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

The primary macroeconomic challenges remain, dealing with the highest inflation in decades while maintaining low unemployment, driving long-term improvements in productivity, and consolidating the fiscal position.

Before providing an update on developments in Australia, I will briefly outline recent global economic developments.

International outlook

Headline inflation in developed economies has started to moderate as energy prices and global supply chain pressures have eased.

Oil prices have retreated to around the level seen in early 2022, and coal and gas prices have come off their peaks but remain highly elevated. A mild winter in Europe has helped to alleviate the near-term risk of a further shortfall in global gas markets. Policy actions to mitigate the impact of the global energy crisis on households have also come into effect.

Globally, monetary policy has been tightened significantly and rapidly, and this will see the global economy slow considerably this year.

The IMF is expecting global growth to slow to just 2.9 per cent this year. Global growth over 2023 and 2024 is forecast to be the weakest two-year period of growth since 2001, outside of the GFC and the pandemic.

In the US, labour market and activity data indicate the economy continued to grow in the second half of 2022. However, there are signs in the housing market, household consumption and business surveys that monetary policy tightening is seeing private demand soften.

China experienced its second slowest rate of GDP growth in over 40 years in 2022, the slowest growth being in 2020. China's sudden exit from zero-COVID has seen an improvement in the near-term growth outlook. Real time indicators of urban residents' mobility point to a bounce in Chinese activity.

In the medium term, China's outlook remains clouded by structural challenges, including a declining population and an investment dependent growth model. The IMF downgraded its medium-term growth forecasts for China by around a quarter to 4.1 per cent compared with its pre-pandemic forecasts of around 5.5 per cent.

Russia's ongoing invasion of Ukraine means the outlook for global energy markets remains fragile and further energy price shocks cannot be ruled out.

Intensifying strategic competition could also become a drag on global growth if it leads to further economic fragmentation and a fraying of trade and investment links.

The IMF has raised concerns that policy-driven fragmentation risks reversing the efficiency gains generated by trade, investment and people flows, potentially exacerbating inflationary and supply chain pressures. In a severe scenario, the IMF estimates that trade fragmentation could reduce long-term global output by up to 7 per cent.

This risk is especially relevant for a medium-size trading nation such as Australia, which has benefited significantly from integration with the global economy.

Expertly managing this risk while responding to the more difficult geostrategic environment will be a defining feature of the coming decade.

Domestic outlook

Key news on the domestic economy since we last met was the release of December quarter inflation data.

Inflation rose to 7.8 per cent through the year, the highest annual rate since 1990.

This was consistent with the forecast at Budget for 7¾ per cent and for inflation to peak in the quarter.

The peak in domestic inflation has primarily been driven by the direct effects of a series of global and domestic cost shocks.

Global shocks raised the price of imported goods and added to the cost of materials used in domestic manufacturing and construction. International freight prices peaked eight times higher than prior to COVID-19 and the surge in global oil prices raised local transport costs.

When cost increases are small and sparse, businesses might not immediately or fully pass through such increases to consumer prices. But the breadth and magnitude of the input price shocks necessitated a more fundamental change. This explains part of the broadening of inflation in the latest data, where around 85 per cent of the consumption basket experienced annual price increases above 3 per cent.

Price pressures in new dwellings and automotive fuel are easing and we expect this to deliver additional indirect benefits.

However, working in the opposite direction, we expect increasing price pressures in some areas, including from energy and housing rents.

In December, the Government announced a package of measures to moderate the sharp rise in household energy bills. The announcement included a mandatory code of conduct for gas producers, temporary price caps for wholesale coal and gas, and energy bill rebates for households to be jointly funded with the states.

Following the December announcement, National Electricity Market futures prices have declined significantly. This is consistent with the price caps on gas and coal helping to ease price pressures in the generation market. If sustained, lower futures prices will be reflected in the Default Market Offer announced by the regulator around the middle of the year.

For gas, at Budget we expected consumer prices would rise by 20 per cent in 2022–23 and another 20 per cent in 2023–24, but now expect prices to rise 18 per cent and 4 per cent over the two years. Following the temporary intervention, we have observed a moderation in prices in the wholesale gas market.

The average east coast wholesale gas price is now sitting around the temporary 12-month price cap of $12/GJ, down from around $20/GJ in November.

Over the year to June 2024, Treasury expects the coal and gas caps to reduce inflation by ½ point. Consumer and small business energy rebates will further reduce inflation over the same period.

Households and businesses will still face substantial increases in energy bills, but the package will make a material difference to reducing cost-of-living pressures.

Rising housing costs remain a source of cost-of-living pressures for many households.

Inflation in newly advertised rental prices has been rising sharply for around a year, reaching 10 per cent nationally in January. The national vacancy rate has reached a near-record low of around 1 per cent.

Despite the slowdown in population growth during the pandemic, underlying demand for housing picked up owing to a fall in the average size of households. This reflects changes in household formation as the community adjusted to rapidly changing circumstances through the pandemic.

More recently strong underlying demand for housing has been driven by a recovery in population growth amid constraints in new housing supply. We expect inflation in CPI rental prices to pick up considerably as the stock of rental agreements turns over, peaking in June of this year.

The ABS' latest Selected Living Cost Indexes, which measure the price change of goods and services and its effect on living expenses for different household types, show increasing interest rates are flowing through living costs.

For example, employee households recorded the strongest increase of all households of 9.3 per cent as mortgage interest charges make up a higher proportion of expenditure compared with other households.

Treasury's recently released Population Statement showed that Australia's population and net overseas migration growth have picked up strongly. Temporary migration has recovered faster than expected.

Net overseas migration numbers are being artificially boosted this year by the resumption of inward flows of international students and working holiday makers. This effect will diminish in subsequent years when the usual inward and outward patterns of international student flows re-establish themselves.

Coupled with a broad softening in hiring demand, increases in net overseas migration should help to ease skills and labour shortages – particularly for the hospitality and retail sectors.

In recent months, the unemployment rate reached its lowest level in nearly 50 years, the participation rate reached its record high, and job vacancies remain elevated.

Broader measures of spare capacity in the labour market that account for underemployment have also fallen. The underutilisation rate, which combines unemployment and underemployment, has been below 10 per cent since May 2022. This is the first time since 1989, that it has remained below 10 per cent over consecutive months.

A tight labour market presents challenges for business in hiring workers.

However, it is associated with a range of positive outcomes and opportunities including stronger nominal wage growth, bringing marginally attached workers into the labour market, and incentivising skills acquisition and investment that contribute to higher productivity.

We can see these benefits in the data. Youth unemployment has fallen to below 8 per cent, well below the average rate of around 12 per cent in the decade following the GFC, and female workforce participation is near record highs.

We are seeing signs of stronger nominal wage growth.

The Wage Price Index increased by 3.1 per cent through the year to the September quarter, the fastest pace since the March quarter 2013, and the national accounts measure of average earnings per hour has also picked up.

We expect to see a small increase in real wages in 2023–24, reflecting the combination of rising wages and falling inflation.

There are several industries experiencing particularly strong growth in wages. This includes retail trade, which has seen the fastest growth of all industries over the past year. Strong wage growth is also present in service industries such as rental, hiring, and real estate services.

Award workers have seen the largest wage increases following the Fair Work Commission's decision to preserve the real wages of low paid workers. On average, award workers received a pay increase of 4.4 per cent through the year to the September quarter of 2022.

Individual arrangements have also shown a response to the tight labour market, with wages rising by 3.5 per cent through the year, while wage growth in Enterprise Bargaining Agreements lagged, rising only 2.6 per cent.

The risk of a price and wage spiral remains low, with medium-term inflation expectations well anchored to the inflation target. Although measures of spare capacity in the labour market show that the market remains tight, the forecast pick up in wages growth to around 4 per cent remains consistent with the inflation target.

As we navigate the transition back to low inflation, it will be crucial that we retain the benefits we are seeing from full employment.

The significant tightening in monetary policy over the past year and ongoing cost-of-living pressures will see domestic growth slow significantly this year.

At the October Budget, we forecast economic growth to slow to 1½ per cent in 2023–24 as cost-of-living pressures and rising interest rates increasingly weigh on consumption.

Recent data are consistent with some slowing emerging in consumption, although underlying developments are still clouded by the recovery in services consumption, including international travel. The December quarter retail trade data showed a small fall, consistent with the expected slowing in discretionary spending on goods.

Treasury will update its economic forecast at the May Budget. There will be some adjustments to account for new developments and data including the stronger outlook for population.

However, we do not see a significant change in the outlook for how the economy is responding to the challenges highlighted in the Budget. The core elements remain the same. Cost shocks and inflation remain a near-term challenge, growth is expected to slow significantly but the unemployment rate should remain at low levels by recent historical standards.

This is sometimes called the narrow path. It is also an uncertain path given the highly unusual circumstances all countries have been facing. In the light of this uncertainty, policy makers will need to be prepared to respond quickly to new evidence as it emerges.

Fiscal position

Since Budget, additional spending has been required to manage pressures in critical areas such as the Energy Price Relief Plan, floods and ongoing commitments to respond to COVID-19 waves.

The December Monthly Financial Statements showed tax receipts running ahead of the October Budget forecast, reflecting higher-than-expected collections from both individuals and companies. This is, in part, led by employment income being stronger than expected.

A key driver of forecasts for nominal GDP and tax receipts is changes in commodity prices and assumptions for their future growth. Headline revenue estimates are sensitive to the approach and assumptions Treasury uses to account for developments in volatile commodity markets.

Treasury's general approach is to analyse supply and demand factors driving commodity prices in the long term and assume that prices correct relatively quickly to long-run anchors via glide paths. This approach for setting commodity price assumptions ensures the Budget does not lock in the impact of volatility from inherently unpredictable commodity prices.

While this approach provides a clear indication of the underlying medium-term Budget position, it can often result in substantive revisions to near-term revenue forecasts.

Generally, bulk commodity prices have been above their Budget assumptions, except for the oil price, which is now well below what we assumed. On their own, higher commodity prices than we assumed would see an upgrade to revenues at the May Budget.

Working in the other direction for resource revenues is the recent almost 8 per cent appreciation in the Australian dollar against the US dollar. The higher Australian dollar works to offset the impact of higher US dollar denominated commodity prices.

Our current approach includes publishing sensitivity analysis that allows users of the Budget to understand the impact of alternative commodity prices assumptions on revenues. This ensures the Budget statements are a transparent representation of the fiscal position and associated uncertainties.

Irrespective of the commodity price modelling methodology, we expect fiscal challenges to persist over the medium term.

Persistent deficits of around 2 per cent of GDP are projected, with several payments growing faster than the economy. This includes interest on government debt, and growing expenditure on the NDIS, health, aged care, and defence.

Interest payments and the NDIS are projected to be the two fastest growing payments over the next decade, growing by around 14 per cent per year on average from 2022–23 to 2032–33.

The projected structural deficit throughout the medium term makes the need for fiscal consolidation clear. Further, that improvements to the cost effectiveness and productivity of government services and government funded services are crucial to lowering cost growth.

I've also included in the tabled version of my opening statement three pieces of work currently underway at Treasury that may be of interest to the Committee – *Measuring What Matters Statement*, the Government's Employment White Paper and the RBA Review.

In the interests of time I won't go into them now.

Thank you for the opportunity to provide this update.

Policy processes

Measuring What Matters

The October Budget included a Government commitment to release a new stand-alone *Measuring What Matters Statement* in 2023.

The Statement will bring together a broad range of social and environmental indicators in addition to traditional measures of economic strength. It will help us to better understand and respond to some of the more challenging issues facing our economy.

Currently, Treasury is considering the written submissions that were provided following the last Budget to develop a draft set of goals and measures for the Statement.

One example of an issue that could be informed by broader analysis is social mobility. The Treasurer has recently discussed Treasury analysis on this issue, which showed that intergenerational income mobility in Australia is relatively high compared with other countries.

Measuring What Matters complements the Government's objectives for full employment. In addition, a focus on labour market measures — rather than just the unemployment rate — presents an opportunity to better understand developments. This could include measures like job quality and satisfaction, participation by traditionally disadvantaged cohorts, and broader measures of individuals' availability and willingness to work.

The Government's Employment White Paper

Articulating the Government's objectives for full employment will be an important focus of the Employment White Paper, to be published this September.

Treasury is currently undertaking a consultation process on the White Paper. And we will co-host an academic conference with the Australian National University in April to explore topics on the labour market and full employment to support the development of the White Paper.

RBA Review

As you are aware, the independent Review of the Reserve Bank of Australia is scheduled to provide its final report to Government in March. Treasury has seconded staff to the Secretariat supporting the expert Panel. The Review has been consulting extensively, including with domestic and global experts, businesses, unions, the community sector and the general public.