Opening statement to the Economics Legislation Committee

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The Australian economy has proved itself resilient to the ongoing effects of the pandemic and other shocks. Throughout each successive wave, the recovery has been stronger than expected and Australians have adapted quickly to living with COVID-19.

Key to this is that Australia has avoided the labour market scarring feared early in the pandemic. In February, the unemployment rate was at 4 per cent, and the participation rate at a record high of 66.4 per cent.

While the surge in cases associated with the Omicron outbreak in January and February caused significant disruption in some industries, the effects on aggregate activity have been relatively muted.

We expect that future waves of COVID will occur and this remains a risk to the outlook. But given our high vaccination rates and increased immunity in the community, our ability to 'live with COVID' has improved and the impact of future waves is expected to be modest unless a significantly more virulent strain emerges.

Two new shocks and sources of uncertainty have arisen – the floods and Russia's invasion of Ukraine.

The floods in Queensland and New South Wales have generated severe hardship for affected communities. Individuals and communities affected by the floods face destruction of their home or place of work, temporary displacement, loss of incomes and a long road to recovery.

The direct economic cost of the floods is expected to generate a drag on real GDP growth of around ½ a percentage point in the March quarter. The impact will be felt through reduced activity mainly in the local agriculture, mining, retail trade, accommodation and food services, and construction industries.

Trade will be affected, with coal exports to be relatively subdued in the quarter. Although this will be to a lesser extent than in previous severe weather events, such as during and following Cyclone Yasi when coal exports dropped by 7 per cent, because coal mines had already been operating at reduced levels. Local agricultural businesses have experienced loss of livestock and output, but at the aggregate level exports are unlikely to be significantly affected.

Over coming years, the direct and immediate costs will be partially offset by increased investment to replace and rebuild damaged housing, infrastructure, inventories and household goods. The additional demand may place further upward pressure on the supply of materials and labour in the construction industry.

Russia's invasion of Ukraine and the spill-over effects are creating significant headwinds for the global recovery. The invasion is having devastating social and economic impacts in Ukraine and sanctions are causing a sharp economic contraction in Russia. For other countries, the risks include sharply higher energy and agricultural prices, further strains on global supply chains and likely further impacts on confidence (after what has been a tumultuous couple of years).

At this stage, global growth is expected to be around ¾ of a percentage point lower in 2022 – and global inflation around 1½ percentage points higher – primarily through higher oil, gas and wheat prices. The full effect will depend on the duration and severity of the conflict and the extent of energy, commodity and trade disruptions.

Australia is better placed than many countries to absorb these impacts. Being a net energy and commodities exporter and having little direct trade with Russia, Australia will benefit from higher export earnings. However, higher fuel and other prices will negatively affect household confidence and consumption, and lead to higher inflation.

Economic outlook

Despite this uncertainty, the outlook for the Australian economy is for strong growth and sustained low unemployment.

Real GDP is forecast to grow at 4¼ per cent in 2021-22. Stronger-than-expected consumer spending and employment outcomes have led to an upgrade to growth relative to MYEFO.

The latest available data indicate strong underlying demand. Consumer spending and employment in the December quarter both exceeded expectations relative to MYEFO.

Total tax receipts in the 3 months to February are running $12.6 billion stronger than expected at MYEFO. Income tax withholding receipts are $4.4 billion higher than the MYEFO profile, which is consistent with recent strength in employment and broader measures of wage growth.

As pandemic-related support continues to taper, private sector activity is expected to become the main driver of growth. Real GDP growth is forecast to grow by 3½ per cent in 2022-23 and 2½ per cent in 2023-24. The unemployment rate is forecast to fall to 3¾ per cent in the second half of 2022 and remain low.

Strong household balance sheets, low unemployment and increasing wages growth put households in a strong position to increase consumption and rebalance their demand away from goods and back toward services.

Investment will be supported by strong business balance sheets, temporary business tax incentives and increasing capacity utilisation.

Record prices for bulk commodities will also boost incomes and support growth in the near term.

Risks to the outlook

While underlying demand remains strong, there are substantial risks, both domestic and international.

Our forecasts assume that further waves of COVID-19 and new variants will emerge from time to time, but that future waves do not have the same repercussions for absenteeism seen in January.

Yet there remains a great deal of uncertainty around the health repercussions of new variants. If a new more virulent variant emerges so that absenteeism reaches levels similar to the peak in January 2022, annual GDP growth could be around ½ percentage point lower than forecast, with unemployment up to ¼ percentage point higher.

COVID-19 remains a downside risk to the global outlook. Recent COVID-19 outbreaks in China's port cities and manufacturing regions, including lockdowns in Shanghai over the past week, demonstrate the continued risk the pandemic poses to supply chains. Economic activity in China could well be more affected by the pandemic in 2022 than it was in 2021 as China has not yet transitioned to living with the virus.

The potential for an extended conflict in the Ukraine to generate more significant disruptions is a second downside risk for the global economy.

Russia is an important global commodity supplier, producing 18 per cent of the world's gas and 12 per cent of world's oil. Russia and Ukraine together supply almost 25 per cent of the world's wheat. The invasion has increased the risk of supply disruptions, pushing up and increasing volatility in energy, agricultural and metals prices.

While Australia is relatively well positioned to weather these disruptions, other economies with greater reliance on energy and food imports will experience greater economic impacts. A prolonged conflict will increase the risks associated with the negative terms of trade and confidence shocks for these countries.

Inflation outlook

Current events are expected to exacerbate existing supply chain difficulties and drive a further increase in the already-high levels of global inflation. Currently, inflation stands at 7.9 per cent in the US and 6.2 per cent in the UK, and is expected to increase further.

In Australia, inflation pressures have also picked up, but by a lesser amount. Our central forecast is for inflation to pick up to 4¼ per cent through the year in the March and June quarters.

Of this, around 1 percentage point is due to the direct effect of higher oil prices on fuel. Without the reduced excise, inflation would have been forecast to rise to 4½ per cent in the June quarter. Broader global energy price and supply chain pressures will also put pressure on prices for other consumer goods in the near term.

Our forecasts assume oil prices will reduce from the recent peak of above $125 per barrel but remain elevated throughout the forecast period. A more prolonged period of higher oil prices could add a further ¼ percentage point to annual inflation in mid-2022.

The assumed fall in oil prices and an easing of supply chain pressures is expected to steadily reduce global inflationary pressures. However, the tight domestic labour market and strengthening of wages growth will see headline inflation remain at the upper end of the Reserve Bank's target band for some time, 2¾ per cent to June 2024 and to June 2025.

Our current expectation is for wage growth to continue to increase. While wages have picked up in occupations with particularly tight labour supply, aggregate wage pressure has been slower to emerge. Nonetheless, there are signs that firms are increasing remuneration to attract workers in a competitive market, for example through the payment of bonuses or higher wages to new hires.

The Wage Price Index (WPI) increased to 2.3 per cent through the year to the December quarter of 2021 and is forecast to rise to 2¾ per cent by mid-2022 and 3¼ per cent over 2023 and 2024.

AENA on an hourly basis – a measure of worker's earnings in the National Accounts – has grown faster than the WPI, at 3.5 per cent through the year to December quarter of 2021. AENA per hour is forecast to grow by 5 per cent by mid-2022, before settling back to around 3 ½ to 3 ¾ per cent over the next 2 years.

At Budget, Treasury reduced our assumption of the NAIRU (the level of unemployment below which inflation would be expected to accelerate) to 4¼ per cent from 4¾ per cent.

Treasury has taken this stance as spare capacity has reduced more rapidly than expected, while wage growth has increased more slowly than is consistent with the NAIRU being 4¾ per cent.

Further, we have not seen the labour market scarring that was feared at the start of the pandemic. In contrast, the observed strength in employment means that more people in the labour force have gained and retained skills that increase their employability, favouring a lower estimate of the NAIRU. As I have noted previously, there is considerable uncertainty around the estimates of the NAIRU. In the Budget, we illustrate how wages might vary with different assumptions.

Inflationary pressures in Australia are moderate relative to comparable countries.

However, the balance of risks to inflation are to the upside, both in Australia and overseas.

The stronger and more uncertain outlook for global inflation is raising the risk that inflation expectations in major countries may drift up, making it more difficult for central banks in containing inflation without a policy-induced 'hard landing'.

An orderly normalisation of both fiscal and monetary policy settings to support sustained low unemployment and stable inflation will be a key challenge for policy makers over coming years.

Closing remarks

The central message from the outlook is that the domestic economy is in a strong position. We face the substantial risks that confront the global economy from this position of strength.

There is an opportunity to harness the strong underlying momentum in the economy to sustain full employment and see Australians prosper through prolonged engagement with the workforce and stronger incomes.

There is an opportunity for monetary policy to normalise following a prolonged period of accommodative policy.

Australia, as a net energy exporter, is well placed to manage the risks associated with higher commodity prices as a result of Russia's invasion of Ukraine.

Finally, high vaccination rates and the adaptability of Australian households and businesses see the economy well placed to weather future waves of Omicron or new variants.