Senate estimates opening statement – February 2019

Introduction

Good morning.

Since my last appearance before you in October of last year, there have been two particularly notable events involving Treasury. The Mid-Year Economic and Fiscal Outlook – or MYEFO – was released in mid-December and the final report of the financial services Royal Commission was delivered to the Governor-General on Friday, 1 February and released publicly with the Government's response the following Monday.

I will touch on both of those this morning, as well as provide an update on the economic outlook and some recent changes to Treasury's organisational structure.

MYEFO

Let me first refer to the mid-year update and data releases since then.

The fiscal outlook as published in MYEFO indicated a smaller deficit in the current financial year relative to what was published in the 2018 Budget, with a return to surplus of $4.1 billion, which is 0.2 per cent of GDP, forecast in 2019-20.

Looking further ahead, ongoing surpluses were projected from 2020-21 and the cumulative underlying cash surplus over the four years from 2018-19 was expected to be $30.4 billion, nearly double the estimate in the 2018 Budget.

The fiscal position has clearly benefited from solid economic growth, a strong labour market and commodity prices remaining higher for longer than was assumed in the 2018 Budget.

The decade taken to return to budget surpluses has been a lived experience of the long lasting fiscal impacts of financial shocks and economic transitions that occur as an economy rebalances.

But the MYEFO shows, even with those surpluses being realised, that while accumulated debt from ongoing deficits will be reduced – gross debt will still be in the order of 14.6 per cent of GDP in 2028-29. With new downside economic risks emerging, it is vital that fiscal discipline be maintained to ensure Australia has budget headroom to be adequately prepared for any adverse surprises.

Global economic outlook

Reflecting further on the global economic outlook, the MYEFO forecasts for global growth of 3¾ per cent in 2019 and 2020 remained unchanged from what was published in the 2018-19 Budget and major trading partner growth was revised down slightly to take into account the impact of trade tensions on the US and Chinese economies.

Nevertheless, the MYEFO forecast for Australia's major trading partner (MTP) growth of 4 per cent in 2019 and 2020 was stronger than the global outlook as a whole. MTP growth has more direct relevance to Australia's economic prospects.

Since MYEFO was published, both the World Bank and IMF have slightly lowered their forecasts for global growth with revisions occurring largely in economies outside of Australia's major trading partners.

While the IMF is now forecasting global growth to be 3.5 per cent in 2019 and 3.6 per cent in 2020, those forecasts are still above the 10-year average global growth rate of 3.4 per cent.

Around an otherwise relatively robust global growth outlook, the downside risks appear a little more prominent than at MYEFO and the discussion of these risks has intensified.

The US and China are still negotiating to prevent new tariff measures in addition to those imposed late last year by both countries. So trade tensions remain a risk to the global outlook, noting that a positive outcome from those negotiations is a potential upside risk to global growth prospects.

There has also been some easing of growth momentum in Japan and Europe, and real GDP has fallen for two consecutive quarters in Italy, compounding ongoing concerns about the European banking system. Brexit negotiations are overlaying further uncertainty around the near-term outlook in Europe, particularly as the exit deadline rapidly approaches with a formal arrangement not yet in place to manage the process.

China faces mounting pressure to address its financial sector risks, while vulnerabilities associated with an increase in global indebtedness, including in emerging economies, also present a risk to the international outlook.

Balancing those risks, more favourable macroeconomic policy settings in key economies, particularly China, could lead to growth being stronger than forecast.

A bounce-back in growth momentum in the US is also a possibility following the extended government shutdown earlier in the year, offsetting the temporary negative impacts from that event.

The US Federal Reserve statement in January noted that it will be patient as it determines future policy adjustments, which helped stabilise financial markets and increased confidence about the outlook for the US economy.

Domestic economic outlook

Moving on to the domestic economy, the economic outlook in MYEFO came off the back of weaker-than-expected September quarter GDP growth and uncertainty around the impact of the drought.

While a soft result, growth in the September quarter was broadly based, with consumption, dwelling investment, net exports and public final demand all contributing to growth. These were partially offset by a negative impact from inventories and a significant fall in mining investment, following the near completion of the construction phase of major resource projects, including in the LNG sector.

The September quarter result contributed to a small revision down in the growth outlook in MYEFO relative to Budget, with real GDP growth forecast to be 2¾ per cent in 2018-19 which is around Australia's estimated potential growth rate.

The economy and domestic demand are expected to strengthen over the forecast period, supported by rising mining investment, and faster growth in household consumption and non-mining business investment.

Since MYEFO, there have been a number of events relevant to the economic outlook. And we continue to receive more up-to-date data on the economy, which on balance has been slightly more negative than expected, increasing risks to the outlook.

As all of us are aware, there have been floods recently in north Queensland where there have been reports of major stock losses in addition to the loss of many farms, houses and, unfortunately, lives too. I would like to express my sympathy to everyone who has been affected by the floods.

Treasury will continue to monitor the flood situation, both for its localised impacts, as well as for any impacts on the macroeconomic outlook.

The expected recovery from the current drought also continues to be a key uncertainty for the forecasts. The drought continues to play out across various areas of the country, particularly south-eastern Australia.

As stated in MYEFO, the decline in agricultural production in 2018-19 is expected to subtract around ¼ of a percentage point from real GDP growth. Downgrades to winter crop production are expected to be partially offset in the short term by increased livestock slaughter rates.

A downward trend in building approvals over 2018 has coincided with accelerated declines in housing prices, and further falls could result in weaker-than-expected dwelling investment in the future. Falling housing prices could also cause consumer spending to be weaker than forecast.

A general slowing in the pace of credit growth, despite monetary policy remaining accommodative and interest rates remaining low by historical standards, is also adding to the uncertainty around consumer spending and investment.

It should be noted, however, that slower credit growth has occurred alongside a range of actions taken by regulators in recent years to improve lending standards. It is also important to put some longer-term perspective on the recent moderation in housing prices.

During the period of substantial price growth between 2012 and 2017 combined capital city housing prices rose by around 50 per cent, driven by growth in Sydney of around 75 per cent and in Melbourne of around 60 per cent. However the recent moderation has only partly unwound this growth. Combined capital city housing prices have fallen by around 8 per cent from their recent peak in September 2017, with Sydney prices down around 12 per cent from their peak in July 2017 and Melbourne prices down almost 9 per cent from their peak in November 2017. Despite these declines, capital city housing prices are around 35 per cent higher than their 2012 levels.

Turning to some of the upside risks to the outlook, it is worth highlighting that commodity prices have generally remained higher than assumed at MYEFO.

Iron ore prices started climbing as companies started re-stocking before the Chinese Lunar New Year. They have since spiked even higher as a result of a tragic tailings dam collapse in Brazil.

Strength in metallurgical coal prices has waned recently but prices remain broadly consistent with the MYEFO assumption of falling spot prices. Australian thermal coal prices have fallen recently but it is difficult to determine what is driving the change in prices given the Chinese Lunar New Year holidays.

Given the impact that volatile commodity prices can have on the fiscal outlook, it is important to look through short-term spikes in preparing the commodity price assumptions that underpin the economic forecasts. In the lead-up to the Budget, we will continue with our past practice of undertaking extensive business liaison on the outlook for commodity prices.

Labour market conditions have also remained strong. Around 270,000 jobs were created in the past year and the unemployment rate has fallen to 5 per cent, its equal lowest level since 2011. Solid employment growth is forecast to continue over the forecast period and is expected to ultimately support a pick-up in wage and price growth.

The participation rate in December 2018 remained elevated at 65.6 per cent. Pleasingly, in recent years the participation rate has been driven up by both more females and mature age workers joining the workforce. Nevertheless, despite falls in the number of youth unemployed, the youth unemployment rate remains too high at 11.2 per cent.

In summary, while the central forecasts are sound, we are preparing Budget forecasts against a backdrop of increased uncertainty and accumulating downside risks.

Global growth is still expected to occur at a pace that will support continued growth in Australia. And, importantly for Australia, we are still expecting major trading partner growth to be better than global growth. Domestic growth also remains close to potential and the outlook for the labour market remains positive.

The December quarter national accounts next month will be an important read on economic momentum as the forecasts are prepared for the budget on April 2.

Royal Commission

I will now turn briefly to the financial services Royal Commission.

The Report delivered on 1 February laid bare the extent of misconduct in the financial services industry that damaged individuals and the overall reputation of the financial sector.

The Commissioner directed primary responsibility for misconduct in the industry to the entities concerned and those who managed and controlled them – boards and senior management.

The Commission made more than 20 referrals of possible legal action to the regulators for further examination.

Importantly, the Royal Commission re-affirmed the 'twin peaks' regulatory model and, in fact, more properly extended its application to superannuation.

In its response, the Government indicated it intends to take action on all 76 recommendations contained within the Royal Commission's Final Report, in some cases going further than the Commission's recommendation. The Government stated that its focus is to restore trust in the financial system and to deliver better consumer outcomes, while maintaining the flow of credit and continuing to promote competition.

Work has already commenced on implementing the Commission's recommendations with, for example, the APRA Capability Review team and terms of reference being announced.

As you would be aware, Treasury made a number of submissions and provided other background information to the Royal Commission. We also established a Taskforce to provide advice to Government in preparation for the

Commissioner's final report. Before that, Treasury was involved in a large number of legislative and other measures to strengthen the financial sector and improve its performance.

Public submissions of the type made to the Royal Commission by Treasury are made on relatively rare occasions. One issue, in particular, where Treasury did express a strong opinion was in relation to the role of mortgage brokers in promoting competition. As governments of all persuasions have recognised, it is important that care be taken to not damage – and where possible, to enhance - competition in the banking sector.

I am pleased to inform the Committee that the Commissioner supported, agreed with and recognised many of the issues raised by Treasury in its submissions to the Royal Commission.

This, and Treasury's other work in relation to the financial sector, is a tangible demonstration of Treasury's policy expertise and its ability to provide valuable advice to the Government. The Commissioner's remarks in his Final Report, in particular, are a testament to the quality of the staff in a number of divisions across all the Treasury groups.

The Treasury Taskforce will now turn its attention to implementing the Government's response to the Royal Commission report. The Taskforce will work closely with an Implementation Committee that will shortly be established to guide and support timely implementation that will consist of Treasury, ASIC, APRA, the OPC and other agencies as required.

Organisational issues

Before I finish, I would like to briefly outline a number of organisational changes that I have put in place and that have occurred within the Department.

Meghan Quinn, who was formerly Deputy Secretary of Structural Reform Group is now Deputy Secretary of the Macroeconomic Group. This has allowed a consolidation of functions previously undertaken in Structural Reform Group into the Macroeconomic and Fiscal Groups.

Macroeconomic Group will increase its focus on productivity and understanding the structural changes occurring in our economy and the productivity and micro-data project work from the former Structural Reform Group will move into the Macroeconomic Group.

By combining macro and micro into a single Group I want to achieve a sharper alignment between whole-of-economy aggregates, forecasting and analysis and policy choices about growth drivers and productivity. There will also be greater synergies in analytical and modelling expertise to support work across Treasury.

Treasury's work on industry and sectoral policy reforms will now be located in Fiscal Group. Having sectoral structural reform sitting alongside the agency-facing functions within Fiscal Group will facilitate partnering with agencies on structural reform initiatives and also provide synergy benefits.

I believe this dual focus on economy-wide productivity and sectoral structural reform will deepen Treasury's capability in this area of micro-economics – an area in which I have a deep interest and years of experience earlier in my career. It will also tangibly demonstrate that structural reform and competition are not the focus of a single group, but are enmeshed across the work of the whole Department.

I would also like to welcome Paul Verschuer to the Department who started with us on Monday as the Deputy Secretary of Markets Group. Paul joins us after just over 2 years at the NSW Treasury Corporation. Prior to that he held many senior roles across the banking industry, including at Westpac and Macquarie Bank. Paul will bring deep financial market expertise to Treasury.

Thank you.