

## Pre-Budget Economic Outlook: a Quick Guide

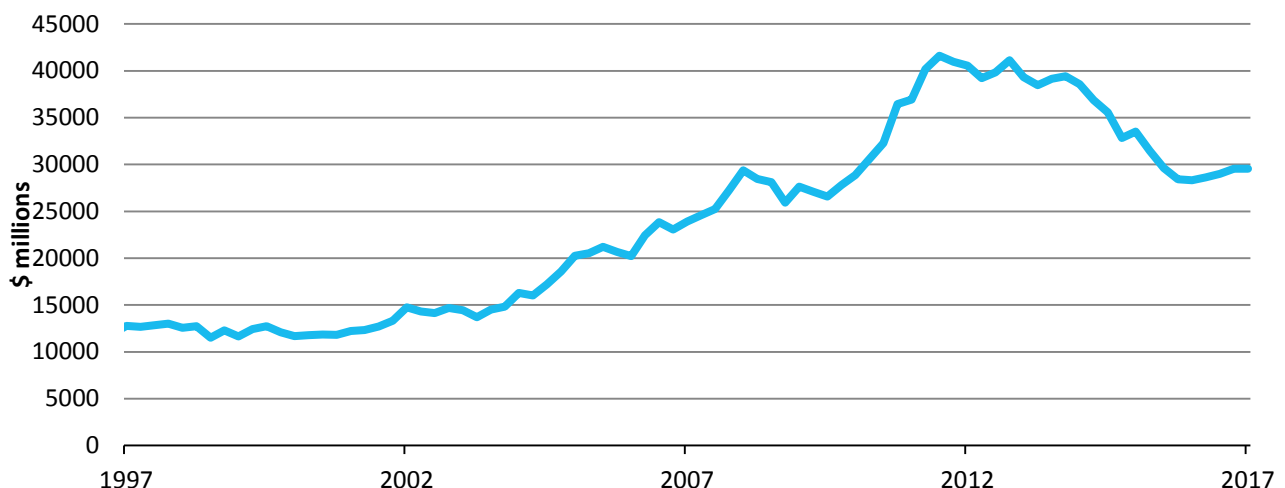
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Economics Section

### *Outlook for the domestic economy*

#### General economic conditions

One of the most important developments of the last 12–18 months has been the increase in private sector investment, as measured by private new capital expenditure (shown in Figure 1). This increased substantially between 2010 and 2012, owing to historically significant increases in mining investment. Between 2012 and 2014 the level of new investment remained at around \$40 billion per year, before falling to less than \$30 billion in 2015–16. That reduction appears to have stopped and returned to growth in 2017. While it is not certain whether this improvement will continue, business confidence remains at elevated levels,<sup>1</sup> which suggests the economic environment is conducive to further investment.

**Figure 1: Private new capital expenditure**



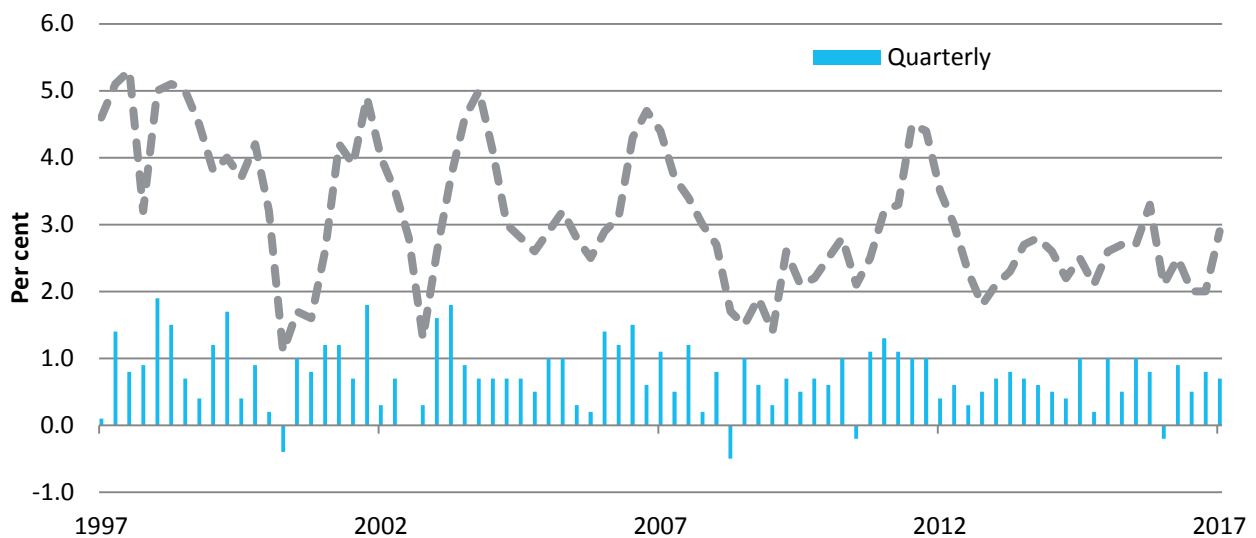
Source: Australian Bureau of Statistics (ABS), [Private new capital expenditure and expected expenditure, December 2017](#), cat. no. 5625.0, ABS, Canberra, 1 March 2018.

1. NAB Group Economics, '[NAB Monthly Business Survey: March 2018](#)', NAB website, 10 April 2018.

The primary measurement for economic growth is Gross Domestic Product (GDP), which is the total value of transactions in a given period. GDP is shown in Figure 2. GDP growth has been relatively subdued over the last five years, averaging 2.4% per year, slower than the 3.0% average annual growth experienced between 2003 and 2008. However, a number of indicators including business investment, business confidence, and rising employment, point to a likely acceleration of economic growth.

GDP growth can provide a growth dividend to the budget, in which a growing economy potentially allows the Commonwealth to capture more revenue and is better positioned to fund services without raising taxation rates.

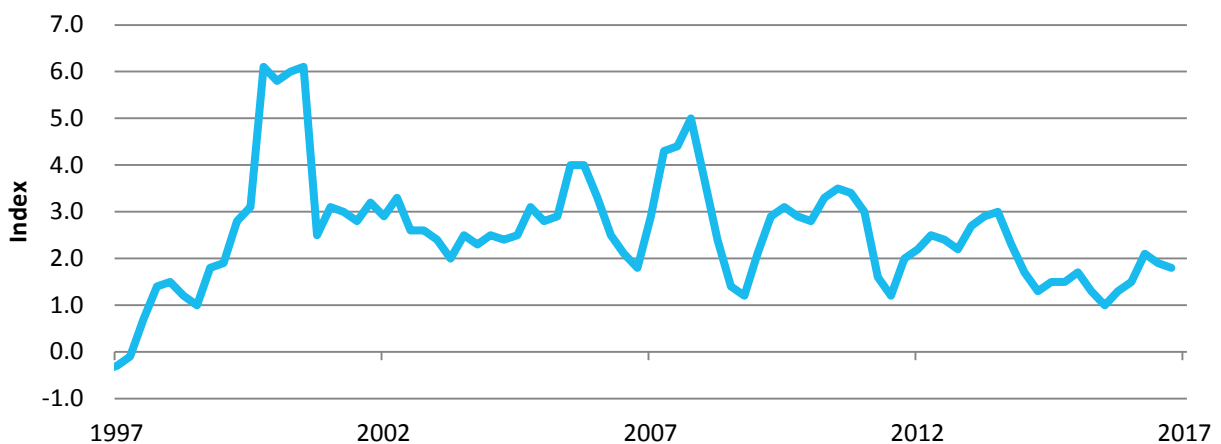
**Figure 2: GDP and GDP growth**



Source: ABS, [Australian national accounts: national income, expenditure and product, Dec 2017](#), cat. no. 5206.0, ABS, Canberra, 7 March 2018.

The Reserve Bank of Australia (RBA) has an inflation target of 2–3 per cent per annum but inflation has largely remained in the 1.5–2.0 per cent band for the last four years, as shown in Figure 3. While high inflation is generally regarded as being problematic, low rates of inflation can also present a challenge. If the increase in private investment flows through to GDP, it may begin to apply upwards pressure on inflation. Inflation can affect the budget in a variety of ways but the most direct effects are on GST receipts and indexation (such as for pensions or fuel excise).

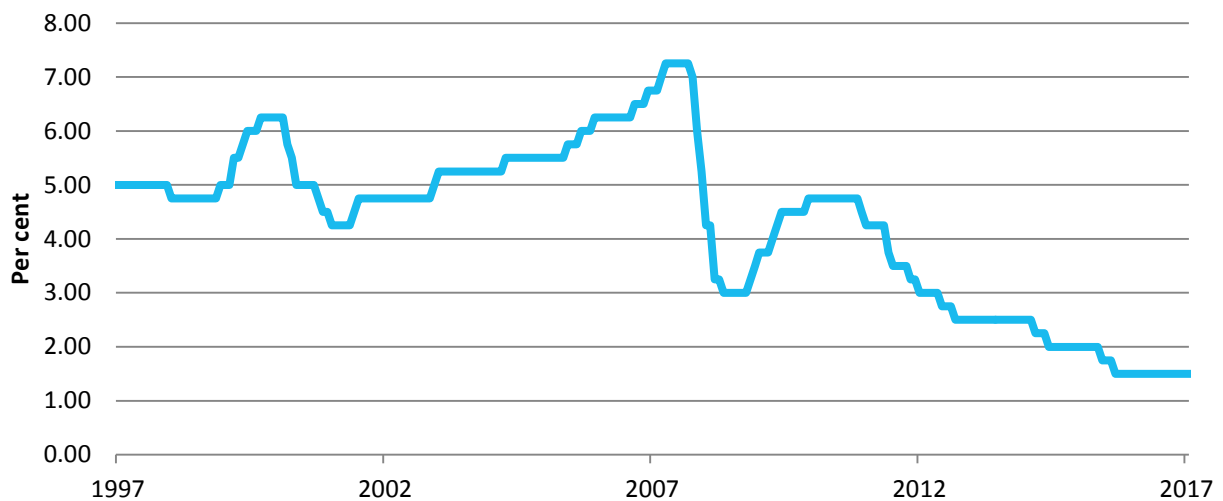
**Figure 3: Consumer Price Index (CPI)**



Source: ABS, [Consumer Price Index, Australia, March 2018](#), cat. no. 6401.0, ABS, Canberra, 24 April 2018.

Low rates of growth and inflation have led the RBA to maintain a cash rate target of 1.5 per cent since August 2016. The low cash rate is a form of economic stimulus, allowing individuals, firms, and governments to borrow at lower rates of interest. If GDP and inflation were to increase in response to investment growth, it may lead the RBA to begin raising interest rates, although financial markets are not pricing in an interest rate rise until late 2019 and the RBA Governor has indicated that any increase would be gradual.<sup>2</sup>

**Figure 4: Reserve Bank of Australia (RBA) cash rate**



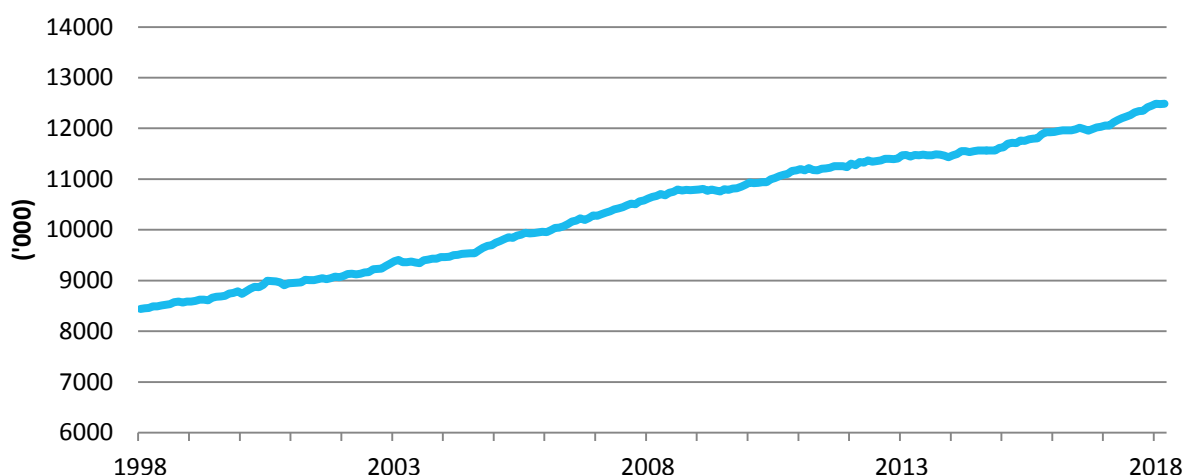
Source: [RBA Statistics \(Cash Rate\)](#), 4 May 2018.

### Household economic conditions

Total employment increased significantly in the past 12 months, with almost 150,000 jobs created in the last 12 months, an increase of 2.6 per cent, as shown in Figure 5. It is likely that the uptick in capital expenditure contributed to this increase and future increases in employment may depend on continued growth in this area. Increasing employment supports the budget by reducing government expenditure on social security while increasing income tax receipts.

2. P Lowe [Monetary policy decision](#), media release, no. 2018-11, Reserve Bank of Australia, Sydney, 1 May 2018.

**Figure 5: Total employment**



Source: ABS, [Labour Force, Australia, March 2018](#), cat. no. 6202.0, ABS, Canberra, 19 April 2018.

Coinciding with large increases in total employment has been an increase in the participation rate, which measures the proportion of Australians in paid employment or actively seeking employment. The participation rate reached a record high (65.8 per cent) early in 2018, slightly surpassing the pre-Global Financial Crisis (GFC) peak, although it has since fallen slightly to 65.7 per cent. The increases in employment and participation suggest that some individuals may be moving directly into employment after absences from the labour market, without being included in unemployment statistics.

**Figure 6: Participation rate**

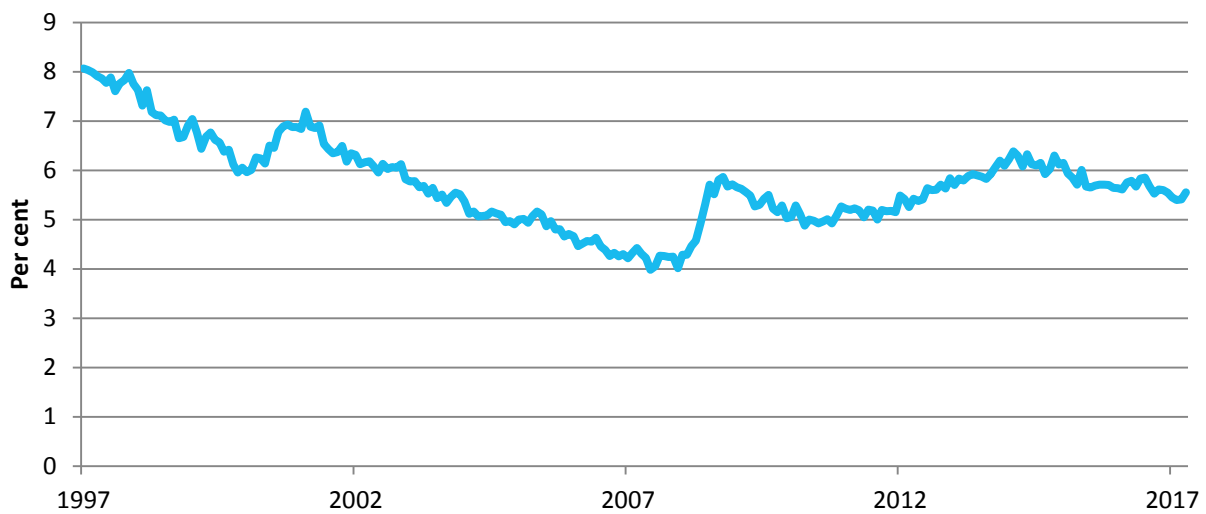


Source: ABS, [Labour Force, Australia, March 2018](#), cat. no. 6202.0, ABS, Canberra, 19 April 2018.

Growing participation has also meant that the increase in total employment has not led to a significant decrease in the unemployment rate, which has fallen slightly in the last 12 months (0.3 percentage points) but remained at 5.5 per cent from January to March 2018. It is not clear how much slack (potential additional labour supply) remains in the labour market at this time, but an unemployment rate of less than 5 per cent is generally regarded as reflecting full employment.<sup>3</sup>

3. T Cusbert, 'Estimating the NAIU and the unemployment gap', Reserve Bank of Australia, *Bulletin*, June quarter 2017.

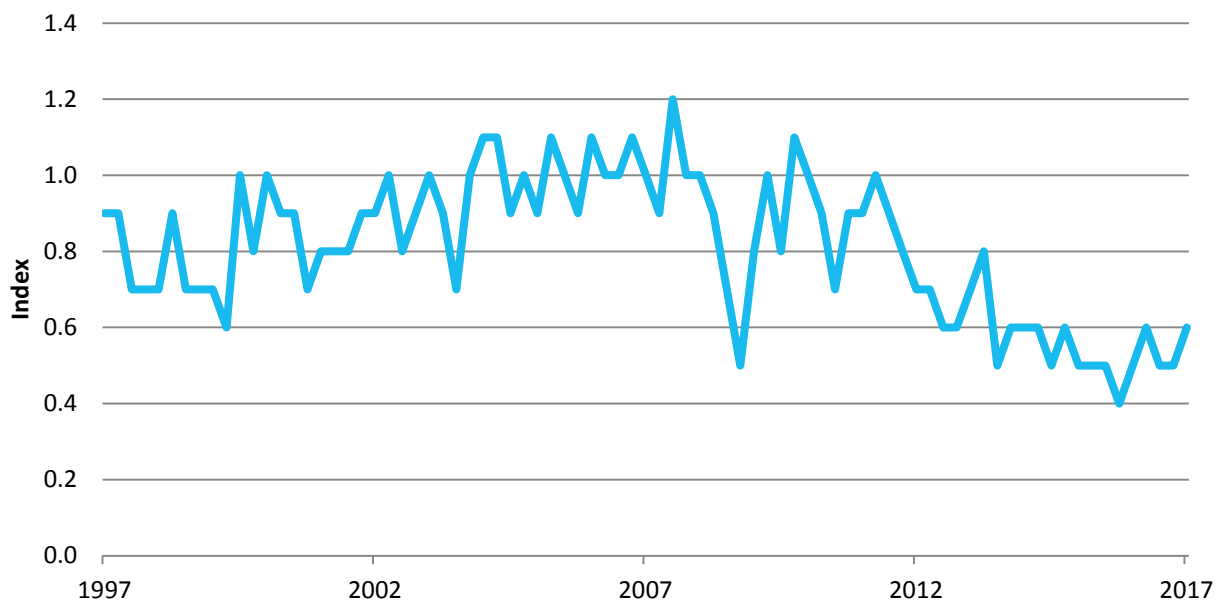
**Figure 7: Unemployment rate**



Source: ABS, [Labour Force, Australia, March 2018](#), cat. no. 6202.0, ABS, Canberra, 19 April 2018.

Quarterly wage growth (as measured by the Wage Price Index) has been subdued for the last five years, largely remaining in a range between 0.3–0.6 per cent. This is significantly lower than the 0.8–1.0 per cent growth which was experienced between 2008 and 2013 and may reflect the amount of slack in the labour market. Despite low growth, consumer sentiment remains positive.<sup>4</sup> There is a general view that wages growth will increase once the economy moves closer to full employment, but uncertainty around participation makes forecasting this outcome less certain.<sup>5</sup> However, increasing competition amongst employers is theoretically likely to support higher wages and higher income tax receipts for the Commonwealth.

**Figure 8: Wage Price Index**



Source: ABS, [Wage Price Index, Australia, December 2017](#), cat. no. 6345.0, ABS, Canberra, 21 February 2018.

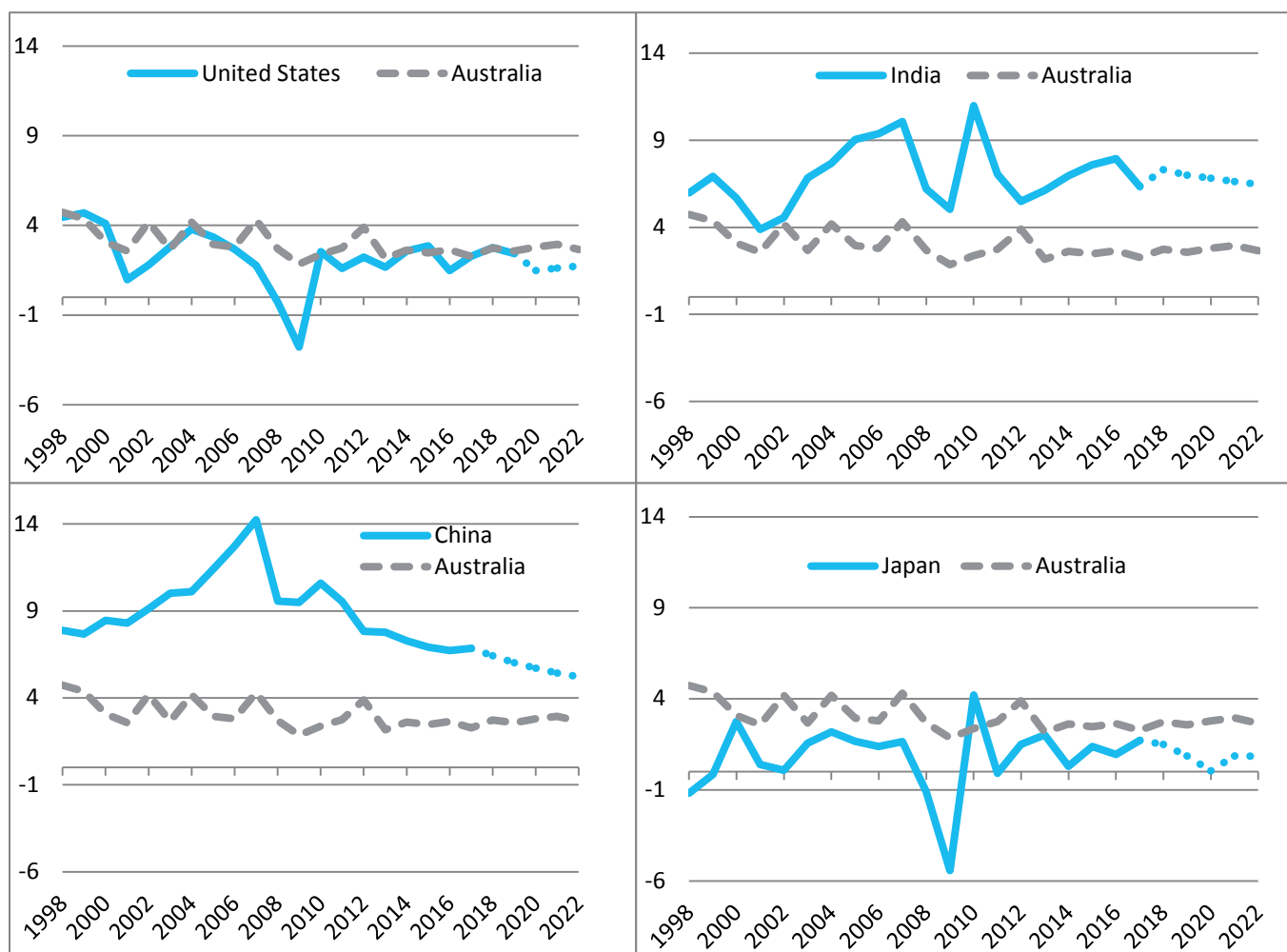
4. B Evans, '[Consumer sentiment stabilises](#)', Westpac, *Bulletin*, 11 April 2018.

5. For example, I Arsoo and R Evans, '[Wage growth in advanced economies](#)', Reserve Bank of Australia, *Bulletin*, March 2018.

## Outlook for the global economy

The economies of Australia's major trading partners have exhibited stronger than expected performance in the previous twelve months. The United States economy has grown more quickly than expected and early evidence suggests that the company tax cuts are driving increased investment, which may support further growth over the forward estimates.<sup>6</sup> Chinese growth has also demonstrated resilience, maintaining annual GDP growth above 6 per cent despite concerns of a slowdown. Indian GDP growth also rebounded after a slight slowdown in growth in 2017. Japan recently experienced its strongest GDP growth since 2013 and South Korean growth remains positive.

**Figure 9: GDP growth, major trading partners**

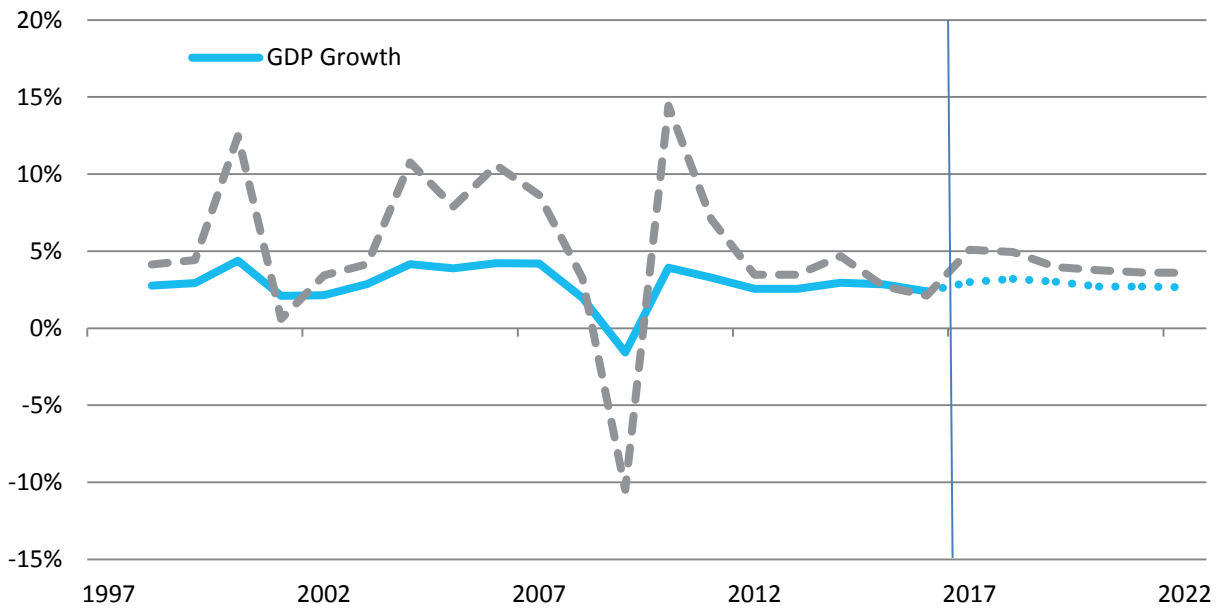


Source: [Oxford Economics](#), Global Economic Databank, 4 April 2018.

Growth in global GDP and global trade has been low but relatively consistent since the GFC, although conditions have recently shown signs of improvement. According to data provided by Oxford Economics, global GDP growth has averaged 2.7% in the last five years, increasing to 3.0% in 2017 and is forecast to rise to 3.2% in 2018. Global trade has grown by 3.6% in the last five years, rising to 5.1% in 2017 and forecast to grow 5.0% in 2018.

6. L Wang, '[Trump tax windfall going to capex way faster than stock buybacks](#)', Bloomberg website, 27 April 2018.

**Figure 10: Global GDP growth and trade growth**

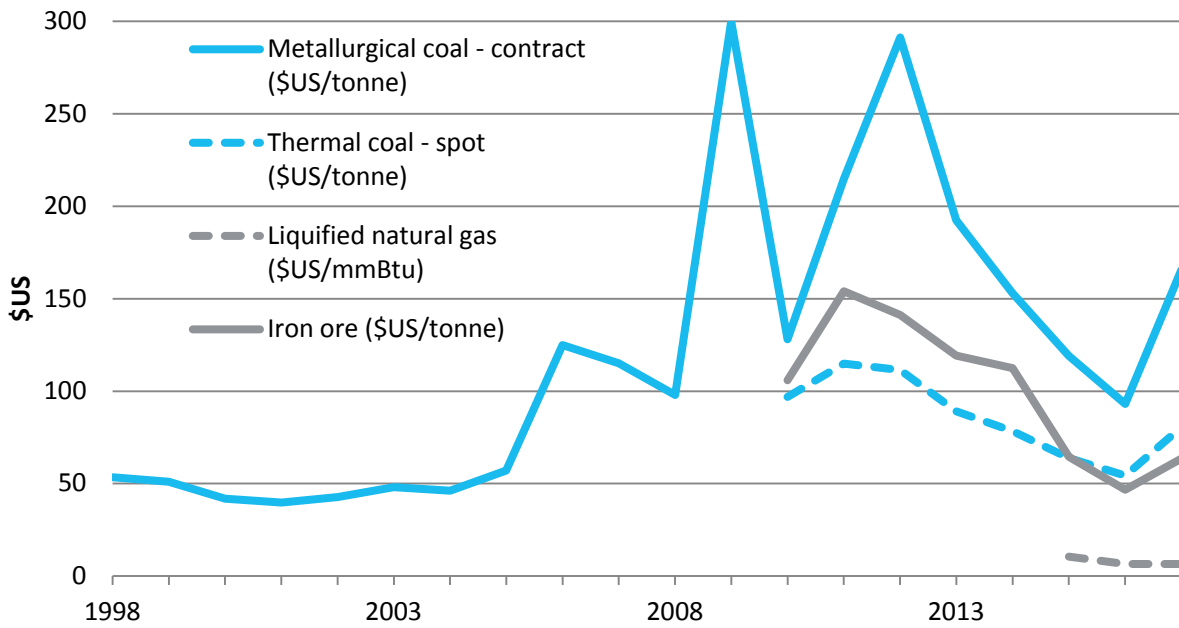


Source: [Oxford Economics](#), Global Economic Databank, 4 April 2018.

Despite the apparent strength in major advanced and developing economies, significant risks and uncertainties remain. One of the most prominent concerns is that of an escalation in the trade dispute between the United States and China, although recent media reports suggest that the risk of this has diminished. Nonetheless, there is a risk that protectionist policies may become more widely adopted around the world, impairing the ability of major trading nations (such as Australia) to export its products.

Another uncertainty is the path of major commodity prices. Some commodity prices were unexpectedly strong in 2017–18, including prices for Australia’s major export commodities (including iron ore, metallurgical coal, thermal coal, and liquefied natural gas (LNG)) which have remained higher than forecast in the 2017–18 Budget. This has resulted in higher than expected revenue for the Commonwealth in the form of company tax and mineral royalties. Recent updates to the RBA Index of Commodity Prices and some private sector forecasts point to a decline in these commodities over the coming financial year, though the level of certainty is not high. On the other side of the ledger, Australia imports significant volumes of crude and refined oil and prices for these commodities remain higher than forecast.

**Figure 11: Prices of major Australian export commodities**

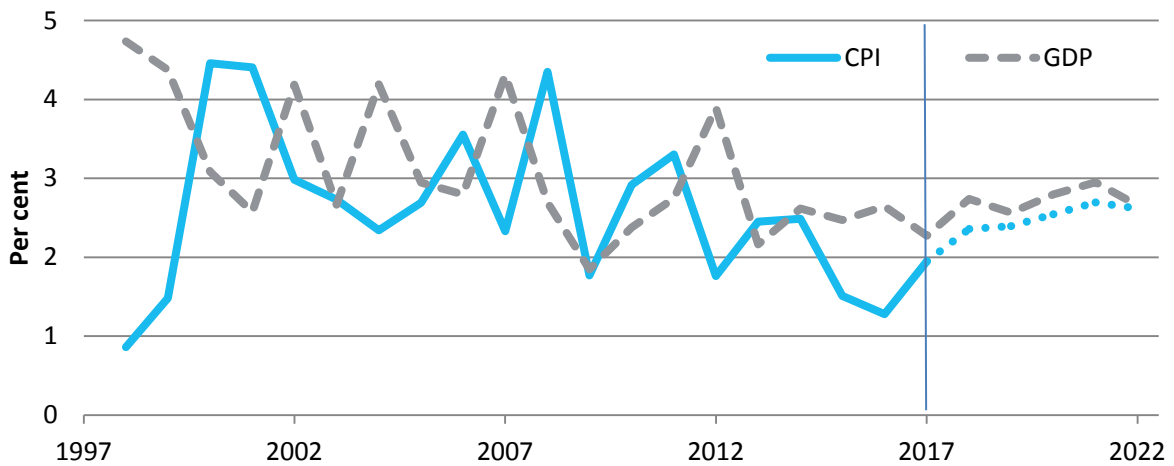


Source: Historical data (Table 6), *Resources and Energy Quarterly*, 8(1), March 2018.

### Headline figures

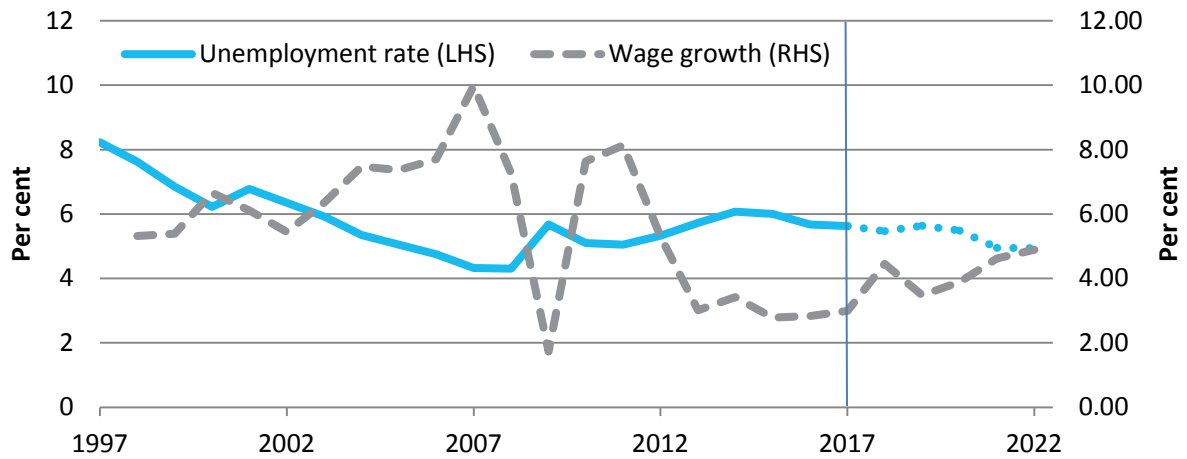
The headline figures are the key forecasts which inform the Budget’s estimates. Previous Budgets have made upwards revisions to the headline figures for 2018–19 and, given the stronger than expected performance of the Australian and global economies in 2017–18, it appears likely that they will be revised higher in the 2018–19 Federal Budget. This will result in higher taxation revenue (particularly through company taxes, income taxes, and the GST) and lower Commonwealth expenditure. However, significant uncertainties remain about the future level of investment and employment growth, which could result in economic conditions deviating markedly from the Government’s expectations.

**Figure 12: Gross Domestic Product (GDP) and Consumer Price Index (CPI).**



Source: [Oxford Economics](#), Global Economic Databank, 4 April 2018.

**Figure 13: Historical and forecast unemployment rate and wage growth**



Source: [Oxford Economics](#), Global Economic Databank, 4 April 2018.

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