Senate Economics Legislation Committee

ANSWERS TO QUESTIONS ON NOTICE

Treasury Portfolio

Budget Estimates

2014 - 2015

Department/Agency: Treasury
Question: BET 8
Topic: Capex Survey
Reference: Hansard page no. 40 - 01 June 2015
Senator: Ketter, Chris

Question:

Senator KETTER: In your modelling for these growth projections, are you able to identify what are the major risks to attaining those projections you have made?
Ms J Wilkinson: In terms of the forecasts, we have outlined in Budget Statement No. 7 what some of the key risks to the forecasts are. We have outlined that in statement No. 7 to some detail. We have also provided in statement No. 7 an estimate of our confidence intervals around the forecasts for the major variables. I can certainly take it on notice, but I think it would be worthwhile to go back to the working data which outlines, if you like, the rationale for the medium-term methodology. There are risks on both sides. Five years, on average, for an output gap to close is actually a reasonably conservative assumption. If you like, one of the differences between our forecasts and forecasts that the IMF have for the Australian economy, for example, is that they think the output gap may close more quickly. It is actually hard—different recoveries take place at different times over different periods. What we have used is an average looking back over history for how long it takes for an output gap to close, and we have used very open and transparent assumptions about how rapidly it would then close.
Senator KETTER: I take it the capex survey last week, with those declining investment figures in non-mining, would be of some concern for the future.
Ms J Wilkinson: The outcomes for the capex survey are relevant for the forecast period, not for projections. As I mentioned earlier, there is no question that the capex results were weaker, particularly on the non-mining side, than we had expected. But we use the capital expenditure survey data along with a range of other indicators to try and come up with our best guess of the outlook for non-mining investment. While there is no question that the capital expenditure survey outlook for 2015-16 was weaker than we had expected, there are a range of reasons why we still feel reasonably comfortable with the forecasts that we have included in the budget. In part, that is because of things like the fact that the capital expenditure survey was completed by 4 May, well before the budget was landed, but it is also because there are other indicators. There are other surveys which paint a stronger picture for non-mining investment. We certainly consider that within the non-mining sector we may not need the sorts of lead times that you do need on the mining side in order to actually realise investment levels.

Answer:

- Treasury's forecasting approach divides the forecast horizon into three periods: a two-year short-term forecast period, a five-year medium-term adjustment period during which the output and unemployment gaps close, and a long-term projection period during which the economy grows at its trend rate of growth.
- The forecasts and projections are developed using a range of assumptions. Sensitivity analyses around different assumptions were presented in Statement 7 of Paper 1 in the 2015-16 Budget.
- Over the past 20 years, Treasury's forecasts of real GDP growth have exhibited little evidence of bias.
- Treasury's short-term forecasting methodology uses a mix of econometric models, data, information from business liaison, and expert opinion to settle on near-term forecasts of GDP.
  - As stated in Budget paper 1, key risks to the current forecasts are around the pace and timing of the pick-up in non-mining investment, the strength of the global economic recovery and the rebalancing of growth in China.
  - Real GDP forecasts in the Budget are based on assumptions about the exchange rate, interest rates and oil prices. For example, a lower exchange rate than assumed would be expected to result in higher growth in Australia's export volumes, including in tourism and manufacturing. Import prices would be higher, resulting in lower growth in import volumes. This would lead to a larger contribution of net exports to economic growth, although there would be some mitigating effect on real GDP from the impact of higher import prices on real household income.
  - A faster pick-up in Australia's economic growth in 2015-16 could be driven by stronger than forecast household consumption in response to rising housing and stock market wealth. Rising consumer spending could lead to higher employment growth, capacity utilisation and stronger investment. Stronger than expected growth in Australia's major trading partners could provide a fillip to exports and in turn boost incomes and demand throughout the economy.
- The current methodology recognises the need for an adjustment period over which the economy transitions from a cyclical high or low to its potential level of output.
  - The timing to close the gap between actual output and the estimated level of potential output is highly uncertain. Based on Treasury working Paper 2014-02, a key assumption of the current methodology is that the output gap is closed over

five years consistent with historical observation. If the actual length of the cycle is shorter or longer than predicted, it would imply higher or lower nominal GDP.

- The long-term projection period is characterised by a trend growth rate estimate (potential GDP) based on assumptions around trend levels of labour productivity, growth in the labour force, and the trend unemployment rate. This follows the approach used in the 2015 IGR and documented in Treasury Working Paper 2014-02.
  - Trend labour productivity is assumed to grow at its average rate over the past 30 years.
  - Labour force projections are based on detailed assumptions about population and labour force participation for different age and gender cohorts. These also incorporate key assumptions about the fertility rate, the mortality rate and net overseas migration.
- The 2015 IGR provides a sensitivity analysis on the impacts of variations to the population, participation and productivity assumptions. The results show that the proposed policy results are robust to variations in underlying assumptions.
- The current methodology also assumes that the terms of trade will fall from its level at the end of the forecast period to the level observed in 2005-06 by 2019-20, and remain constant thereafter.
  - The methodology is based on a bottom-up forecasting framework. Each element of the terms of trade has been modelled using extensions of existing short-run econometric forecasting models, expert advice and credible publicly available information.