

DR STEVEN KENNEDY PSM
SENATE ESTIMATES OPENING STATEMENT – MARCH 2020

Thank you for this opportunity to once again make an opening statement to the Committee.

I would like to thank the Committee for allowing Treasury to appear today rather than yesterday due to the release of the National Accounts.

In my remarks, I will discuss the international and domestic economic outlook, within which I will discuss the economic impact of the summer's bushfires and provide a preliminary assessment of the impact of the emergence of the COVID-19 coronavirus, an event that is continuing to unfold. I will also update the Committee on Treasury's thinking on fiscal policy and macroeconomic policy more broadly in the face of these circumstances.

INTERNATIONAL OUTLOOK

At the time of the 2019-20 MYEFO, our assessment was that global economic growth had weakened in 2019 with the weakness widespread, including among our major trading partners in Asia. We considered that this weakness was close to bottoming out, and there would be a gradual pick-up in global growth in late 2019 and into 2020.

This was consistent with the IMF's update in January, forecasting global growth to lift in 2020 and 2021. The IMF forecasts were for global growth to rise from 2.9 per cent in 2019 to 3.3 per cent in 2020 and 3.4 per cent in 2021.

Activity was expected to be supported by accommodative monetary policy settings, fiscal policy in some jurisdictions, an improvement in global manufacturing, signs of bottoming out in the electronics and auto cycle, and expectations for some form of a trade deal between the US and China.

As it transpired, there was a 'Phase one' trade deal struck between those two countries in early 2020. The UK election and subsequent ratification of the withdrawal agreement also settled some of the uncertainties around Brexit.

At the start of the year, we began seeing some signs of an improvement in global economic conditions. World merchandise trade volumes increased 0.5 per cent through the year to December 2019. The February 2020 data for PMI manufacturing saw the EU record its strongest PMI in over a year, and the US remained in expansionary territory. Labour markets also remained robust, with unemployment rates near record lows in the US, the euro area and Japan.

However, the emergence of COVID-19 in late December has significantly negatively impacted the near-term outlook for China and in the past couple of weeks concerns have broadened to other nations as this virus has spread. I will address the potential economic impact of COVID-19 shortly.

DOMESTIC OUTLOOK

Turning to the domestic outlook, at MYEFO, a number of the factors affecting domestic growth in 2019, such as falling housing prices, low housing turnover and the drought, were expected to wane. Further, towards the end of 2019, there were encouraging signs emerging for the domestic economy. GDP growth was stronger in 2019 than in the second half of 2018, while the labour market continued to outperform expectations with employment growth remaining around 2 per cent and the participation rate reaching record highs.

At MYEFO we forecast a gradual improvement in consumption in response to stronger household disposable income growth and an improvement in the housing market. Household disposable income growth is being supported by the personal income tax cuts, ongoing labour market strength, a pick-up in real wage growth, and supportive monetary policy settings.

Consistent with our assessment at MYEFO, the housing market is showing continued signs of improvement with capital city housing prices continuing to pick up and auction clearance rates improving. Export performance has been strong and as has been the case for a number of years, public final demand is strongly contributing to growth.

Mining investment is forecast to contribute to growth in 2019-20 for the first time in seven years as miners invest to maintain their large capital stocks and maintain productive capacity. This assessment was supported with the recent release of the CAPEX survey. Non-mining business investment was expected to be steady and a large pipeline of government infrastructure investment is still to be delivered. Dwelling construction is expected to recover by the end of 2020-21.

The drought continues to persist. While the recent rainfall is welcome, current advice is that it may be insufficient to break the drought in some areas. Farm GDP detracted 0.2 percentage points from real GDP growth in 2018-19 and at MYEFO it was forecast to detract a further 0.1 percentage points from growth in 2019-20.

Turning now to yesterday's release of the December quarter 2019 National Accounts. The data confirm that the Australian economy improved in 2019 relative to the weak second half of 2018. In the December quarter, real GDP grew by 0.5 per cent to be 2.2 per cent higher through the year. Calendar year growth in 2019 was 1.8 per cent, above the OECD average and higher than every G7 nation except the United States.

This is a solid result given headwinds from the weaker global economy in 2019, as well as the ongoing drought.

However, two key events have arisen since MYEFO that materially affect our assessment of the economy – this summer's bushfires and the emergence of COVID-19.

BUSHFIRES

The recent devastating bushfires are having significant negative environmental, social and economic impacts.

The environmental and social impacts are not easily quantified but are substantial.

With around 12.7 million hectares of land burnt and an estimated billion wildlife killed, many of which were already threatened species, vulnerable ecosystems have been badly affected. The Department of Agriculture, Water and the Environment has identified 113 species that are in need of urgent management. Dr Sally Box, the Threatened Species Commissioner, has noted that some species are under long-run threat as a result of the fires (Department of Agriculture, Water and the Environment 2020).

The social impacts of the bushfires are also profound. Reconstruction and recovery efforts will help, but it will not reverse them entirely. Evidence from past episodes suggest bushfires can lead to long lasting physical and mental health effects and destroy cultural heritage (Stephenson 2010). Research by the University of Melbourne after the Black Saturday fires found mental health problems continued three to four years after the fires. This emphasises the importance of the mental health policy responses that have been announced by the Government. The research also found that community involvement improved mental health outcomes, highlighting the need to rebuild social infrastructure during recovery efforts, not just physical infrastructure (The University of Melbourne 2016).

The bushfires have also had a negative economic impact. Our current expectation is that the bushfires will detract around 0.2 percentage points from GDP growth across the December 2019 and March 2020 quarters. Most of this impact will fall in the March quarter, before reconstruction and recovery activity picks up and other spending supports growth from the June quarter onwards.

The negative economic impacts will primarily be as a result of lower household consumption and tourism in combination with other effects on the agriculture and forestry sectors. Household consumption is expected to be lower both as a result of the direct impact on affected regions, as well as from the impact of widespread smoke haze across major east coast cities.

This past bushfire season has reminded people of the increased probability of these events in the face of climate change. The CSIRO predicts climate change will make bushfires more likely as fire weather patterns worsen as a result of an increase in weather patterns with hot and dry winds and fuel becoming drier (Sullivan 2010 and CSIRO 2019). Treasury continues to work with its portfolio agencies and other departments to understand the impacts of climate change and their implications for the economy.

COVID-19

The other major event to occur since MYEFO is the outbreak of COVID-19. As of yesterday, globally there have been approximately 91,868 confirmed cases and 3,131 deaths. The majority of these cases have been in China but given the interconnected nature of our world, and the transmissibility of the virus, COVID-19 is spreading across the globe with 77 countries having now reported cases. In Australia, there have been 41 confirmed cases of the virus of which 21 have recovered and returned home. This data is regularly updated by the Department of Health (Department of Health, 2020).

The global economic impacts of COVID-19 are continuing to emerge but there is little doubt that they are serious.

To date, the economic impacts are being most profoundly felt in China but they are now spreading across the globe. In China, activity in the services sector, particularly transport, real estate and hotel and catering, has plummeted. Many manufacturing plants have temporarily ceased or reduced operations. China's official manufacturing PMI fell by 14.3 points in February, and is now in contractionary territory at 35.7 points. This is the largest contraction in the history of the index. The impact on China will be large, with the OECD in its interim economic outlook released earlier this week, suggesting growth will be around 0.8 percentage points slower this year at 4.9 per cent. This is down from a forecast of 5.7 per cent forecast in November.

Given the size of China, which now accounts for around 19 per cent of global output in purchasing power parity terms, and its extensive international trade links, the impact in China is flowing across the world. For example, reduced travel has seen around 70 airlines cancelling all international flights to China and a further 50 cutting back operations. Global supply chains are being interrupted, not just in China, but in Italy and elsewhere. We are also seeing the cancellation of major conferences and events in parts of the world.

Given the high degree of uncertainty surrounding the economic impacts of COVID-19, Treasury is assessing the situation on an ongoing basis. Global equity markets have fallen sharply during the past couple of weeks and remain volatile. Importantly, despite the volatility in markets, there are no indications of systemic stress or financial market malfunctioning at this time.

The scale of the economic impact on Australia and the world will depend on a number of factors. The extent to which the virus spreads, how quickly it spreads, disruptions to ports and seaborne freight, and should COVID-19 become more prevalent in Australia, the direct impact it has on domestic economic activity.

We have undertaken a preliminary assessment of what the impact of COVID-19 might be in the March quarter, and at this stage, we expect the virus to detract at least a half of a percentage point from growth in the March quarter 2020. This preliminary estimate takes into account the direct impacts on tourism, international education exports and some exchange rate effects. It does not include supply chain disruptions or other potential broader impacts.

Beyond this preliminary estimate for the March quarter it is too early to tell, given the uncertainties, what the full impact of the COVID-19 coronavirus will be on the Australian economy.

Treasury will continue to review the COVID-19 economic impacts on an ongoing basis, including by consulting widely across government, State Treasuries, financial institutions, and with business.

FISCAL OUTLOOK AND MACROECONOMIC POLICY

I would now like to turn to the fiscal outlook and macroeconomic policy in the face of these shocks to the economy.

In 2018-19 the Budget was in balance. The 2019-20 MYEFO update forecasted a surplus for 2019-20 and across the forward estimates.

The bushfires and now the emergence of the COVID-19 coronavirus will undoubtedly have a negative impact on the fiscal position.

While acknowledging the complexity of a modern economy, I thought it may be helpful if I outline the stylised pathways through which revenue and expenditure could be impacted by such shocks before outlining our thinking on macroeconomic policy.

Revenues are closely aligned with the state of the economy. Around half of our taxation receipts are derived from taxing individuals and a further 20 per cent from company taxes. When there is a negative shock to the economy, one of the first impacts to emerge is lower profits. This directly reduces company tax collections.

Expenditures are also affected and they will increase. Two examples of automatic increases in expenditures are the emergency payments we have seen in response to the bushfires and any increases in welfare payments where the financial circumstances of affected household have deteriorated.

Beyond these automatic movements in taxes and expenditures, which assist in stabilising the economy, it makes sense for discretionary fiscal actions to be taken in response to significant shocks to the economy.

The recent bushfires, the emergence of the COVID-19 coronavirus, and before these most recent shocks, the global financial crisis are examples of shocks that comfortably satisfy the significance criteria.

To effectively target responses to any economic shock an assessment needs to be made of the nature of shock.

When COVID-19 first emerged in China many, including Treasury, examined the potential impact on the economy through the lens of the impact of SARS.

However, it is now clear that the impact of COVID-19 on the economy will be different to SARS. The impact of SARS took on a V shape, a sharp relatively contained reduction in activity, mostly in Asia, followed by a quick bounce back.

The economic impact of COVID-19 is likely to be deeper, wider, and longer when compared with SARS. It will create more risk of a prolonged downturn and fiscal support will be needed to accelerate the recovery of the economy, especially once the health and health management effects of COVID-19 begin to fade.

A feature of COVID-19 shock is that it impacts both supply and demand and has a particular time dimension unlike other shocks.

Many economic shocks transmit primarily through the financial sector and can lead to large reductions in demand. For these shocks, responses are often tailored around support to the financial sector to support the flow of credit, and support for aggregate demand through investment and consumption to prevent a negative spiral in the labour market. In these circumstances timely discretionary monetary policy is also important.

With COVID-19, we are already seeing both supply and demand impacts. The supply side impacts are reflected in delays in business inputs being imported because of disrupted transport networks. The demand impact to date in Australia, has mostly been through the impact on education and tourism services.

We will see further demand impacts due to concerns by households and businesses about the impact of COVID-19, in other words confidence will be affected. The demand impacts will likely outweigh the supply impacts and increasingly so over time.

Given the characteristics of this shock, support for business will be important to encourage businesses to maintain employment. Assistance should be targeted to those businesses and sectors most materially affected. As the immediate health concerns fade, support for aggregate demand will become more important.

In other words, an effective fiscal response to COVID-19 will need to take the features of the shock into account. We also need to take into account the underlying features of the economy at the time of the shock.

As the Prime Minister and Treasurer have indicated, the Government is considering the shape and size of the fiscal policy response to COVID-19. This response will be supported by the timely move in monetary policy implemented by the RBA.

In terms of fiscal policy, allowing the fiscal position to temporarily deteriorate as a result of this shock is entirely consistent with a medium-term fiscal framework that supports sustainable patterns of expenditure and taxation over the medium term.

The Australian economy is very well placed to respond to this shock.

Not only because of its high-quality economic institutions and the underlying strength of the economy but perhaps more importantly because of our world leading health sector and its advanced preparedness to respond to the presence of COVID-19 in Australia.

ORGANISATIONAL PRIORITIES

I would like to take this opportunity to inform the Committee about some organisational changes of Deputy Secretaries at Treasury and highlight some of our organisational priorities.

Jenny Wilkinson joined Treasury in late January as the Deputy Secretary of Fiscal Group. Jenny is also Treasury's Champion for Gender Equality, which is one of the diversity pillars in Treasury's Inclusion and Diversity Strategy 2019-2021.

Paul Verschuer, previously the Deputy Secretary of Markets Group, now leads a new group which brings together Foreign Investment Division (FID) and Corporate Services and Business Strategy Group (CSBSG).

Diane Brown is the Acting Deputy Secretary of Markets Group.

Implementation of the Government's response to the **Financial Services Royal Commission** remains a priority for the Department, with most of the required legislation to be introduced into Parliament by mid-2020. Treasury is working closely with ASIC, APRA and the OPC to deliver on those timeframes. Throughout 2020, the Royal Commission reforms will dominate Treasury's legislative program, with the work required equivalent to around three-quarters of Treasury's current program. To date, the Department has assisted the Government to complete 24 of its commitments, including passing two Bills this year, and it has made significant progress on a further 35 commitments through the release of exposure draft legislation or consultation papers.

Treasury has continued to provide Secretariat support for the **Retirement Income Review** that was announced by the Treasurer in September 2019. Since the Review commenced, the Panel has consulted with over 50 different stakeholders from a range of different disciplines. The consultation paper was released on 22 November 2019, with over 420 submissions being received from both individuals and industry stakeholders sharing their views on what the Review should include. The consultation period closed on 3 February 2020 and all the submissions are now being reviewed. The Panel are still on track to deliver their final report to Government by June 2020.

The Treasurer announced in December 2019 that the next iteration of the **Intergenerational Report** (IGR) will be released in July 2020. Budget Policy Division have a dedicated team coordinating the IGR who are working across my department and other key APS agencies to deliver the report.

We are also preparing the 2020-21 Budget which will include an update on the economic and fiscal outlook.

Thank you for the opportunity to provide this update.

REFERENCES

Department of Agriculture, Water and the Environment 2020, *Australian Government bushfire recovery package for wildlife and their habitat: Provisional list of animals requiring urgent management intervention*, viewed 3 March 2020, <www.environment.gov.au/biodiversity/bushfire-recovery/research-and-resources>

Department of Health 2020, <www.health.gov.au/news/health-alerts/novel-coronavirus-2019-ncov-health-alert>

Stephenson, C 2010, *A literature review on the economic, social and environmental impacts of severe bushfires in south-eastern Australia*, Bushfire Cooperative Research Centre

Sullivan, A 2020, *A dry landscape and a dire season: we explain the current bushfire environment*, CSIROscope, viewed 3 March 2020, <blog.csiro.au/explain-current-bushfire-environment/>

CSIRO 2019, *Climate change information for Australia*, viewed 3 March 2020, <www.csiro.au/en/Research/OandA/Areas/Oceans-and-climate/Climate-change-information>

The University of Melbourne, 2016 *Beyond bushfires Final report 2010-2016*