Opening statement to the Economics Legislation Committee
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Secretary to the Australian Treasury
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Thank you for the opportunity to make an opening statement.

The global and domestic economic outlook

The global economic outlook has deteriorated markedly since the April Pre-election Economic and Fiscal Outlook (PEFO).

It is becoming probable that major developed economies will soon experience recessions and it is likely China will grow at the lowest rate in over 30 years outside of the pandemic.

Inflation in many countries is at its highest level in the era of independent central banks.

The primary causes of these ructions are two-fold: pandemic and war.

Overlaying these proximate shocks are enduring trends: rapid economic and social transitions to mitigate and adapt to climate change; ever expanding demands on government to deliver services; a global demographic transition; and the re-emergence of great power competition, with sharp rivalry between different systems and values.

Such significant shocks, coming in the midst of these powerful enduring trends is something that few of us have experienced, challenging policy makers both here and around the world.

The successful pathway through these shocks is often described as narrow. I'd say the pathway is partly hidden from us, policy flexibility in the period ahead will be crucial.

There are bright spots, many countries are experiencing near full employment conditions.

It is not lost on policy makers how valuable this outcome is and how we must do all we can to retain full employment as we tackle the inflation challenge.

One of the impacts of Russia's unjust war against Ukraine is being transmitted through higher energy and food prices.

International gas prices rose over six-fold from March 2021 to September 2022 and have been a key source of intensifying cost-of-living pressures for consumers around the world.

Reflecting the same pressures on energy markets, thermal coal prices have risen more than four-fold.

Together this is driving rarely seen increases in electricity prices. In the UK, electricity prices have already risen by 63 per cent, in the euro area by 53 per cent, and in the US by 27 per cent, compared to pre-pandemic levels. And prices are expected to rise further in these countries.

Rising gas and energy prices are combining with persistent supply chain pressures, extraordinary stimulus in response to the pandemic, adverse weather events, and interruptions to food exports to drive significant global inflationary pressures.

Inflation is at 8.2 per cent in the United States and at 10.1 per cent in the United Kingdom, both around 40-year highs. In the euro area, inflation has reached 10.7 per cent – the highest level in the euro area's history.

In response, central banks around the world are tightening monetary policy in what has been the most rapid and synchronised tightening cycles since the advent of inflation targeting.

This synchronised tightening raises the risk of a policy miscalculation that could see a sharper than forecast slowdown across multiple countries simultaneously.

Another key risk to global demand is a sharper slowdown of domestic demand in China than expected. Rolling COVID-19 lockdowns and a downturn in the property market have weakened growth prospects.

<u>The domestic outlook</u>

We have been fortunate to be less affected than others by these global shocks but nevertheless, we have been significantly affected.

In response to the sharp recovery from the pandemic and inflation, monetary policy is rapidly tightening here in Australia. Reflecting this tightening, economic growth is forecast to slow from 3¼ per cent in 2022–23, to 1½ per cent in 2023–24. Growth in 2023–24 is forecast to be 1 percentage point less than at PEFO.

Strong consumption growth of 6½ per cent in 2022–23 is expected to be temporary, driven primarily by the ongoing rebound in services spending and international travel as the impacts of pandemic activity restrictions continue to wane.

By early 2023, the services driven recovery is expected to ease, with consumption growth slowing to 1¼ per cent in 2023–24. And as more mortgages roll off fixed-rate terms, an increasing number of households will see the impact of increasing interest rates on their budgets.

Declining household wealth arising from ongoing expected falls in housing prices will further contribute to the slowing of consumption growth.

Workers at the lower end of the income distribution are expected to be impacted most sharply by the rising cost of essentials, as the cost of food, housing and energy make up a larger share of their spending.

The implications for welfare recipients and retirees are more complex due to indexation and higher interest rates, something I'll return to shortly.

We expect the current very tight labour market conditions to gradually ease as economic activity slows.

Employment growth is forecast to slow to ¾ per cent in 2023–24 and the unemployment rate is expected to increase to 4½ per cent.

While this is slightly above our assumption of the NAIRU – a proxy for full employment – of 4¼ per cent, it remains below pre-pandemic levels of around 5 per cent.

The expected impact of the recent floods in Eastern Australia has been partly incorporated into the outlook. These floods illustrate the risk of devastating weather events occurring more regularly and their impact on the livelihoods of Australians.

Treasury's preliminary estimate is for floods to detract around ¼ of a percentage point from GDP growth in the December quarter, largely offset by increased activity across the second half of the 2022–23 financial year.

Domestic inflation

Inflation is expected to peak at 7¾ per cent by December 2022, before easing gradually to 3½ per cent by June 2024.

While this peak remains the same as the profile prepared for the July Ministerial statement, high inflation is expected to persist for longer than previously expected, largely due to the pass-through of higher energy prices to household bills.

Electricity and gas prices are expected to directly contribute ¾ percentage points to inflation in 2022–23 and 1 percentage point in 2023–24.

This assumes consumer electricity prices will increase by an average of 20 per cent nationally in this financial year and 30 per cent next year.

Data released by the ABS the day after the Budget shows that, excluding the temporary impact of state subsidy schemes, electricity prices would have risen by around 16 per cent in the September quarter this year.

The increase in prices this financial year reflects increases in the default market offers published in May by the Australian Energy Regulator (AER) and associated market dynamics.

The same dynamics that are flowing through global electricity prices are flowing through here in Australia albeit with a lag.

Wholesale electricity prices this year have nearly trebled compared to last year and east coast wholesale gas prices remain more than double their average prior to Russia's invasion of Ukraine.

At the same time, domestic weather events and supply constraints combined with strong demand in residential construction and consumer goods, are contributing further to generalised price growth.

Fresh produce prices were already elevated from severe weather events earlier in the year and are now expected to stay elevated following the October floods and continued wet weather.

The fiscal position

The near-term outlook for the fiscal position has improved since PEFO, with the underlying cash deficit improving by $41.1 billion in 2022–23 and $12.5 billion in 2023–24. Gross and net debt are expected to be lower in each year of the forward estimates.

Higher-than-expected inflation has increased the cost of delivering payments. Excluding new policy, payments have been revised up by $92.2 billion over 4 years. Around a third reflects increased indexation of payments ($34.1 billion over 4 years).

The latest income support payment indexation on 20 September, was the largest indexation increase in pensions in 12 years, and allowances in 30 years.

Higher inflation will continue to materially increase payments in subsequent 6 monthly indexation updates (March and September), until inflation returns to the RBA's target range. Payments will then stabilise at a proportionally higher level.

While inflation weighs especially on lower income households, the automatic indexation of Government payments to the headline consumer price index (CPI) will likely shield the most vulnerable households from the worst effects, albeit with a lag.

ABS living cost indexes for pensioner and other government transfer recipient households have grown more slowly than the CPI over the past 12 months. As a result, on average, for those wholly reliant on benefit payments indexed to CPI their incomes will rise a little more than their living costs. This is an average calculation, and we appreciate circumstances can vary widely for payment recipients.

With prices set to grow faster than wages for a period, indexation of pensions will continue to be linked to growth in consumer prices rather than benchmarked against male total average weekly earnings.

Over the past 20 years, on average, the Age Pension was 27.4 per cent of the Male Total Average Weekly Earnings (MTAWE) for singles and 42.9 per cent for couples.

This is forecast to increase to 30.2 and 45.5 per cent respectively in 2024, before slowly declining thereafter.

Similarly, JobSeeker payments are also forecast to rise as a proportion of MTAWE to 21.5 per cent for singles, a level not seen since 2006.

Price indexation of benefit payments through the inflation spike may therefore have the unusual side-effect of reducing income inequality as payments grow as a share of average wages.

High Australian dollar commodity prices and stronger than expected employment outcomes continue to support upgrades to the outlook for tax receipts.

Excluding new policy, tax receipts have been revised up $132.5 billion over the 4 years to 2025–26, with around two-thirds of this increase occurring in 2022–23 and 2023–24.

As a net energy exporter, this is a positive offset to the negative effects of the war in Ukraine that few other countries enjoy.

As commodity prices are assumed to return to their long run fundamental levels, and the labour market softens, the increase in tax receipts moderates. Over the medium-term, the outlook for tax as a share of GDP is largely unchanged from PEFO.

While the medium-term outlook for receipts is largely unchanged since PEFO, payments as a share of GDP are expected to be around 1.5 percentage points higher by 2032–33.

The 3 changes that drive this deterioration are assumed lower productivity, higher borrowing costs and the upward revision to the estimated cost of the NDIS.

By applying these changes to PEFO, we can illustrate their influence. For example, if these factors had applied at PEFO, the budget deficit would have been even worse in the medium term than that projected in the current Budget.

Higher interest rates have increased Government debt costs by $12 billion over 4 years.

Higher interest rates steadily increase debt costs as the Government issues new debt at higher interest rates to finance ongoing deficits or refinance maturing existing debt.

The 10-year bond yield – which approximates the average issuance yield on new debt – is assumed to be 3.8 per cent across the forward estimates, compared to 2.3 per cent at PEFO.

Over the medium-term, the 10-year yield is assumed to rise to 4.3 per cent by 2032–33, around 70 basis points higher than assumed at PEFO.

When nominal GDP growth rates exceed the yield on debt, debt as a share of GDP will decrease if the primary cash deficit – that is the deficit excluding interest – is not too large.

At PEFO, gross debt to GDP was expected to begin to reduce in 2025–26 when the primary cash deficit was 0.8 per cent of GDP.

Higher borrowing costs and lower nominal GDP growth projections in the October Budget mean more active budget repair is required to stabilise debt-to-GDP in a timely way.

This means the primary cash deficit in 2025–26 would need to be around 0.5 per cent of GDP to achieve the same debt reduction.

Reflecting the changed debt dynamics, gross debt is now expected to stabilise at 46.9 per cent of GDP in the final 3 years of the medium-term projection period.

Responding to the challenges of the time

Rebuilding fiscal buffers

In this Budget, the Government returned much of the upgrade in receipts to the bottom line and constrained spending, significantly lowering near-term deficits and debt.

There is the potential for further upgrades to near-term receipts reflecting the cautious approach taken to forecasting commodity prices. Should this be the case, it would be prudent to take the same approach.

However, beyond the near term, the budget pressures are more profound and will likely require a combination of spending restraint and increases in taxes to reduce deficits and lower debt.

We are fortunate in Australia to begin this journey with a relatively lower level of debt as a proportion of GDP than in many countries. Nevertheless, necessary policy decisions will be difficult in order to best promote the national interest.

I am hopeful that having so fulsomely laid out the fiscal challenges in this Budget, the subsequent policy debate will be productive, considered and understanding of the need for trade-offs.

Policy in the case of war-driven shocks

In the light of the impacts of the Ukraine war on the economy, I thought it might be useful to outline how at Treasury we are thinking through these impacts in providing advice to Government.

I will focus initially on the war-driven relative price shock.

Economists are fond of saying that the solution to high prices is high prices. This is a shorthand way of saying that when supply is short or demand is strong in a particular part of the economy, high prices send a signal to suppliers and investors that it is worth investing in the area and supply expands. Moreover, the same high prices send a signal to consumers to look for alternatives and adjust their pattern of demand.

Further, that calls for government intervention to address high prices are likely to get in the way of a necessary and ultimately helpful adjustment.

There are many conditions that underpin this policy conclusion but in most circumstances Treasury would support such an approach.

However, the circumstances of war-driven price shocks are different and outside the frame of such an approach. In our view, such shocks bring into scope government intervention.

For example, the current gas and thermal coal price increases are leading to unusually high prices and profits for some companies; prices and profits well beyond the usual bounds of investment and profit cycles.

The same price increases are leading to a reduction in the real incomes of many people, with the most severely affected being lower income working households. The energy price increases are also significantly reducing the profits of many businesses and raising questions about their viability.

In summary, the effects of the Ukraine War are leading to a redistribution of income and wealth and disrupting markets.

The national interest case for this redistribution is weak and it is not likely to lead to a more efficient allocation of resources in the longer term.

Policy responses could take many forms but in the current circumstances of generalised price pressures, they need to be mindful of not contributing further to inflation.

This would suggest to us, that interventions that directly address the higher domestic thermal coal and gas prices are more likely to be optimal. Australia is uniquely placed to pursue this type of intervention given it is a net exporter of energy. I would add that as the shock to Australia varies by state and territory reflecting their individual energy policies, any response should also take this into account.

Further, such interventions need not subtract from policies that address the broader challenges to reduce the emission intensity of electricity production in Australia if well designed.

Given the hopefully temporary nature of the energy shock, measures to address the price increases should also be temporary and regularly reviewed. Even if the war in Ukraine persists, global supply and demand will adjust over time.

There are many nuances and details surrounding policy development in these areas but hopefully this helps the committee understand in broad terms how Treasury approaches these issues in developing advice for government.

Changes at Treasury since previous Estimates

Staffing matters

In finishing, I would like to acknowledge former Treasury Deputy Secretary Maryanne Mrakovcic, who recently retired after a long and distinguished public service career. Maryanne appeared in front of this committee for more than two decades.

I also want to acknowledge the contributions of former Treasury deputy secretaries Jenny Wilkinson and Meghan Quinn, who have both deservedly been promoted to Secretary roles since the committee last met.

New Deputy Secretaries at Treasury are Sam Reinhardt for Fiscal Group and Diane Brown for Revenue, Small Business and Housing Group, while Robert Jeremenko is currently the Acting Deputy Secretary for Markets Group. Treasury has a couple of notable new functions, with Victoria Anderson Acting Deputy Secretary of the Employment Taskforce and Hamish McDonald the Head of the RBA Review Secretariat.

In the Treasury portfolio there have also been changes, and I'd like to acknowledge the significant contribution of Wayne Byres who recently retired as Chair of APRA.

The new APRA Chair is John Lonsdale, who was previously a Deputy Chair and before that a Deputy Secretary at Treasury; we warmly congratulate John on his appointment.

I've also included in the written version of this statement changes at Treasury announced in the Budget regarding climate change modelling and wellbeing, but in the interests of time I won't go into them now.

Thank you for the opportunity to provide this opening statement.

Climate change modelling

The Government's recent Budget funds a significant capability uplift within Treasury, including establishment of a new Climate and Industry Modelling Branch, to model climate risks and opportunities for the Australian economy.

Understanding the economic impacts of domestic and global climate change mitigation policies remains an essential question as we progress further along the path of net zero transition. However, better understanding the economic impacts of the physical risks of climate change on the Australian economy and its regions, is also fundamental.

Treasury's modelling capability will allow for the incorporation of longer-term climate impacts into future budgets and intergenerational reports. The October Budget lays the groundwork for this, identifying the numerous channels through which climate change could impact Australia's economy and fiscal position.

Budget Statement 4: Measuring what matters

Statement 4 in the Budget – Measuring What Matters – considers international experience with progress and wellbeing frameworks and indicators. The Statement considers metrics drawn from the OECD Framework for Measuring Well-being and Progress, and how Australia compares internationally.

Over coming months, Treasury will continue working and consulting to inform the development of a standalone Measuring What Matters Statement in 2023. Treasury is inviting public written input on how to better measure wellbeing, which will inform the 2023 Statement.