

JOINT ECONOMIC FORECASTING GROUP REPORT

ECONOMIC OUTLOOK FOR
2013-14, 2014-15 and 2015-16

March 2014

This report incorporates domestic and international data
released up to 10 April 2014

EXECUTIVE SUMMARY

The transition away from resources-investment led growth has started, with strong growth in resources exports and an increase in household sector expenditure. However, capital expenditure intentions in the non-resources business sector remain weak, and a soft labour market and uncertain job prospects continue to weigh on the outlook.

Compared with the December report, forecast real GDP growth in 2013-14 has been revised higher to 2½ per cent, from 2¼ per cent previously, owing to stronger-than-expected activity in the household sector. Growth forecasts in 2014-15 and 2015-16 are unchanged at 2½ per cent and 3 per cent, but an improvement in non-resources business investment could generate an upside surprise.

The economic outlook remains uncertain owing to the conflicting influences of a sharp fall in resources investment, a declining terms of trade and fiscal consolidation against the stimulus from historically low interest rates and an exchange rate that has retreated from its highs of early 2013. The uncertain economic outlook is reflected in the divergent forecasts among the agencies and the private sector (Table 1, Appendix B).

Forecast nominal GDP growth in 2013-14 has been revised higher to 4 per cent, from 3½ per cent previously, largely on account of the stronger-than-expected outcome in the December quarter. However, key commodity prices have fallen sharply since the beginning of the year. The profile of weaker growth in 2014-15 and stronger growth in 2015-16 mirrors changes to the forecast terms of trade.

Consistent with the December report, the global economy is expected to gradually improve in 2014. Advanced economies are picking up, especially the United States and the United Kingdom, while growth in China remains solid. Emerging market economies have softened of late in part due to tighter global financial conditions, but emerging Asia is expected to benefit from a pickup in activity in the advanced economies. The risks are more balanced than previously, with developments in US monetary policy an ongoing influence on US and global prospects.

Table 1: Key domestic and international forecasts^(a)

	2012-13	2013-14		2014-15		2015-16	
	Outcome	December	March	December	March	December	March
Real GDP	2.6	2 1/2	2 3/4	2 1/2	2 1/2	3	3
Nominal GDP	2.5	3 1/2	4	3 1/2	3 1/4	4 1/4	4 3/4
Unemployment rate	5.6	6	6	6 1/4	6 1/4	6 1/4	6 1/4
Underlying inflation	2.5	2 3/4	2 3/4	2 1/4	2 1/2	2 1/2	2 1/2
WPI	2.9	2 3/4	2 3/4	2 3/4	3	3	3
Terms of trade	-9.8	-5	-5	-5	-6 1/2	-3	-1 3/4
World GDP (b)	2.9	3 1/2	3 3/4	3 3/4	3 3/4	3 3/4	3 3/4
Major trading partners GDP (b)	4.6	4 1/2	4 3/4	4 1/2	4 3/4	4 1/2	4 3/4
China (b)	7.7	7 1/2	7 1/2	7 1/4	7 1/4	7	7
United States (b)	1.9	2 1/2	3	2 3/4	3	2 1/2	2 3/4
Real GDP forecast comparison							
RBA		2 3/4		2 3/4		3 1/2	
PM&C		2 3/4		2 1/2		3	

Note: Text in blue indicates a forecast upgrade, while red text indicates a forecast downgrade. Forecasts for the domestic economy are based on the assumption of a trade weighted index of around 69 and \$US exchange rate of around 90 US cents.

(a) Real GDP, nominal GDP, the terms of trade, world GDP, major trading partner GDP, China and United States are year-average growth. Underlying inflation and the WPI are through-the-year growth to the June quarter. The unemployment rate is the rate for the June quarter.

(b) International GDP figures are calendar year average growth for 2013, 2014, 2015 and 2016.

Source: ABS cat. no. 5206.0, 5302.0, 6202.0, 6345.0, 6401.0 and Treasury.

Outlook for the International Economy

Table 2: Key international forecasts

	2013	2014		2015		2016	
	Actual	Dec JIEG	Mar JIEG	Dec JIEG	Mar JIEG	Dec JIEG	Mar JIEG
China ^(b)	7.7	7 1/2	7 1/2	7 1/4	7 1/4	7	7
India ^(b)	3.9	4 3/4	4 3/4	5 1/4	5 1/4	5 1/2	5 1/2
Japan	1.6	1 1/4	1 1/2	1	1	1 1/4	1
United States	1.9	2 1/2	3	2 3/4	3	2 1/2	2 3/4
Euro area	-0.4	3/4	1	1 1/4	1 1/2	1 1/4	1 1/2
Other East Asia ^(c)	3.9	4 1/2	4 1/2	4 3/4	4 1/2	4 3/4	4 3/4
Major Trading Partners	4.6	4 1/2	4 3/4	4 1/2	4 3/4	4 1/2	4 3/4
World	2.9	3 1/2	3 3/4	3 3/4	3 3/4	3 3/4	3 3/4

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

(a) Calculations for World, euro area and other East Asia growth rates use GDP weights based on purchasing power parity (PPP). Calculations for Major Trading Partners use 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 publications, IMF, Thomson Reuters and Treasury.

Global growth is lifting after subdued growth in 2013 ...

The global economy is expected to improve over the forecast period with growth now forecast at around 3½ per cent in each year. This follows global growth of 3 per cent in 2013, the slowest pace since the global financial crisis. While weak, the 2013 result was slightly higher than the 2½ per cent forecast at December JIEG, owing to some positive late surprises. The improved outlook is largely driven by recoveries in advanced economies, particularly the US.

Growing momentum in advanced economy recoveries accompanied by solid growth in China has seen the global growth forecast for 2014 upgraded by a quarter of a percentage point to 3½ per cent — despite some moderation in major emerging market economies such as Brazil and Russia. Several emerging market economies experienced acute bouts of financial market volatility in January, triggered by a range of concerns including the tapering of asset purchases by the US Federal Reserve but also weak Chinese PMI data and political uncertainty in individual countries.

While further volatility through the year remains possible for individual emerging market economies this is not expected to spill over to the global economy as a whole.

Owing to advanced economy recoveries and more recent export data showing further shifts towards fast-growing Asian economies, Australia's major trading partner growth forecast for 2014 has also been upgraded by a quarter of a percentage point to 4½ per cent, and is projected to remain at that pace over the forecast period to 2016.

... led by a strengthening recovery in the US with fewer political roadblocks...

The United States continues its steady recovery with encouraging signs in the second half of 2013 as through-the-year growth to the December quarter accelerated to 2.5 per cent. While there have been concerns about the extent to which recent weak data reflects more than just the impact of severe weather, fundamentals continue to suggest modestly above average growth. Continued improvements in the

housing market, sturdier household finances and a rapid expansion in the supply of low-cost unconventional gas will provide continued support to consumption. Along with ample capacity and supportive financial conditions this is providing an important tailwind to the recovery and has seen the forecasts upgraded to 3 per cent in both 2014 and 2015.

Since December JIEFG short-term fiscal uncertainty in the US has abated with the passage of a bill by Congress to suspend the debt ceiling until March 2015. This follows the budget deal in December 2013, putting both these issues beyond the mid-term elections in November. The easy passage of the debt ceiling bill suggests a change in atmospherics in Washington on fiscal issues at least for the time being.

The other major policy development in the US since December JIEFG was the US Federal Reserve's decision to begin gradually unwinding its asset purchases in January, followed by subsequent announcements in February and March to continue this process. Signalling a vote of confidence in the US recovery, the Fed's announcements have largely avoided generating the same volatility and sharp rise in interest rates seen in mid-2013, suggesting that financial markets have taken in their stride the actual process of reducing the pace of asset purchases. Nonetheless, the US economy has a lot of ground to make up.

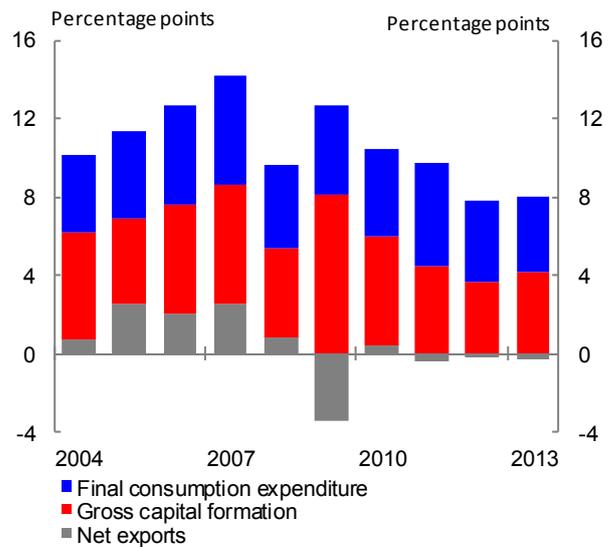
In Japan, growth in 2013, particularly in the first half, was boosted by fiscal and monetary stimulus from the first two arrows of Abenomics. The weaker than expected growth outcomes in the second half of 2013 suggested some stalling in the recovery, but this is largely due to poor net export performance with import growth surging ahead of export growth. Private demand continues to improve, with investment picking up in the December quarter and combined with a firming labour market and government stimulus to offset the first of two consumption tax hikes, on 1 April, the 2014 forecast for Japan has been upgraded by quarter of a percentage point to 1½ per cent.

Broad-based inflation outcomes will assist in Japan making a sustained exit from persistent deflation and allowing wages to pick up and support consumption in the face of the tax hike. The structural reforms announced as part of the third arrow have largely disappointed in their pace and scope, and as such, until material benefits to Japan's potential growth rate appear, growth over the forecast period is expected to revert to trend of around ½ to 1 per cent.

... with growth in China still solid...

In China, the economy grew 7.7 per cent in 2013, unchanged from 2012, but slightly above the official growth target of 7.5 per cent. Following a moderation in the first half of 2013, growth picked up in the third quarter, led by the Chinese Government's growth-supportive policy measures introduced mid-year including support for infrastructure spending and tax cuts, as well as improvements in external demand.

Chart 1: Contributions to Chinese growth



Source: CEIC China Database and Treasury.

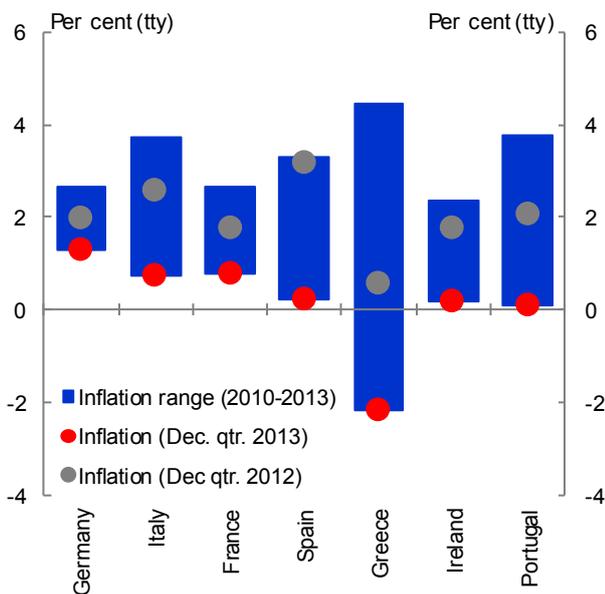
Looking ahead, China is expected to maintain solid but slowing growth over the near term, and with this assessment unchanged since December JIEFG, forecasts remain for growth to moderate from 7½ to 7 per cent out to 2016. Notwithstanding recent softening indicators, China is expected to achieve its growth target of around 7½ per cent this year, provided the Government can successfully manage the risks, particularly those emanating from the financial sector. Further, with inflation remaining low there is room for the authorities to introduce growth-supporting measures if needed.

In the medium to longer term, if solid growth is to be sustained, the Chinese authorities must successfully transform the economy to a more balanced growth model with a focus on innovation and continually moving up the production chain into higher value-added products.

... while the emergent euro area recovery remains weak, uneven and fragile.

Since December JIEFG, the outlook for the euro area has slightly improved, mainly as a result of stronger-than-expected GDP outcomes in the second half of 2013, with euro area through-the-year growth to the December quarter positive for the first time in two years. The improvement has especially been seen in some of the poorly performing economies such as Portugal and the Netherlands. Aided by an improving global outlook, exports from the periphery, such as Spain, Ireland and Portugal have picked up. Accordingly, while the recovery remains weak, uneven and fragile the euro area forecast for 2014 has been slightly pushed up to 1 per cent.

Chart 2: Deflation in the euro area?



Source: Thomson Reuters Datastream.

General disinflation in the euro area combined with anaemic growth, may see longer term inflation expectations drift down, raising the risk of deflation. While lower inflation in the periphery, and in some cases deflation, is improving competitiveness relative to Germany, the prospect of widespread deflation carries the risk of increasing real debt burdens and prematurely raising real interest rates. Persistent weak inflation outcomes raise the prospect of further monetary expansion, notwithstanding the political complications for the European Central Bank (ECB) in undertaking any form of unconventional monetary policy.

Emerging Asia has weakened lately but there are signs of improvement.

In India there are early signs of improving conditions on the back of stronger export growth and solid agricultural output. However, weakness in

consumption and investment, the primary drivers of the current slowdown and as much explained by structural as cyclical factors, have so far showed little signs of abating. India’s medium-term growth potential remains constrained by significant structural impediments to growth, a lack of fiscal space to implement reforms and a weak business climate. Little reform progress is expected before the general elections commencing in April 2014. In late January, the Reserve Bank of India surprised markets by tightening monetary policy further to offset the sell-off in the rupee and tackle rising inflation. The move comes as the central bank takes steps toward introducing a new monetary policy framework, which includes inflation targeting.

In Indonesia, growth moderated in 2013 with a slowing in investment on the back of tighter financial conditions, and the economy faced headwinds from the effects of renewed financial market turbulence and higher subsidised fuel prices. While financial conditions and structural impediments will weigh on growth, resilient domestic demand and a pick-up in exports to advanced economies are expected to support growth at relatively robust levels of around 5% per cent in 2014. A key risk is the possibility of political instability and protectionist policies in the lead up to the presidential election in the middle of this year.

Outlook for the Domestic Economy

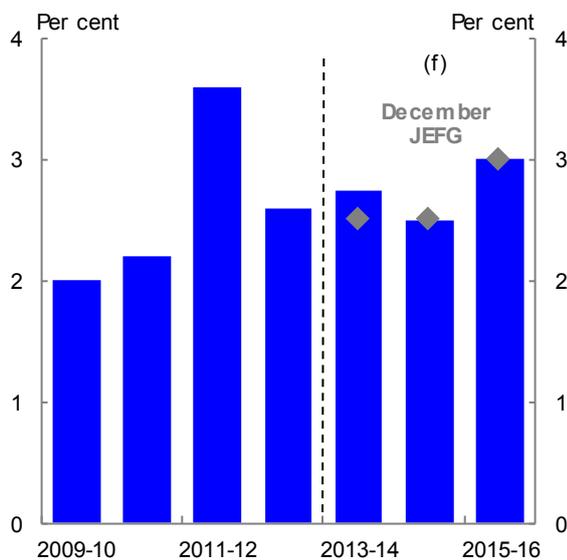
Below trend growth as the move away from resources investment continues...

The outlook for real GDP continues to be dominated by the opposing effects of a sharp fall in resources investment, a declining terms of trade, and continued fiscal consolidation, against a recovery in the non-resources sectors as they respond to historically low interest rates and a weaker exchange rate over the past year.

Since December JIEFG, the outlook for the household sector has strengthened, but this has been partly offset by weaker-than-expected investment intentions in the non-resources business sector. The profile for resources investment and exports is broadly unchanged.

Overall, forecast real GDP growth in 2013-14 has been revised higher to 2¾ per cent, from 2½ per cent previously. Forecast growth remains unchanged in 2014-15 and 2015-16 at 2½ per cent and 3 per cent, but an improvement in non-resources business investment could generate an upside surprise (Chart 3).

Chart 3: Real GDP forecasts



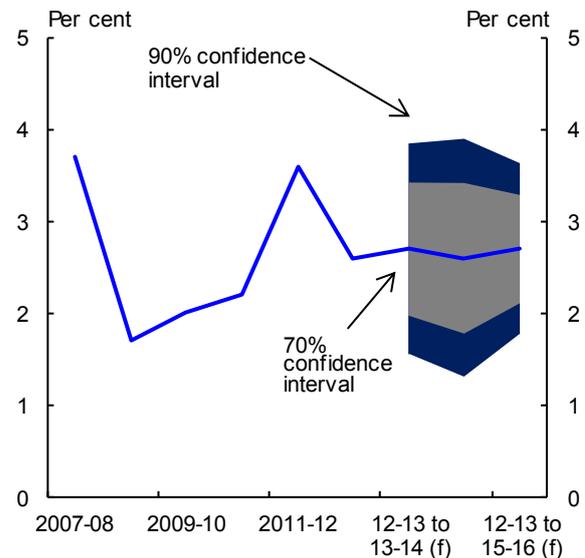
Source: ABS cat. no. 5206.0 and Treasury.

The economic outlook remains uncertain as is evident in the divergent forecasts among the JIEFG agencies and the private sector (see Appendix B). Forecast real GDP is broadly in line with the Consensus median

forecast, while the forecast unemployment rate is higher than consensus in 2015 and commodity prices are below median expectations.

The degree of uncertainty can be estimated based on past forecast errors and presented using confidence intervals. The average annualised real GDP growth over the two years from 2012-13 to 2014-15 is expected to be around 2.6 per cent, with the 70 per cent confidence interval from 1.8 to 3.4 per cent (Chart 4). See Appendix A for an explanation of the confidence interval methodology and its interpretation.

Chart 4: Confidence intervals around forecast real GDP



Note: Confidence intervals are based on Budget forecast errors (please see Appendix A for further information).
Source: ABS cat. no. 5206.0, Budget papers and Treasury.

The JIEFG forecasts are based on an interest rate profile consistent with market expectations and includes two 25 basis point interest rate increases by the end of 2015, and an exchange rate that remains unchanged at a trade weighted index of around 69 and a US exchange rate of around US 90c.

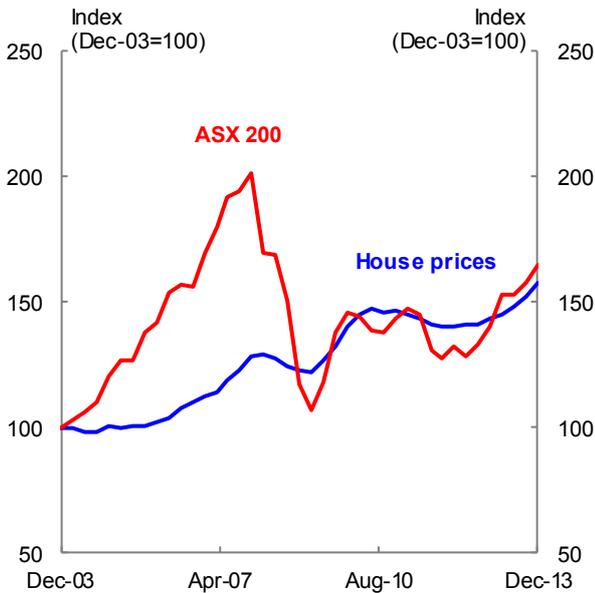
... reflecting an improved outlook for the household sector ...

Forecast consumption growth has been revised higher since December JIEFG. Household consumption is forecast to grow by 2½ per cent 2013-14, 3 per cent in 2014-15 and 3¾ per cent in 2015-16, as the household

sector and other parts of the non-resources economy continue to respond to low interest rates.

Recent gains in household wealth have been driven by rising equity and house prices (Chart 5). Consumption has responded to these gains growing at an annualised rate of 3 per cent over the second half of 2013, despite ongoing weakness in labour income growth.

Chart 5: House and equity prices

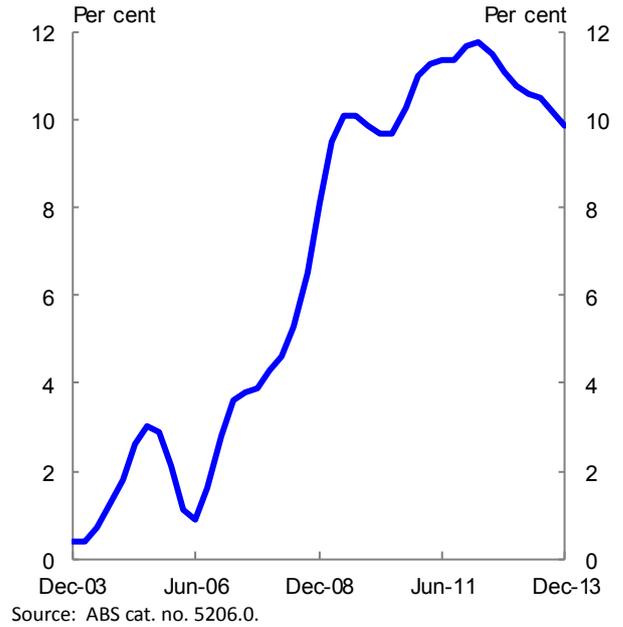


Source: ABS cat. no. 6416.0 and RBA.

The recent improvement in consumption at a time of modest income growth has generated a decline in the household saving ratio. After peaking in early 2012 the trend saving ratio has declined by around 2 percentage points to 9.9 per cent in the December 2013 quarter (Chart 6).

Household income is expected to grow a little more strongly than expected in December, reflecting slightly stronger wages growth, but still remain weak by historical standards. Gains in household wealth are expected to support a further modest decline in the saving ratio to 8½ per cent in 2015-16.

Chart 6: Trend household savings rate

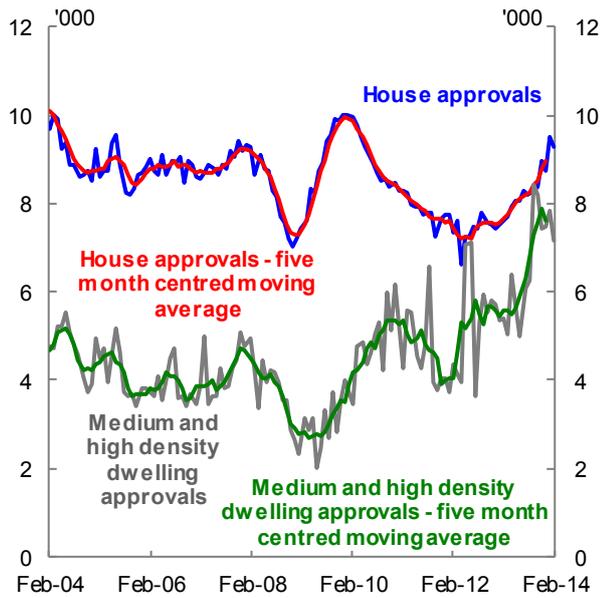


Dwelling investment is also forecast to grow more rapidly than expected in December, with leading indicators suggesting that dwelling construction activity will rise strongly in the near term. Dwelling investment is forecast to grow by 3½ per cent in 2013-14, 7½ per cent in 2014-15 and 5½ per cent in 2015-16.

Recent outcomes indicate there has been a longer than usual delay between building approvals and activity. Building approvals for dwellings have risen by 23 per cent over the past year, and in trend terms are at their highest level ever (Chart 7). However, dwelling investment is only growing modestly, with investment in new housing rising by 2.7 per cent through the year and falling by 0.1 per cent in the December quarter.

Liaison suggests that part of the reason for the longer than usual delay is the larger contribution being made by higher density approvals, which are more complex projects to manage. If this is the case, dwelling construction activity should rise strongly over the near term, with strong fundamentals, including population growth and interest rates, supporting continued growth further out.

Chart 7: Residential building approvals



Source: ABS cat. no. 8731.0.

One development worth watching is the recent weakness in alterations and additions, which declined by more than 10 per cent over late 2011 and 2012 and has yet to recover. This is surprising given that the construction of new dwellings grew over the same period and that house prices and turnover have risen strongly since. The disparity could be due to the difficulty associated with measuring alterations and additions if more of this work is being done directly by home owners. However, some of this activity would appear in consumption if this were the case.

... offset by a steeper decline in business investment.

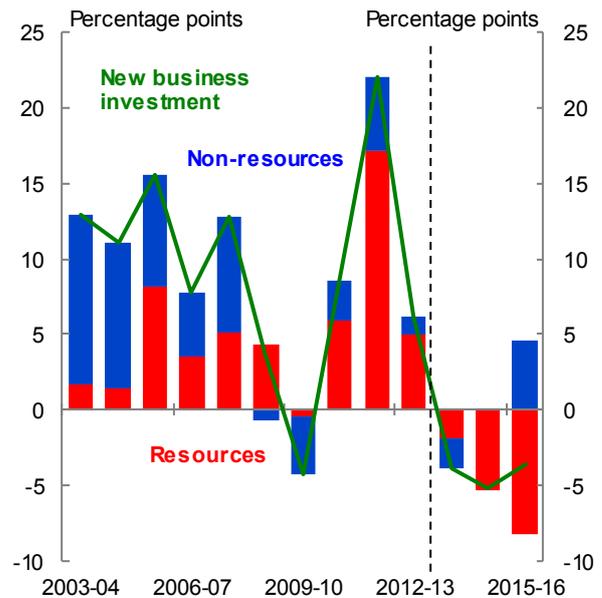
A key recent source of uncertainty for the outlook has been the scale and timing of the anticipated recovery in non-resources business investment. While the timing of the fall in resources investment is also uncertain, there is more confidence about the magnitude of the decline given the small number of large LNG projects that are underpinning this profile, and the small number and significance of any other projects that are likely to be approved in the near term.

Investment outcomes in the December quarter were weaker than expected, with weakness across both asset types and industry sectors. This result indicates that both the lumpiness of resources-related investment and caution in the non-resource sector affected the outcome. The December outcome is also consistent with reports from business liaison that firms are reluctant to replace capital until they have a clearer sense that demand is improving.

Capital expenditure intentions for 2014-15 were surveyed for the first time and also indicated that investment plans remain more conservative than expected outside the resources sector. In particular, weaker near-term intentions for new machinery and equipment investment has driven a fall in forecast new business investment in 2013-14 and 2014-15, with investment forecast to decline by 4 per cent and 5½ per cent.

Investment in new machinery and equipment and new buildings is expected to pick-up in 2015-16 following the earlier period of restrained investment as firms respond to improving demand and existing levels of spare capacity are absorbed. Resources investment is still expected to fall sharply in 2015-16, but overall new business investment forecasts have been upgraded to a decline of 3½ per cent from a fall of 4 per cent in the December round (Chart 8).

Chart 8: Contributions to growth in new business investment, resources and non-resources sectors



Source: ABS cat. no. 5204.0 and Treasury.

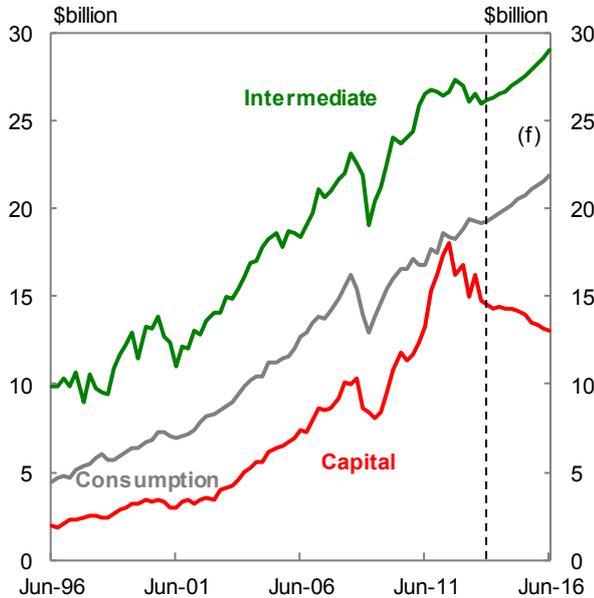
Net exports are forecast to contribute to growth consistently ...

An ongoing aspect of the move beyond the investment phase of the resources boom is the corresponding rise in export volumes and decreased requirement for capital related imports.

The forecast contribution from net exports has been increased to 1¼ percentage points (from 1¼ percentage points in the December round) in 2013-14, but remains unchanged at 1 percentage points in 2014-15 and 1¼ percentage points in 2015-16.

The upgrade to the net exports contribution in 2013-14 has been driven by a downgrade to import forecasts, reflecting the December quarter outcome and the revised outlook for investment. Over the forecast period, imports of capital goods are expected to decline as construction on LNG projects winds down (Chart 9).

Chart 9: Import volumes



Source: ABS cat. no. 5302.0 and Treasury.

... with export volumes remaining strong but prices weaker in 2014-15.

Exports are forecast to continue growing strongly, driven by rising commodities export volumes generated by the completion of major expansion projects. An upgrade to forecast growth in 2013-14, from 5 per cent to 5 ½ per cent, reflects recent strength in rural exports following strong winter crop production in Western Australia and parts of South Australia and Victoria.

Export growth is forecast to be weaker in 2014-15, and unchanged in 2015-16 compared with December, reflecting downgraded forecasts for rural and non-bulk commodity exports in 2014-15 based on the most recent forecasts from ABARES and BREE. The downgrade in rural exports reflects the current drought in Queensland, New South Wales and parts of South Australia and Victoria. Exports are forecast to grow by 5½ per cent in 2014-15 and 7 per cent in 2015-16.

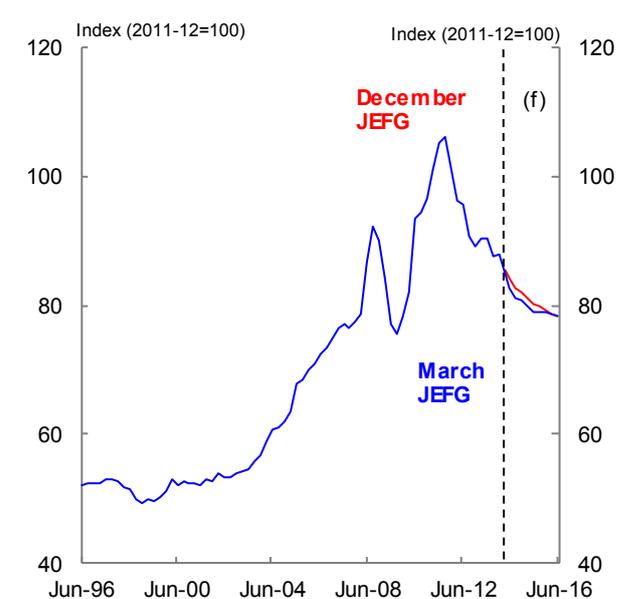
After holding up during the second half of 2013, iron ore and coal prices have fallen sharply since the

beginning of the year, with iron ore and thermal coal prices down around 13 per cent and prices of metallurgical coal around 19 per cent. The soft prices are due to weaker demand for steel, a period of negative sentiment around China’s economic growth prospects, as well as ample supply, including from Australia, where coal export volumes were up 12 per cent in the December 2013 quarter.

In line with recent falls, export price forecasts have been revised down for the remainder of 2013-14. Iron ore prices are expected to fall further in 2014-15 and 2015-16, albeit at a slower rate than forecast in December to reach an unchanged level. The decline in the near-term reflects growing global supply and slower demand growth for steel. Metallurgical and thermal coal prices are both expected to recover slightly from their current low spot prices, but have been revised down from the December round. Metallurgical coal prices are expected to rise slightly over the forecasting period as global supply growth slows, and thermal coal prices are forecast to remain stable.

Changes to the export price forecasts have been the main influence on changes to the forecast terms of trade. Forecast terms of trade growth has been downgraded in 2014-15 and upgraded in 2015-16 to reach approximately the same level. Overall the terms of trade are expected to fall by 5 per cent in 2013-14, 6½ per cent in 2014-15 and 1¾ per cent in 2015-16 (chart 10).

Chart 10: Terms of trade



Source: ABS cat. no. 5206.0 and Treasury.

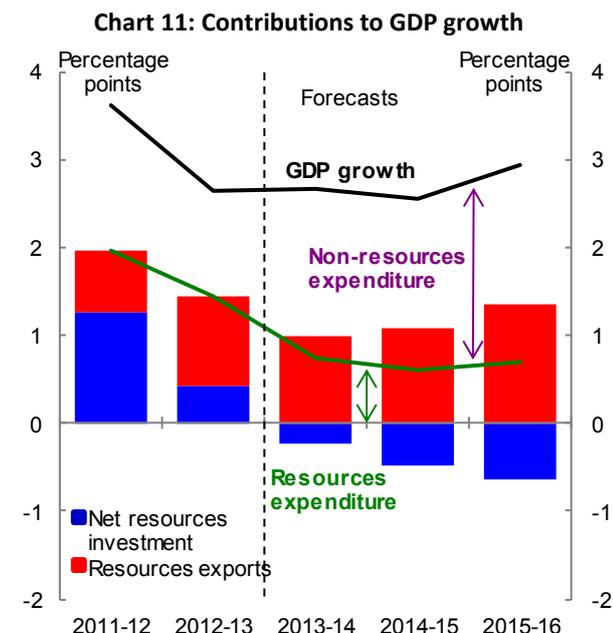
There are risks associated with the exports forecast. Firstly, non-resources exports have been subdued under the influence of a strong exchange rate for an extended period. A weaker exchange rate, which is historically an outcome associated with a fall in the terms of trade, would benefit exports in general.

Conversely, recent falls in coal prices may force some Australian production to shut down, although the influence of 'take or pay' contracts with infrastructure providers appears to be limiting the supply response to date.

Another downside risk is the uncertainty surrounding the timing of the increase in supply from newly completed resources projects, particularly LNG projects that rely on gas sources that use more recently developed extraction technologies. There is also more uncertainty associated with the price of LNG exports, not only because prices depend on an uncertain oil price, but also because the pricing in contracts is opaque.

The outlook is a balance between opposing forces...

Overall, the resources sector is forecast to continue contributing to growth. However, with the decline in resources investment, this contribution to growth will be smaller than in previous years despite the benefit of higher exports (chart 11).



The other identifiable factor that is weighing on growth is the public sector. Public final demand growth

is forecast to remain well below average, as all levels of government continue to pursue fiscal consolidation. These forecasts are based on a direct translation of the fiscal settings outlined in MYEFO and the latest available state budgets.

New public demand is forecast to grow by 1¼ per cent in 2013-14 and 2014-15 and by 1 per cent in 2015-16, which is a slight upgrade in 2013-14 and 2014-15 and a slight downgrade in 2015-16. Over the past 10 years, new public final demand has averaged a robust 3.4 per cent growth, so these forecasts represent a significantly smaller than average contribution to overall growth.

The positive influence on the economy from accommodative monetary policy is more difficult to predict. Sustained low interest rates are most clearly affecting the dwelling sector, and there are clearer signs that household consumption is also beginning to respond. However, household consumption, while improving, is expected to remain limited by weak income growth, and a still-elevated household saving ratio.

Businesses should also start to respond to better demand and catch up on prior investment forgone, once existing levels of spare capacity are absorbed. This is expected to start happening in a meaningful way in 2015-16 (chart 8). However, were this to happen sooner or more strongly than forecast, as expected by the RBA, overall GDP growth could be stronger than forecast.

... which is generating a soft labour market with weak wage growth...

Notwithstanding better employment growth in early 2014, overall employment growth has been weak in 2013-14 averaging around 8,000 jobs per month. The unemployment rate is 5.8 per cent and would be higher still if the participation rate had not declined over the past year.

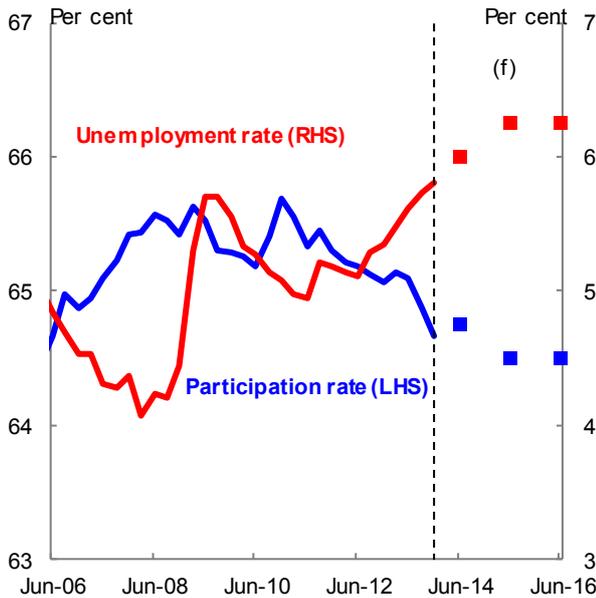
While some of the strong monthly outcomes in early 2014 were partly due to random sampling, the underlying improvement together with a continued modest strengthening in job advertisement data, suggest employment growth to the June quarter 2014 will be a little stronger than expected in the December round.

The participation rate is expected to drift lower. The March forecasts include a new methodology that

captures the influence of discouraged workers, which appears to have been the dominant driver of the recent trend decline in the participation rate. The participation rate is forecast to fall further to 64½ per cent in the June quarter of both 2015 and 2016.

With the forecast participation rate a little lower than in the December round, the unemployment rate forecast is also marginally lower in the June quarter 2015, but is unchanged in rounded terms. Across the forecast period, unemployment is still expected to drift up slowly before stabilising at 6¼ per cent (chart 12).

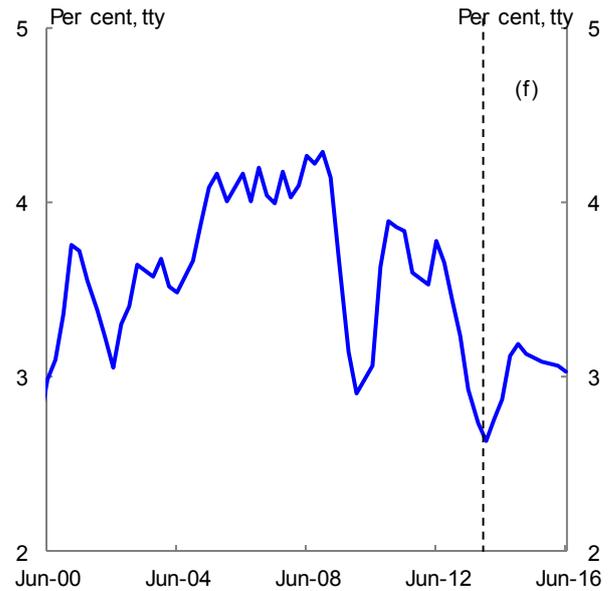
Chart 12: Unemployment and participation rates



Source: ABS cat. no. 6202.0 and Treasury.

Recent wage growth has been very subdued, and weak wage growth is forecast to continue, reflecting the spare capacity expected to persist in the labour market. Marginally lower unemployment in 2015 has led to a small upgrade to forecast wage growth that year. The wage price index is forecast to grow 2¾ per cent through the year to the June quarter 2014, and 3 per cent to both June 2015 and June 2016 (chart 13).

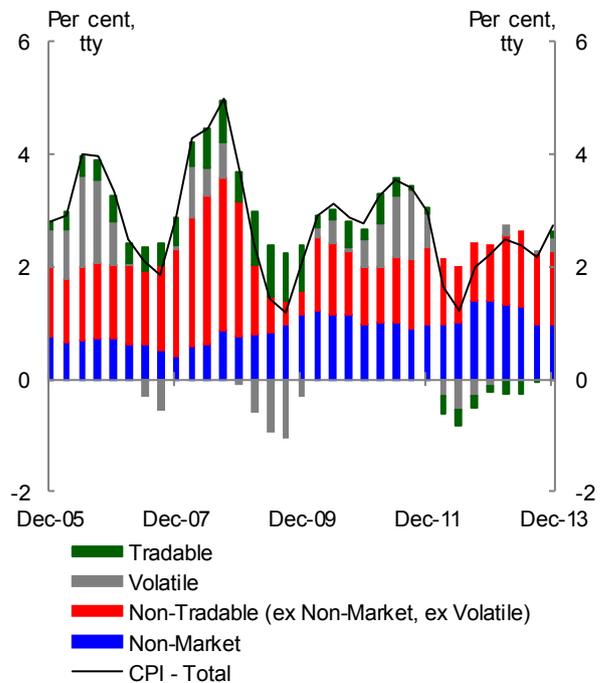
Chart 13: Wage price index



Source: ABS cat. no. 6345.0 and Treasury.

The December quarter CPI outcome was a little above expectations at 0.8 per cent and 2.7 per cent through the year. Prices of tradable items rose reflecting the depreciation of the exchange rate experienced over 2013, but non-tradable inflation remained above 3½ per cent in through-the-year terms, where it has been for most of the previous four years (chart 14).

Chart 14: Contributions to annual CPI outcomes



Source: ABS cat. no. 6401.0 and Treasury.

A muted response to weak growth in unit labour costs from sectors that would normally be expected to

generate lower prices because of their heavy reliance on labour inputs appears to have contributed to the stronger than expected outcome. The March quarter result, released on 23 April, should help shed light on whether this response is merely delayed, or if the services sector has been able to raise profit margins.

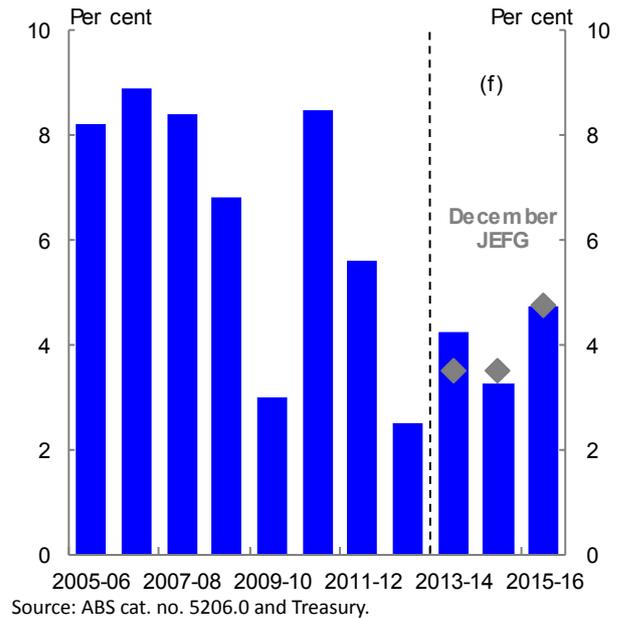
The March round forecasts are based on an assessment that lower unit labour costs will start to promote weaker services inflation and that underlying inflation over the forecast period will be moderate. The estimated impacts of the repeal of the carbon tax and tobacco excise policy changes are modelled separately and then added to the profile.

Both underlying and headline inflation are forecast to be ¼ of a percentage point stronger to the June quarter of 2015, mirroring the small increase in wages. The other change to the forecasts is an additional ¼ of a percentage point to headline inflation up to June 2014, following the December 2013 outcome. Underlying inflation is forecast to be 2¾ per cent to the June quarter 2014, and 2½ per cent to the June quarters of both 2015 and 2016.

...and below trend nominal GDP growth...

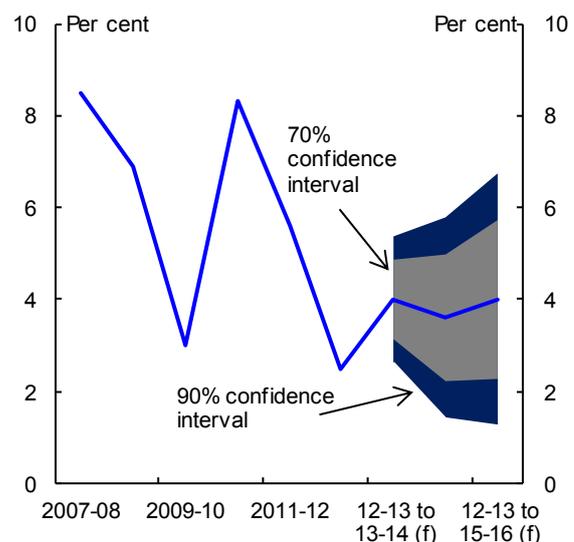
Forecast nominal GDP growth in 2013-14 is stronger than in December JIEG, reflecting the upgrade to the real GDP forecast and stronger than expected domestic price growth. However, nominal GDP growth is expected to be weaker in 2014-15 and stronger in 2015-16 driven by changes to the forecast for the terms of trade (Chart 15). Overall, nominal GDP growth is expected to remain weak, reflecting continued declines in the terms of trade and weak wages growth.

Chart 15: Nominal GDP growth



The uncertainty around nominal GDP growth forecasts is larger than around real GDP growth forecasts, reflecting the compounding nature of two sources of uncertainty: the outlook for real GDP and the outlook for prices or the GDP deflator. The average annualised nominal GDP growth over the two years from 2012-13 to 2014-15 is expected to be 3.6 per cent, with the 70 per cent confidence interval from 2.2 to 5.0 per cent (Chart 16 and Appendix A).

Chart 16: Confidence intervals around forecast nominal GDP



Note: Confidence intervals are based on Budget forecast errors (please see Appendix A for further information).
Source: ABS cat. no. 5206.0, Budget papers and Treasury.

... while upside risks to the outlook have become more visible...

Since the December round, the upside risks to the forecasts have become more visible. In particular, the household sector is more clearly responding to low interest rates. Although investment intentions still remain weak, a further improvement in the household sector would provide a better incentive for non-resources firms to upgrade their investment intentions.

Nevertheless, downside risks remain. The fall in resources investment is likely to be volatile from quarter to quarter, while the associated rise in exports also has uncertain timing. Together, these effects could generate short term volatility in GDP. The non-resources business sector is battling against a still-elevated exchange rate and a reluctance to invest until demand has clearly improved. Weaker-than-expected growth in the non-resources sector could generate a softer labour market, which would in turn have repercussions for household consumption.

... International downside risks, both new and old, remain.

While the improved outlook is encouraging, downside risks, both new and old, remain. Though the US recovery is strengthening, careful handling is still required around monetary policy. The normalisation of unconventional monetary policy remains a risk if not deftly managed and communicated effectively. Both the US Federal Reserve and the Bank of England have announced changes to their forward guidance in light of improving economic developments.

In the short term, China needs to manage the transition to a more balanced growth model, while avoiding financial risks stemming from shadow banking activities and high leverage in some sectors of the economy. For both China and Japan, the need for structural reform brings with it the risk of policy missteps.

The euro area's anaemic growth could yet see disinflation turn into deflation, potentially forcing a policy response from the ECB, and adding to the risks for the euro area recovery. A permanent resolution to the crisis will require further politically difficult reforms, such as the successful implementation of a single banking resolution authority. There has been some progress with the European Parliament and Council recently reaching provisional agreement on a proposed mechanism. The Troika has concluded at staff-level its latest review of the Greek bailout program. Progress is being made on structural reforms and fiscal consolidation, however, it remains likely that further debt restructuring will eventually be needed.

Several emerging market economies experienced an acute bout of financial market volatility in January on concerns that domestic vulnerabilities would be exposed as the funding terms they attracted during the height of unconventional monetary policy in advanced economies become less favourable. Attention increasingly of late has been on the 'fragile five' — Brazil, India, Indonesia, Turkey and South Africa — which have current account deficits, remain exposed to global financial market volatility, have structural reform challenges and all hold elections this year. Unlike the episode in May 2013, the January episodes of volatility had a wider range of triggers than just US monetary policy developments, and were largely idiosyncratic such as political developments in Ukraine and Thailand, and fears over slowing Chinese growth.

Geopolitical risks and the transmission of these through global financial market and trade channels cannot be discounted given recent political developments in the Ukraine and Russia. This has subsequently sparked a round of sanctions by the G7. To date, these developments are not expected to materially alter the central case for the global economy given that sanctions are not targeting areas of mutual economic interdependence, such as energy.

Table 3: Domestic economy forecasts (a)

	Outcomes (b)	Forecasts		
	2012-13	2013-14	2014-15	2015-16
Panel A - Demand and output(c)				
Household consumption	2.0	2 1/2	3	3 1/4
Private investment				
Dwellings	-0.1	3 1/2	7 1/2	5 1/2
Total business investment(d)	6.1	-4	-5 1/2	-3 1/2
Non-dwelling construction(d)	13.9	-2 1/2	-9 1/2	-12 1/2
Machinery and equipment(d)	-4.3	-9 1/2	-2	7
Private final demand(d)	2.8	1 1/4	1 1/2	2
Public final demand(d)	-1.3	1 1/4	1 1/4	1
Total final demand	1.9	1 1/4	1 1/2	1 3/4
Change in inventories(e)	-0.3	- 1/4	1/4	0
Gross national expenditure	1.6	1	1 3/4	1 3/4
Exports of goods and services	6.0	5 1/2	5 1/2	7
Imports of goods and services	0.5	-3	2	2 1/2
Net exports(e)	1.2	1 3/4	1	1 1/4
Real gross domestic product	2.6	2 3/4	2 1/2	3
Non-farm product	2.8	2 1/2	2 3/4	3
Farm product	-3.6	5	-4	1
Nominal gross domestic product	2.5	4	3 1/4	4 3/4
Panel B - Other selected economic measures				
External accounts				
Terms of trade	-9.8	-5	-6 1/2	-1 3/4
Current account balance				
\$billion	-55.3	-49 1/2	-64 1/4	-64 1/4
Percentage of GDP	-3.6	-3 1/4	-4	-3 3/4
Labour market				
Employment (labour force survey basis)(f)	1.3	3/4	1 1/2	1 1/2
Unemployment rate (per cent)(g)	5.6	6	6 1/4	6 1/4
Participation rate (per cent)(g)	65.1	64 3/4	64 1/2	64 1/2
Prices and wages				
Consumer Price Index(h)				
- headline	2.4	3 1/4	2 1/4	2 1/2
- underlying	2.5	2 3/4	2 1/2	2 1/2
Gross non-farm product deflator	-0.3	1 1/4	1/2	1 3/4
Wage Price Index(f)	2.9	2 3/4	3	3

(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 69 and a \$US exchange rate of around 90 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\$115 per barrel. The farm sector forecasts are based on an assumption of average seasonal conditions in 2014-15.

Source: ABS cat. no. 5206.0, 5302.0, 6202.0, 6345.0, 6401.0, unpublished ABS data and Treasury.

Appendix A – Confidence intervals

At MYEFO, confidence intervals around two key economic variables, real and nominal GDP, were reported to reflect the forecast uncertainty of Treasury's estimates. This practice was first introduced at PEFO to help convey to readers a better appreciation of the risks associated with the economic outlook and also improve the credibility and transparency of the forecasting process.

The degree of uncertainty around forecasts can be estimated based on past forecast errors. For GDP forecasts, confidence intervals can be presented around forecasts of annual growth rates or average annualised growth rates. While both measures have merit, providing a reasonable forecast of the level of GDP is important for fiscal variables. For this purpose, the average annualised growth rate is a better summary statistic, since the level of GDP depends on cumulative growth over time. The average annualised growth rate is reported as it captures the effects of cumulative growth, while still giving a sense of what the annual growth rate would be.

For a hypothetical example, if GDP is forecast to grow by 2 per cent in one year and 5 per cent in the next, the level of GDP will be forecast to be roughly 7 per cent higher after two years. This is more effectively summarised by the 3½ per cent average annualised growth rate over the two years than by the two separate annual growth rates.

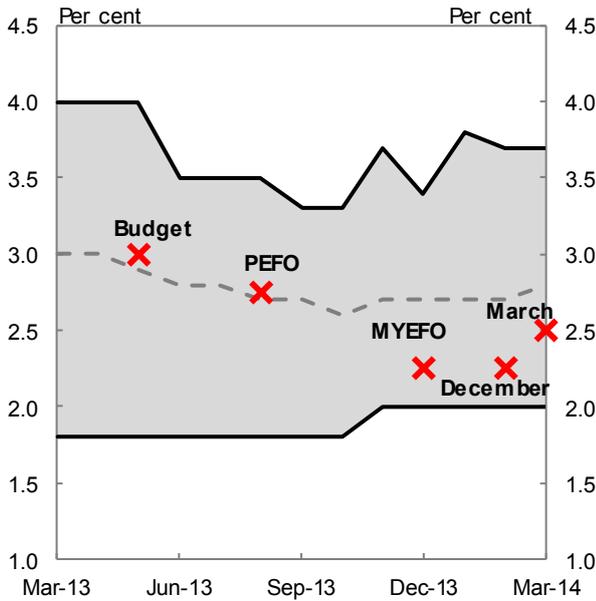
The confidence intervals in the March JFIG report are derived from forecast errors based on budget forecasts from the 1998-99 Budget onwards, with outcomes based on the December quarter 2013 National Accounts. Forecast errors are calculated using the root mean square error of forecast percentage growth rates.

In the charts, the central line shows the outcomes and March JFIG forecasts with annual growth reported for outcomes and annualised average growth rates from 2012-13 reported from 2013-14 onwards.

Appendix B – Forecast comparison

Real GDP forecasts slightly below consensus,...

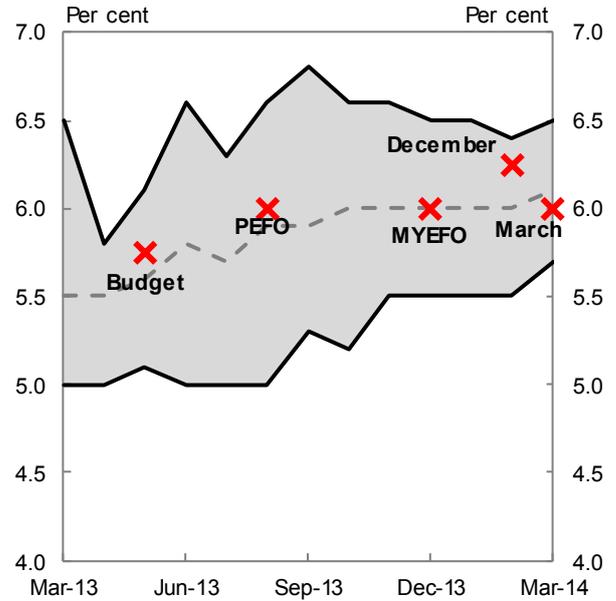
Chart 1: Consensus real GDP forecasts for calendar year 2014



Note: Top and bottom lines represent range of Consensus forecasts. Centre line represents Consensus mean forecast.
Source: Bloomberg and Treasury.

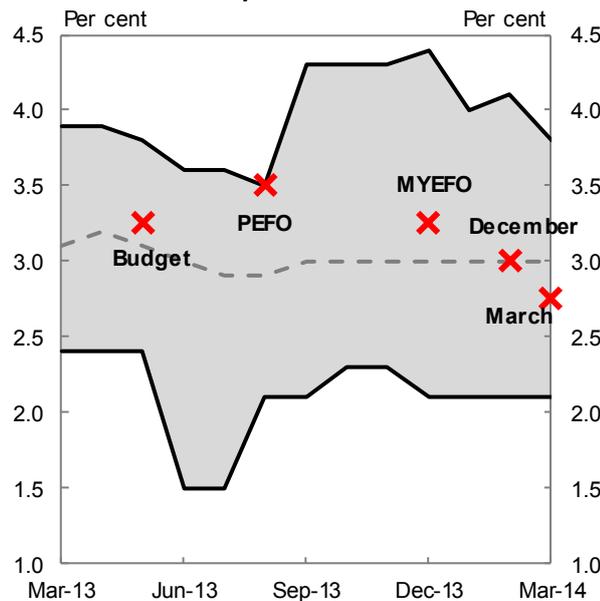
... the forecast unemployment rate is above median consensus in 2015...

Chart 3: Consensus unemployment rate forecasts for calendar year 2014



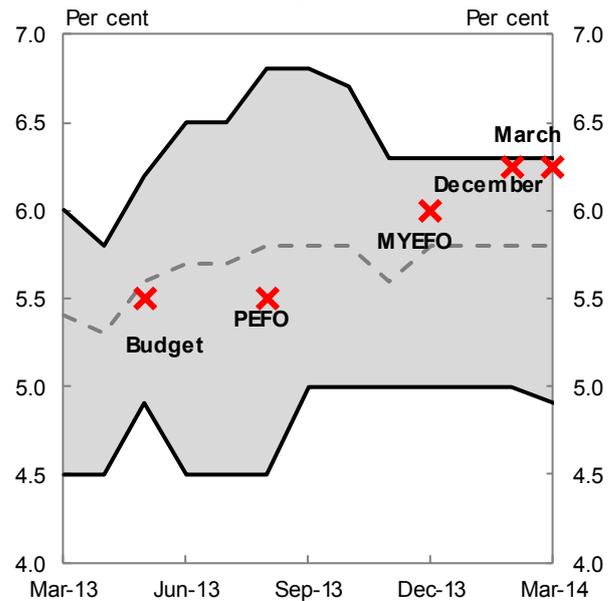
Note: Top and bottom lines represent range of Consensus forecasts. Centre line represents Consensus mean forecast.
Source: Bloomberg and Treasury.

Chart 2: Consensus real GDP forecasts for calendar year 2015



Note: Top and bottom lines represent range of Consensus forecasts. Centre line represents Consensus mean forecast.
Source: Bloomberg and Treasury.

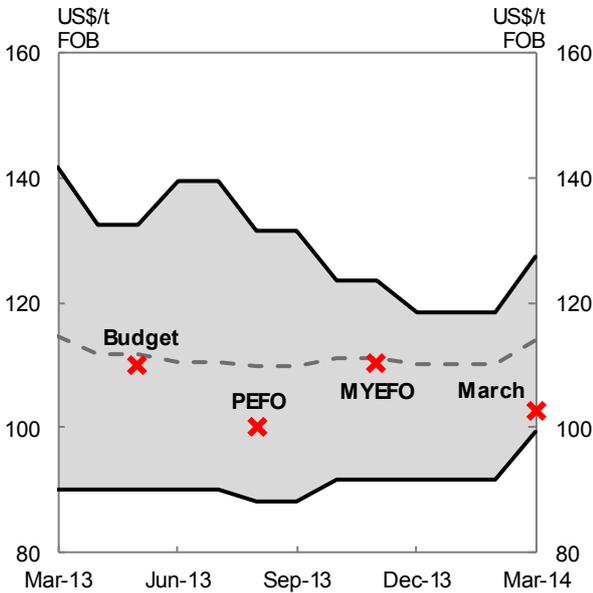
Chart 4: Consensus unemployment rate forecasts for calendar year 2015



Note: Top and bottom lines represent range of Consensus forecasts. Centre line represents Consensus mean forecast.
Source: Bloomberg and Treasury.

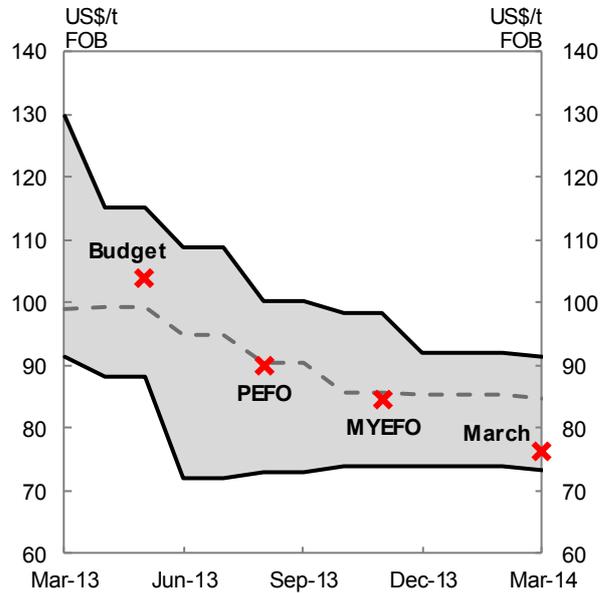
...while bulk commodity price forecasts are at the lower end of consensus.

Chart 5: Iron ore price³ forecasts for calendar year 2014



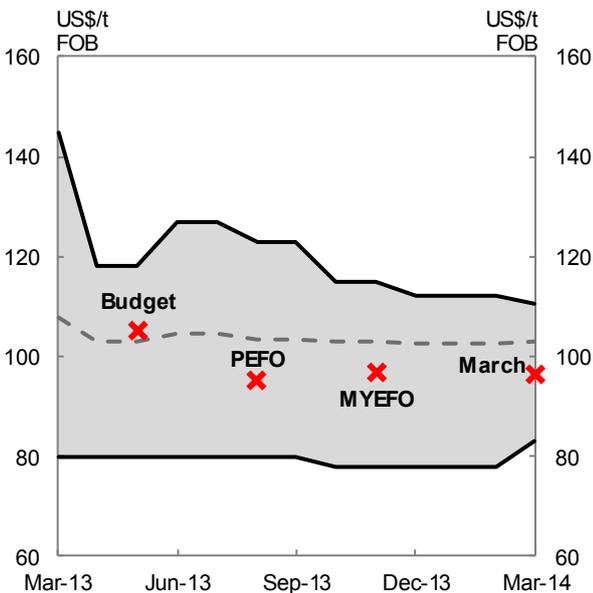
Note: Top and bottom lines represent range of Consensus forecasts. Centre line represents Consensus median forecast. Source: Consensus Economics⁴ and Treasury.

Chart 7: Thermal coal price forecasts for calendar year 2014



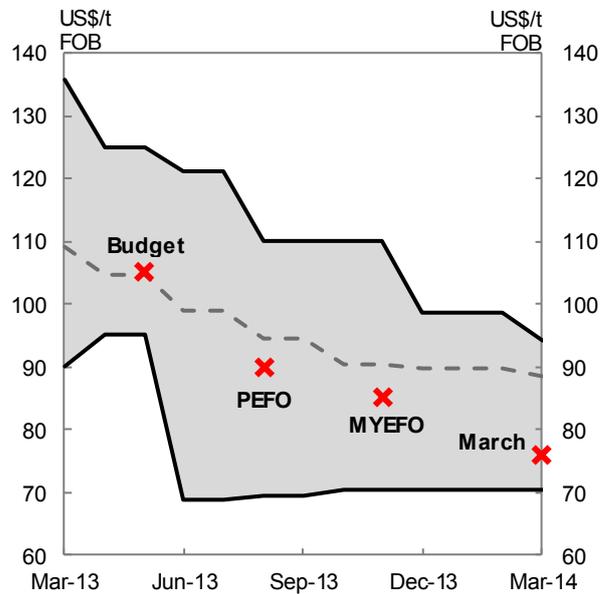
Note: Top and bottom lines represent range of Consensus forecasts. Centre line represents Consensus median forecast. Source: Consensus Economics and Treasury.

Chart 6: Iron ore price forecasts for calendar year 2015⁵



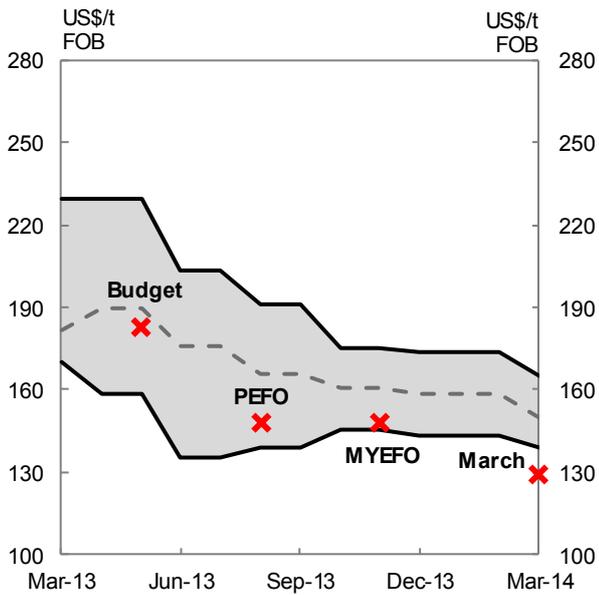
Note: Top and bottom lines represent range of Consensus forecasts. Centre line represents Consensus median forecast. Source: Consensus Economics and Treasury.

Chart 8: Thermal coal price forecasts for calendar year 2015



Note: Top and bottom lines represent range of Consensus forecasts. Centre line represents Consensus median forecast. Source: Consensus Economics and Treasury.

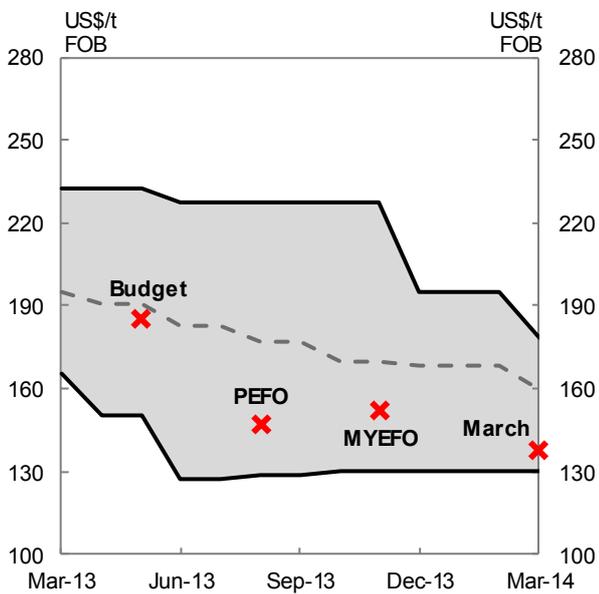
Chart 9: Metallurgical coal price forecasts for calendar year 2014



Note: Top and bottom lines represent range of Consensus forecasts. Centre line represents Consensus median forecast. Source: Consensus Economics and Treasury.

³ Prices are reported on a free on board (FOB) basis.
⁴ Consensus Economics surveys commodity price forecasters every three months.
⁵ Treasury forecasts of commodity prices for Budget and PEFO represent average forecasts to June 2015.

Chart 10: Metallurgical coal price forecasts for calendar year 2015



Note: Top and bottom lines represent range of Consensus forecasts. Centre line represents Consensus median forecast. Source: Consensus Economics and Treasury.