Opening statement to the Economics Legislation Committee
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I would like to start by providing an update to the Committee on the international and domestic economic situation.

Since the release of the Budget, several countries around the world have experienced their highest number of new daily COVID-19 infections and deaths and have had to resort to lockdowns.

We witnessed a rapid escalation of COVID-19 infection rates in Asia.

We have watched the consequences of India's second wave of COVID-19, with average weekly fatalities that spiked in May at over 29,000 confirmed deaths. Both Taiwan and Singapore have recently entered lockdowns after experiencing a sudden renewed spike of infections. Thailand experienced a record number of new COVID-19 infections in May with over 4,000 daily cases while Malaysia just recorded over 9,000 daily cases over the weekend.

Not only do these, and other, outbreaks present significant health challenges globally, they continue to disrupt economic recovery paths in affected countries.

For example, in Canada, the unemployment rate increased by 0.6 percentage points to 8.1 per cent in April, following further lockdowns, with retail and hospitality sectors disproportionately affected.

In Japan, the repeated extension of the state of emergency has further dampened domestic activity. Japan's economy contracted by 1.3 per cent in the first quarter of 2021, following a 4.8 per cent year-on-year contraction in 2020.

On a positive note, new COVID-19 case numbers have continued to decline over the past month in the United Kingdom compared to their peak in January, although there are concerns that daily new case numbers are beginning to rise as a result of virus variants. In the United States, the daily average number of new COVID-19 cases has fallen over the past fortnight to its lowest level since June 2020. This has allowed restrictions to begin to ease in the United Kingdom, Europe and the United States.

The mixed global position clearly shows that the pandemic is not over and that risks to Australia and the global recovery remain heightened.

The recent outbreak in Melbourne again reinforces this point.

Economic recovery

Despite this, here in Australia, the domestic economy has continued to recover and grow strongly. Indeed, the recovery has been stronger than from any major downturn in recent history.

Australia's economic growth outperformed all major advanced economies in 2020. We have seen employment and hours worked rise above their pre-pandemic levels.

As I set out in a recent speech to the Australian Business Economists, I see two key reasons for this stronger-than-expected recovery.

First, Australia has had considerable success in suppressing the virus at a relatively low economic cost.

Second, fiscal policy has been more effective than we may have expected in maintaining economic and social relationships and in supporting the recovery. This was complemented by expansionary monetary policy settings and the flexibility provided in financial markets and rental markets.

Positive health outcomes and continued fiscal policy support have led us to significantly upgrade our expectations for the economic recovery in this Budget. After contracting by 2.5 per cent in 2020, we now expect the economy to grow by 5¼ per cent in 2021. This compares with last year's Budget, where we forecast a fall of 3¾ per cent in 2020, and growth of 4¼ per cent in 2021.

Momentum in the economy, the rollout of vaccines and continued fiscal and monetary policy support are expected to continue to drive broad-based growth over the next few years.

The prospects for this are sound given strong household and business balance sheets, record job vacancies and high levels of consumer and business confidence.

We expect the strength of household balance sheets, reflecting strong income growth and high saving rates in 2020, together with recent strong house price growth, to support above-average growth in consumption in the near term.

Another factor supporting the outlook for growth is improved investment expectations. This reflects the large pipeline of public investment still to be rolled out, strengthened expectations by non-mining firms for near-term capital expenditure, supported by the Government's business tax incentives, and a strong pipeline of dwelling investment.

Labour market: an update on the JobKeeper transition

Turning now to the labour market, I'd like to provide the Committee with an update on the transition from the JobKeeper program.

As outlined in Budget Statement Four, the JobKeeper Payment was a critical element of the Government's policy response. It supported household and business incomes; ensured employees retained relationships with their employer, even when they were stood down;

and it helped ensure firms survived the shutdowns so they could quickly resume trading and hiring once initial lockdowns had passed.

As a result, a record number of workers have returned to their previous jobs during this recovery, facilitating a rapid bounce back in the labour market. We expected the transition from the JobKeeper Payment to be manageable but anticipated that there would be some job losses and potentially an increase in the unemployment rate.

In March, I advised you that Treasury estimated that between 100,000 to 150,000 former JobKeeper workers could lose employment over the months following the end of JobKeeper. This was a forecast based on our assessment at that time of the strength of the economy and labour market.

Early indicators suggest that, while there have been some job losses associated with the end of the program and there may be more in the future, the strength of the broader labour market has meant that many of these individuals are finding jobs.

The Australian Bureau of Statistics has indicated that the end of the JobKeeper wage subsidy did not have a discernible impact on employment between March and April and that changes could reflect usual month-to-month variation in the labour market and some larger than usual seasonal changes around Easter and school holidays.

The unemployment rate fell to 5.5 per cent in April, over a percentage point lower than it was in December, and the number of people receiving unemployment benefits has fallen by around 150,000 since the end of March.

Other partial data which provide some insights are the latest Single Touch payroll data. These data suggested that up to 40,000 former JobKeeper workers lost employment in the first two weeks following the end of JobKeeper. We now have an extra two weeks of data and across the four weeks, around 56,000 former JobKeeper workers lost employment.

In terms of the net labour market impact, it's worth remembering that around 400,000 people move into and out of employment in a normal month and we would expect many of those who lost employment at the end of JobKeeper to regain employment in coming weeks. The May labour market report, to be released on 17 June, will provide the next comprehensive update on developments in the labour market since the end of JobKeeper.

Along with elevated levels of job advertisements, these data continue to give us confidence that the labour market has the underlying strength to absorb workers transitioning off the JobKeeper Payment.

In line with our upgrade to the GDP outlook in the Budget, we expect the unemployment rate to fall to 5 per cent by June 2022 and beyond this to 4½ per cent in 2023-24.

Fiscal policy has played a prominent role in driving down the unemployment rate to date, and we expect this to continue with the additional support coming through this Budget.

The forecast falls in unemployment represent a much faster reduction in labour market slack than expected at the 2020-21 Budget. This raises the question about how far the unemployment rate can fall before generating wage and price pressures.

So, I would now like to touch on the outlook for wages and prices.

The first point is that we have upgraded our wage and inflation forecasts to reflect the stronger labour market and a stronger economy.

The impacts of COVID-19, including falls in global oil prices, and policy responses such as increased childcare subsidies, saw consumer prices fall by 0.3 per cent through the year to the June quarter of 2020, while wages increased by 1.8 per cent over the same period. This helped contribute to increases in household income during the height of the pandemic.

In the near term, we are likely to see a temporary rise in prices due to the unwinding of childcare and other subsidies and the recovery in the global economy. By contrast, short term wage expectations remain low.

Beyond this, we see the path for nominal wages being influenced by three key factors.

First, the amount of labour market slack determines the pressure on employers to increase wages to retain and attract employees. As I discussed at previous Senate Estimates, the Non-Accelerating Inflation Rate of Unemployment (NAIRU) is a measure often used to represent the critical point when substantial pressure is placed on employers to increase wages.

Since our last hearing, Treasury has released a paper estimating a lower NAIRU of between 4½ and 5 per cent. This means that we now expect the unemployment rate will need to be lower than previously thought before we see a substantial pick up in wages. Furthermore, we are now more confident that the recovery from the recession has been sufficiently rapid to avoid a temporary increase in the NAIRU, as generally occurs after a recession.

The second key factor influencing nominal wages is inflation expectations – that is, the rate at which people expect prices to rise in the future. Inflation expectations provide an ‘anchor’ when negotiating wage rises, meaning all else equal, lower inflation expectations lead to lower growth in nominal wages. The recent period of low inflation has contributed to lower inflation expectations and therefore, lower nominal wage growth.

The third factor is productivity growth. An increase in productivity increases the value of labour, which raises wages.

Productivity improvements can be driven by movements in the global productivity frontier, which are then reflected here in Australia through incorporating overseas technological advancements into domestic production processes. Alternatively, productivity improvements can be driven by domestic reform that improves the allocation of resources within Australia.

All things considered, we have taken a relatively cautious view and forecast a pick-up in wages from 2022-23, when we expect the unemployment rate to fall within Treasury's estimated band for the NAIRU, but not before.

This higher wage growth is expected to contribute to a gradual strengthening of inflation, reaching the mid-point of the RBA's target band by 2024.

However, the COVID-19 recession and our recovery are unprecedented in recent history, so the speed with which prices and wages respond to reducing slack in the economy remains a key source of uncertainty.

Wage growth could respond more quickly to a fall in the unemployment rate if we start to see a mismatch in the skills employers are looking for and those looking for work.

Budget assumptions

I would like to briefly touch on the key assumptions underpinning our economic forecasts.

The Budget assumes that a population-wide vaccination program is likely to be in place by the end of 2021. We also assume few domestic restrictions and no extended or sustained state border restrictions over the forecast period. The Budget also assumes that flows across the international border will remain very low until mid-2022.

Australia's economic success is inextricably linked with Australia's ability to successfully maintain strong health outcomes. A key assumption we have made is that we will continue to effectively contain outbreaks going forward. A change in our situation would hinder our ability to keep the domestic economy open and undermine the momentum in the economic recovery.

We have also maintained prudent assumptions for commodity prices. While the iron ore spot price remains elevated, and is currently around US$175 per tonne free on board (FOB), we have assumed that the iron ore price will decline to US$55 per tonne FOB by the end of the March quarter 2022, three quarters later than last year's Budget.

Finally, Treasury forecasts that Australia's population growth in 2020-21 will slow to its lowest rate in over a century, down to 0.1 per cent. The main driver of this low growth is net overseas migration, which Treasury forecasts to be negative in 2020-21 and 2021-22.

Lower population growth will affect the size of the economy, but this will not necessarily have a significant impact on GDP per capita if the pandemic and economic consequences of the pandemic are well managed.

Fiscal policy

I would like to now make some comments on the macroeconomic policy mix.

Monetary policy has provided important support during the pandemic, despite the cash rate reaching the zero lower bound. But there are limitations on how much more support monetary policy can provide.

In periods such as this, with monetary policy constrained and spare capacity in the economy, fiscal policy is an appropriate and effective tool to support demand.

However, it is important that this support is consistent with long term fiscal sustainability.

Sustainable fiscal policy needs to balance the use of our resources across time and generations. It involves weighing the cost of servicing and reducing debt in the future versus the benefits of deploying those resources today.

The Government has updated its Economic and Fiscal Strategy in the Budget, and it contains some important principles that go to fiscal sustainability.

In the first, and current, phase of the Strategy, the focus is appropriately on securing the recovery and driving the unemployment rate down to pre-pandemic levels or lower.

Once the recovery is secured, the fiscal strategy will be focused on growing the economy to stabilise and reduce debt.

By supporting economic growth now and over the medium term, the Strategy will underpin stronger public finances over time.

Based on the Budget forecasts and projections, it remains our view that the fiscal position is sustainable.

The underlying cash balance fell sharply as a result of economic and health support provided in response to COVID-19. As temporary measures are unwound the underlying cash balance improves steadily from 2020-21.

This is despite the prudent assumptions for the iron ore price and forecasts for wages growth that I referred to earlier.

The underlying cash balance is expected to improve to a deficit of $57.0 billion in 2024-25, or 2.4 per cent of GDP, and further improve to a deficit of 1.3 per cent of GDP in 2031-32.

The steady improvement in the underlying cash balance over the medium term reflects payments that are broadly stable as a share of GDP. It also reflects a gradual increase in the tax-to-GDP ratio as a result of the unwinding of temporary tax relief to businesses, through full expensing and loss carry back, and rising personal income tax receipts.

By the end of the medium term, the tax-to-GDP ratio is projected to reach 23.1 per cent of GDP, still lower than the tax cap set out in the Strategy of 23.9 per cent.

Australia's net debt is estimated to be 34.2 per cent of GDP at 30 June 2022, lower than the estimate of 40.4 per cent of GDP at the 2020-21 Budget.

Notwithstanding an increase in yields since the start of the year, the Government's borrowing costs remain near historical lows, and Australia's debt servicing costs are projected to remain low by historical standards at around 1.0 per cent of GDP over the medium term.

Low interest rates, coupled with strong economic growth, suggest that Australia's net-debt-to-GDP ratio will peak at 40.9 per cent of GDP at 30 June 2025 before improving over the medium term to reach 37.0 per cent of GDP at 30 June 2032.

A strong economy, coupled with a disciplined approach to spending, will be key to ensuring debt as a share of GDP stabilises and then declines as projected. A more aggressive tightening of fiscal policy in the current context would be counterproductive.

Conclusion

Australia's economic recovery is well underway and running ahead of expectations.

As the economy expands, we have an opportunity to drive down the unemployment rate below its pre-COVID-19 level and to generate appropriate wages and price growth while maintaining fiscal sustainability.

Australia's success in managing the crisis to date is enabling us to look forward to the next set of challenges. But we must constantly check ourselves and we cannot take our recovery for granted. The emergence of new variants, the continuation of outbreaks in several other countries, and the outbreak in Victoria are a stark reminder that the pandemic is far from over.

To secure the economic recovery, it is of utmost importance that Australians get vaccinated when their turn comes – to help reduce the health and economic risks of future outbreaks and, when safe, enable us to open our international borders.