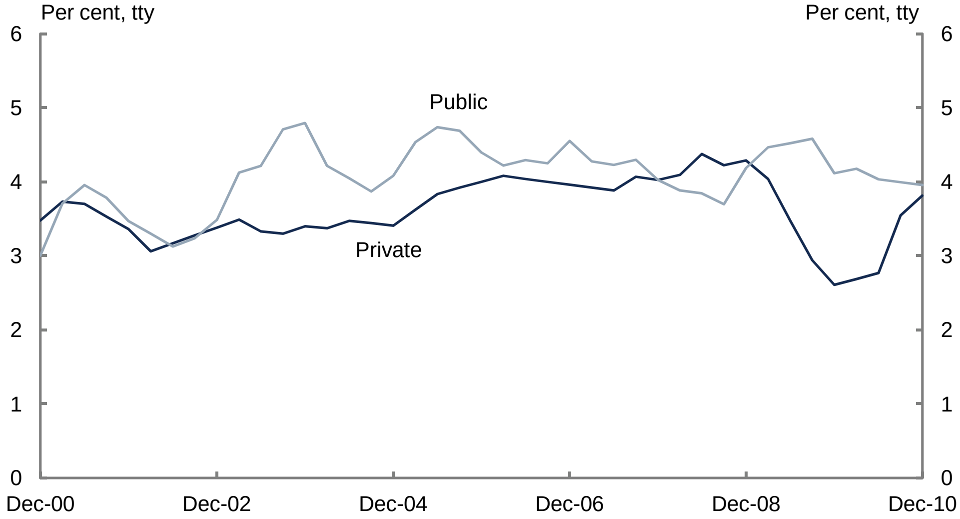
Note: The long-term unemployment rate is defined as the proportion of the labour force unemployed for six months or more.
Source: ABS cat. no. 6291.0.55.001, Bureau of Labor Statistics, Thomson Reuters and Treasury.

Wages

Wages growth increased during 2010, driven by a strong recovery in private sector wages (Chart 13). Wages growth is now around trend, and is expected to increase gradually as the labour market tightens. However, solid growth in aggregate wages is expected to mask considerable divergences between industries, with resource-related industries likely to continue to experience much stronger wages growth than other sectors, supported by extremely strong growth in labour demand.

The Wage Price Index is expected to grow 4 per cent through the year to the June quarters of 2011 and 2012, and 4¼ per cent through the year to the June quarter of 2013.

Chart 13: Growth in the Wage Price Index



Source: ABS cat. no. 6345.0.

Consumer prices

Inflation is contained, but is forecast to rise steadily over the next two years as the economy starts to push against capacity constraints.

Treasury's most recent estimates of the non-accelerating inflation rate of unemployment (NAIRU)[1] — the rate of unemployment at which inflation pressures start to emerge — range between 4½ and 5 per cent. With the unemployment rate expected to decline to the bottom of this range, and the economy forecast to grow strongly, wage and price pressures are expected to build. Moderating these pressures

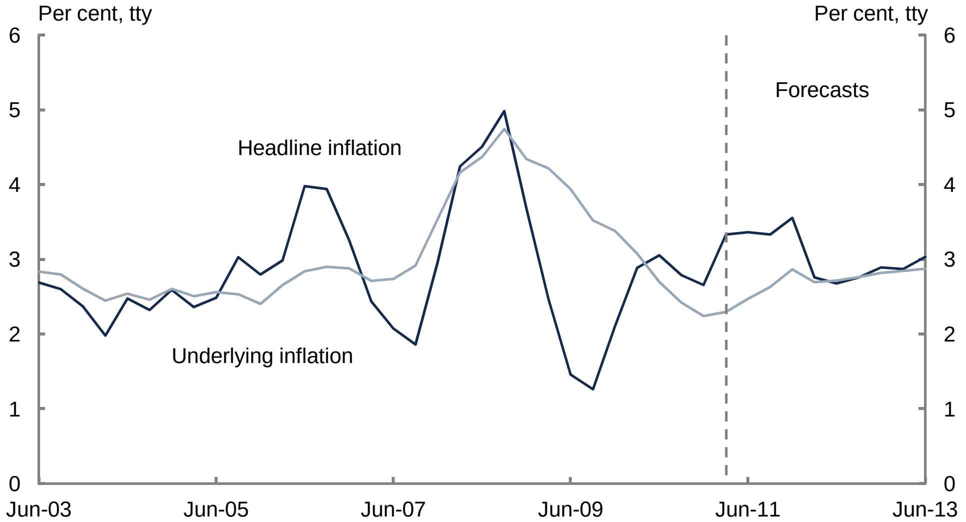
1 Treasury's estimates are based on a methodology detailed in Gruen, Pagan and Thompson (1999), 'The Phillips curve in Australia', Journal of Monetary Economics, and updated in Kennedy, Luu and Goldbloom (2008), 'Examining full employment in Australia using the Phillips and Beveridge Curves', The Australian Economic Review.

are the withdrawal of monetary and fiscal stimulus and the high Australian dollar. However, recent historical experience suggests that, with such a low expected unemployment rate, inflationary risks remain on the upside.

Underlying inflation is currently at around 10-year lows, but is expected to rise from 2½ per cent through the year to the June quarter of 2011, to 2¾ per cent through the year to the June quarter of 2012 and to 3 per cent through the year to the June quarter of 2013.

Headline inflation is expected to increase similarly after an initial spike due to the impact of the floods and Cyclone Yasi on fruit and vegetable prices and the recent rise in oil prices. Headline inflation is forecast to be 3¼ per cent through the year to the June quarter 2011, 2¾ per cent to the June quarter 2012 and 3 per cent to the June quarter 2013 (Chart 14).

Chart 14: Headline and underlying inflation



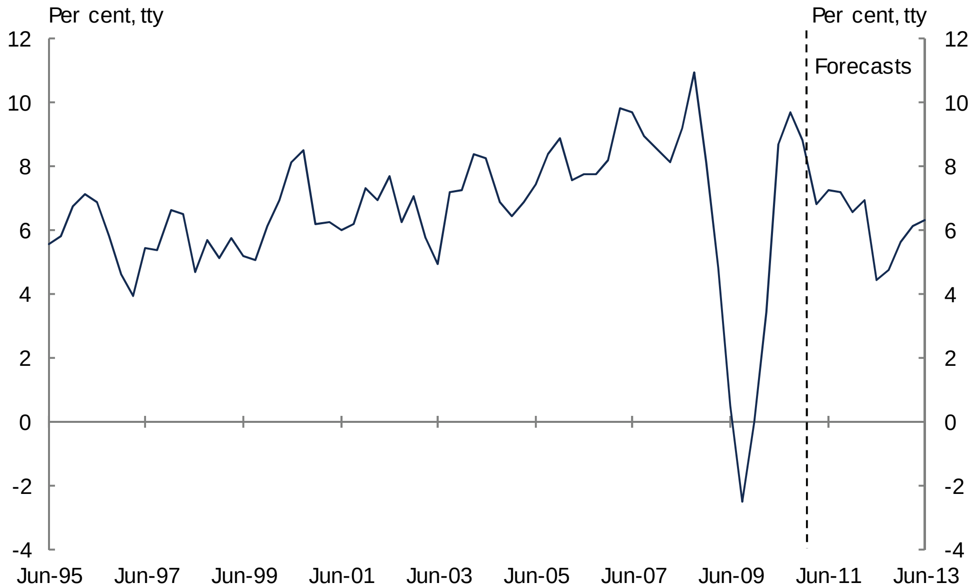
Note: The underlying inflation measure is the average of the RBA trimmed mean and weighted median.
Source: ABS cat. no. 6401.0, RBA and Treasury.

The main driver of inflation over the past decade has been rising domestic goods and services prices. Non-tradables inflation averaged around 4 per cent over the past 10 years, while tradables inflation averaged close to 2 per cent. Australia's tightening labour market, combined with rising prices for health, education and utilities, suggest that non-tradables inflation will remain firm over the period ahead. In addition, while the recent appreciation of the exchange rate will continue to dampen tradable prices in the near-term, import prices may be less of a deflationary influence over the medium-term as advanced economies recover from the GFC and rising wages in emerging market economies add to global manufacturing costs and demand for food and other consumables. This represents a medium-term risk to Australia's inflation outlook.

Incomes

Nominal GDP is expected to grow strongly in 2010-11, underpinned by a sharp rise in the terms of trade. While nominal GDP growth is expected to ease in 2011-12 and 2012-13, it will remain solid, underpinned by strong growth in real activity (Chart 15).

Chart 15: Nominal GDP growth



Source: ABS cat. no. 5206.0 and Treasury.

Following 8 per cent growth in 2010-11, growth in nominal GDP is forecast to ease to 6¼ per cent in 2011-12 and 5¾ per cent in 2012-13, with a declining terms of trade partly offset by rising growth in domestic prices and strong growth in real GDP (Chart 16).

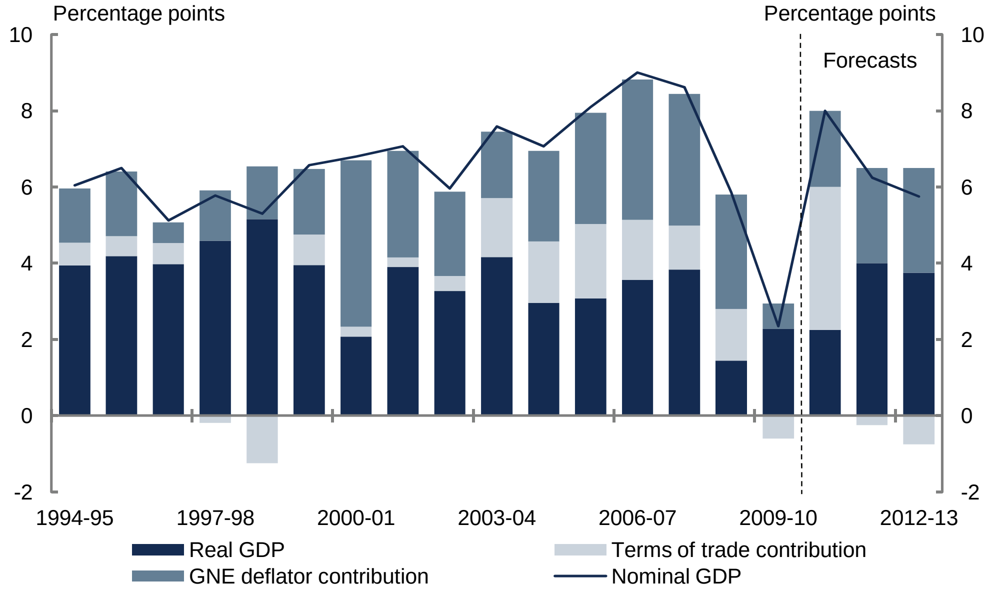
Nominal GDP is distributed throughout the economy mainly as compensation of employees, gross operating surplus and gross mixed income.

Gross operating surplus is expected to grow 5 per cent in 2011-12 and 4¾ per cent in 2012-13. Growth in 2011-12 is largely underpinned by strong mining profits reflecting strong non-rural export volumes growth. While growth in gross operating surplus is expected to be more broadly based in 2012-13, it is expected to ease further, in line with the forecast decline in the terms of trade.

Compensation of employees is forecast to grow 7¼ per cent in 2011-12 and 6½ per cent in 2012-13, underpinned by strong employment and wages growth. The strong growth in compensation of employees is expected to result in an increase in the wage share and a fall in the profit share of income over these years.

Gross mixed income, which includes the wages and profits of farm and other unincorporated enterprises, is forecast to grow a modest 3¾ per cent in both 2011-12 and 2012-13.

Chart 16: Components of nominal GDP growth



Note: The small discrepancy between nominal GDP and the sum of its components is due to interactions which cannot be attributed to individual components.
Source: ABS cat. no. 5206.0 and Treasury.

Medium-term projections

The fiscal aggregates in the Budget are underpinned by a set of forward estimates consisting of short-term economic forecasts and projections based on medium-term assumptions.

The economy is projected to remain at full capacity over the projection period. Real GDP is projected to grow at its trend rate of around 3 per cent per annum over the two projection years of the forward estimates (Chart 17).

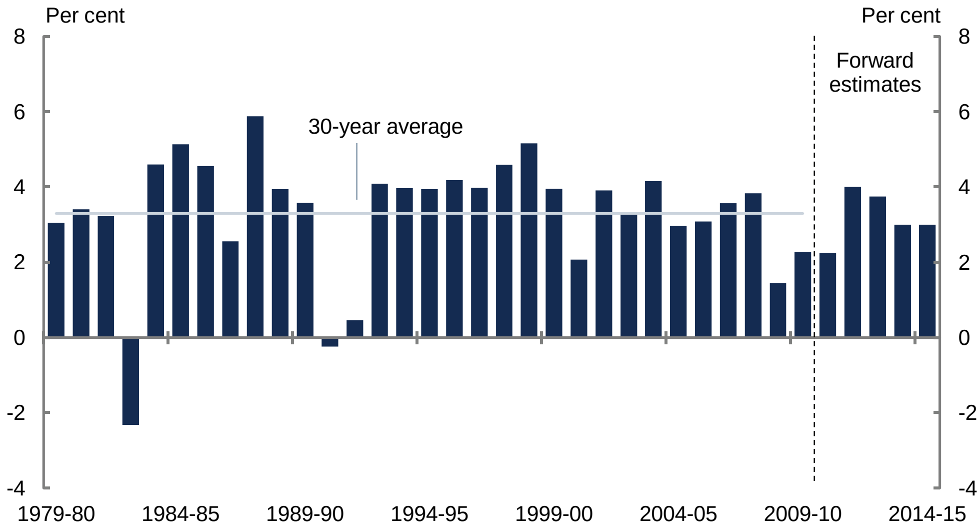
Beyond the forward estimates, real GDP is projected to grow at around 3 per cent until 2017-18, when growth is projected to slow to around 2¾ per cent as population ageing generates a gradually falling participation rate.

The unemployment rate is projected to be 5 per cent over the medium term, the assumption that has long been used for medium-term projections, and near the top of the band of current estimates of the NAIRU (4½ to 5 per cent). Inflation is projected to be 2½ per cent, consistent with the Reserve Bank of Australia's medium-term target band.

The terms of trade are projected to decline by a total of around 20 per cent over a 15-year period, settling just above their 2006-07 level. This reflects an expectation that current levels of commodity prices will not be sustained in the longer term, as supply increases gradually bring down prices over time.

The exchange rate is assumed to remain at its current average level during the forecast period. Over the projection period, the exchange rate is assumed to move in line with the long-term historical relationship between the terms of trade and the real effective exchange rate. This technical assumption has been introduced to provide greater internal consistency during the projection period. This is in contrast to the 2010-11 MYEFO, where the exchange rate was assumed to remain constant at its then current level over the medium term. The current terms of trade projections imply a fall in the real exchange rate of 0.9 per cent per annum over the projection period.

Chart 17: Real GDP growth over the forward estimates period



Source: ABS cat. no. 5206.0 and Treasury.