Opening Statement – March 2018 Senate Estimates

Overview

When we last met, I spoke of the more positive global outlook. Since then global economic momentum has strengthened further. This strength has exceeded the expectations of many forecasters who have now consistently upgraded their outlooks.

Treasury's forecasts of a strengthening in global and Australian growth over the next few years remain on track.

The prospects for the global economy over the next few years are better than they have been at any time since the Global Financial Crisis.

Business investment appears to be strengthening in a range of countries after an extended period of weakness.

Similar improvements are evident in global trade, with most indicators of world trade strengthening nicely.

And in a number of important economies – like the US, Japan, the euro area and the UK – unemployment rates are approaching levels consistent with 'full employment'. In the US the lack of recovery in labour force participation rates may be masking some latent capacity but, all in all, these developments suggest that labour markets are closing in on full employment, a decade after the Global Financial Crisis.

Global growth and policy

Sentiment around the global economy improved significantly through the course of 2017. The IMF recently raised its global growth forecasts for 2018 and 2019 to 3.9 per cent, an upgrade of 0.2 percentage points in each year.

This reflects better balanced global growth than we have seen for some time, as well as some positive spillovers from the recent US tax reform package.

Business investment is improving in the US, Japan and a range of European economies. This will be important to maintain the medium-term growth prospects of large advanced economies as they press against capacity in their labour markets.

One important development since MYEFO has been the passage of the US tax reform package. The scale of the changes and the pre-eminence of the US in the global economy mean that this is a big event. It will attract capital to the US, raise investment and boost their economy.

Estimates of the impact of the US reforms vary. The IMF has raised its growth forecasts for the US a little for the next two years as a result. The Congressional Joint Committee on Taxation estimates an increase in the average level of US GDP by about 0.7 per cent over the next 10 years, before declining thereafter. The impact on Australia and the rest of the world is more difficult to assess. The impact will depend on how other countries respond with their taxes, how much firms reallocate capital to the US instead of elsewhere and how financial markets respond.

The US is not the only country changing its corporate tax rate. Belgium and France have announced plans to reduce their statutory rates below 30 per cent by 2020, while the UK is scheduled to reduce its company tax rate to 17 per cent in 2020.

For Australia, one thing is clear after these changes. We will have one of the highest corporate tax rates amongst advanced economies. In a competitive world for corporate capital flows this represents a challenge.

The passage of tax reform in the US has also brought into focus another key area of potential policy uncertainty over the next few years. Along with potential US infrastructure spending, the tax reforms are expected to have a stimulatory impact at a time when some major economies – the US, Japan, the euro area and the UK – have moved into a new phase of their cycle. That is, these economies have eliminated, or are close to fully utilising, the excess capacity in their labour markets. This means supply side constraints may start to affect their growth prospects, raising the possibility of a lift in inflation.

That would not necessarily be a bad thing. But it will mean a different monetary policy environment than the one we have experienced over the past decade. A number of central banks have already begun gradually adjusting monetary policy. In places like the US, UK and Canada, this adjustment of monetary policy settings will have to be managed carefully.

We have been through an extraordinary period of monetary policy over the past decade. The downturn following the Global Financial Crisis was one of the most synchronised we have experienced in living memory. However, as economies recover the subsequent normalisation of policy is progressing in a less consistent manner.

After several years of unconventional monetary policy from key central banks, the US Federal Reserve is now starting to wind down its quantitative easing measures. However, this contrasts with ongoing quantitative easing in Japan and, to a lesser extent, in Europe.

So far, central banks have very carefully outlined their likely operating approach and very carefully signalled their intentions to markets. As the volatility seen in markets in the past few weeks highlights, the market adjustment to a new economic environment may not always be so smooth.

Recent shifts in perception about the potential pace of policy normalisation can be seen in rising government bond yields, notably in US Treasuries. Recent US wage and inflation outcomes, and prospective US fiscal deficits, are also likely to have played a role. While government bond yields still remain near historic lows, a rapid rise could heighten volatility in equity markets.

Closer to home, China's economy has also remained strong, with GDP growth of 6.9 per cent in 2017. This comfortably exceeded the Chinese authorities' target of 'around 6.5 per cent or higher'. After two years of weakness, Chinese trade flows have lifted, with a stronger global economy resulting in import and export growth picking up in 2017.

That said, the build-up of debt in China's financial sector, along with excess capacity in parts of the economy, continues to pose risks to the outlook.

Looking ahead, we expect a gradual moderation of growth in China, as authorities focus on achieving higher quality growth and addressing these financial risks.

Meanwhile, policy uncertainty and geopolitical risks – in the Middle East and especially on the Korean Peninsula – remain in the shorter term. In the longer term, slow productivity growth and ageing populations remain key concerns for many countries.

Australia's economic outlook

Recent data on the domestic economy has been consistent with our forecasts. At MYEFO we forecast that GDP growth would increase by 2½ per cent in 2017-18 and 3 per cent in 2018-19.

Non-mining business investment, consumer spending, public final demand and exports are expected to support growth in the economy.

A key feature of the forecasts is that the decline in mining investment is having a diminishing impact on the economy. This decline is nearly complete, with mining investment more than 60 per cent below its 2012-13 peak.

It is worth reflecting on this point. Despite the huge decline in mining investment, the economy has performed well. Since the peak in mining investment, the real economy has grown by an average of 2.4 per cent per annum. This is a little below trend but a very good outcome given the magnitude of the adjustment that we have had to make over the past few years.

News since MYEFO has been generally positive.

Employment has grown strongly, as has the number of people entering the labour market. The unemployment rate has fallen from a peak of 6.4 per cent in 2014 to 5.5 per cent. Employment increased by 3.3 per cent through the year in 2017, as the economy added more than 400,000 jobs. Leading indicators of the labour market such as ABS job vacancies, ANZ job advertisements and various business surveys suggest continued improvement.

Businesses continue to report that conditions and confidence are strong. Monthly business conditions have been above average since early 2016. And in the latest NAB monthly business survey, business conditions were at a near-record 19 points. Business confidence in January was at 12 points, also well above the long-run average of 6 points.

The recovery in consumer confidence in the early part of 2018 is encouraging. Consumer confidence is 8 per cent above last year's lows while retail sales seem to have been stronger in the December quarter following a weak September quarter.

The prices for our bulk commodity exports are higher than assumed at MYEFO. But forecasting these prices is notoriously difficult.

At MYEFO, the Government took a prudent and sensible approach to the commodity outlook. Metallurgical coal prices are assumed to decline gradually over the first half of the year to US$120 per tonne. The assumptions for iron ore and thermal coal prices are consistent with those at the 2017-18 Budget, with prices for iron ore remaining flat at US$55 per tonne and thermal coal at US$85 per tonne.

Recent movements in bulk commodity prices illustrate the continued volatility and unpredictability surrounding one of the key drivers of our nominal economy.

Looking across the States, economic conditions for 2018 are generally optimistic. Recent employment figures have exceeded expectations in most jurisdictions, while economic growth is forecast to improve on last year's outcomes.

This was echoed in recent visits to some of our State Treasury counterparts – with New South Wales and Victoria observing strong employment growth, clear 'green shoots' across multiple areas in Queensland and Tasmania benefitting from increases in tourist numbers. The outlook for Western Australia is looking more promising, with signs that the worst may be behind them. The outlook for the Northern Territory remains subdued but the outlook in South Australia, which has experienced high rates of unemployment, is starting to look more promising as the ship building program starts to ramp up.

The intelligence gathered from our state and territory counterparts does suggest that wages are starting to lift. Last Wednesday's wage price index release showed that wage growth reached 2.1 per cent through the year to the December quarter, slightly higher than the market expected, with the education and health

industries being the main contributors to growth. Victoria in particular is seeing stronger signs of wage growth, with growth of 2.4 per cent through the year.

The sluggish pace of wages growth to date has been a constraint on household incomes and spending.

The recent trend in income growth – that is, money in people's hands – is far below that experienced in previous decades.

We know that higher productivity is the best way to increase real wages across the economy.

Treasury's analysis demonstrates that real wages are higher for businesses with higher labour productivity.

If we are to be more prosperous as a society, Australia's policy settings need to move resources to their most productive uses.

The Productivity Commission's work is lighting the way. Their recent 5-year productivity report sets out a series of recommendations across five areas – healthier Australians, future skills and work, better functioning towns and cities and improving markets as well as more effective governments.

These areas were selected because they share important characteristics: they target policy settings that are outmoded by technology, most people can share the benefits, they account for a large share of economic activity, and they matter for the quality of the lives of millions of Australians – now and many years into the future.

The PC has been blunt – *we need to shift the dial on underlying productivity, jolting it out of the mediocre trajectory of recent history.*

There is no certainty that we will be able to achieve income growth from a favourable terms of trade - as we have in the past. New productivity-boosting reforms are one of the few certain ways of raising living standards. As I have pointed out elsewhere, lifting our productivity performance will be key to sustaining the pace of income growth we have enjoyed over recent decades.

But it is important to note that recent slow wage growth has helped the labour market absorb the impact of the huge decline in mining investment that has occurred over the past few years. Without it, we would have seen a less favourable outcome in the labour market.

Annual wage growth is forecast to pick up to 2¾ per cent by mid-2019. Annual headline CPI inflation is forecast to be 2¼ per cent by that point, returning it to the RBA's target range of 2-3 per cent.

Higher wage growth should also support a recovery in consumer spending. Growth in household consumption expenditure has been subdued for some time, with per capita real consumption growth averaging only 1 per cent since the GFC, well below its pre-crisis average of 2.7 per cent. This outcome directly reflects slower growth in real incomes, with per capita incomes growing at only 0.7 per cent compared with the pre-GFC pace of 3.1 per cent.

Consistent with forecasts for stronger wage growth, we forecast household consumption expenditure growth of 2¼ per cent in 2017-18, before strengthening to 2¾ per cent in 2018-19.

The housing market continues as a source of uncertainty.

After experiencing one of the largest booms in housing construction since Federation, dwelling investment appears to have peaked. However, a large

pipeline of dwellings under construction and continued strength in building approvals are expected to support activity for some time.

After the record level of investment in 2016-17, dwelling investment is forecast to decline by 1½ per cent in both 2017-18 and 2018-19.

Capital city dwelling price growth, primarily driven by the Sydney and Melbourne markets, has moderated in recent months following five years of strong growth. Through the year growth in prices has declined from 11.4 per cent in May 2017 to 3.2 per cent in January 2018.

Elevated debt and house prices are something to monitor closely but a number of factors – including increasingly robust lending standards and strong household balance sheets – give us a reasonable degree of comfort that a sharp correction is unlikely.

Progress against APRA's macroprudential measures has been positive with welcome signs of moderation in investor and interest-only residential lending activity.

Banks have reduced investor credit growth to annual rates below 10 per cent. While there has been some limited migration of activity towards non-bank lenders, this is not yet a concern.

New interest-only lending has fallen markedly since mid-2017 which is very positive. Still, the outstanding stock of interest-only loans remains large. This will need to be monitored, as existing loans move towards higher monthly payments or require refinancing. While household debt has risen to around 190 per cent of annual disposable income, interest rates have also fallen, such that the share of household disposable income going to interest payments on household debt remains around its inflation targeting period average.

Moreover, household debt is skewed towards higher income households and is backed by substantial asset holdings. Around 60 per cent of household debt is owed by the top two income quintiles. And the household sector's assets are five times greater than household debt. Though admittedly, much of this is represented by housing assets and less liquid superannuation balances.

Australia's energy system is another sector of interest. The energy sector is in transition, with investment chilled by uncertainty. We have all seen the impact on prices and sometimes on reliability. The Government has adopted the Energy Security Board's proposal for a National Energy Guarantee, and the Energy Security Board is developing this proposal through COAG. This policy should increase certainty for investment and address the challenge of designing a market to deliver affordable, reliable and sustainable power.

Budget update and fiscal outlook

The recent MYEFO charts an improving outlook for our fiscal position, with a projected return to budget surplus in 2020-21. The positive outlook for the economy is not an excuse for relaxing efforts to achieve the projected return to budget surplus over the next few years. Delivering on these projected outcomes is key. It will take continued discipline. There are always risks to the global economic outlook and we must be as prepared as we can to face them. A strong fiscal position is an important economic buffer – in essence, the best insurance policy we can have.

Australia continues to be one of only ten countries to be rated AAA by all three major credit rating agencies. Standard and Poor's recently reaffirmed their AAA credit rating for Australia but maintained a negative outlook on the rating. To avert the risk of a rating downgrade, S&P has highlighted the importance of a sustained improvement in the fiscal outlook, leading to a return to surplus.

The MYEFO was the Government's fifth consecutive budget update to maintain a projected surplus in 2020-21. The budget bottom line improved by $9.3 billion across the forward estimates from last year's Budget to MYEFO. Over the forward estimates, the Budget is now projected to return to a $10.2 billion surplus in 2020-21, up on the $7.4 billion surplus reported at the 2017-18 Budget.

The result reflects both lower payments as well as higher total receipts over the forward estimates. Compared with the outlook at Budget, total payments are $6.5 billion lower over the four years to 2020-21, while total receipts are up $2.8 billion.

Payments are expected to fall to 24.9 per cent of GDP by 2020-21, only slightly above the 30-year historical average.

The upwards revision in receipts shows that a strengthening economy continues to play an integral role in budget repair. Strength in tax receipts comes on the back of increased company profitability, which we are seeing alongside a welcome uptick in non-mining investment.

Additionally, net debt is expected to stabilise, peaking in 2018-19 before falling over the medium term.

Once again, these developments are promising. But there is no room for complacency. Continued fiscal consolidation will be critical to sustaining surpluses beyond 2020-21 and ensuring future economic prosperity.

Conclusion

I remain optimistic that we will see a stronger Australian and global economy over the next few years. Sustained fiscal discipline will help to ensure we remain well positioned to respond to the evolving economic landscape.