

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 Australian economy expanded by 3.6 per cent in 2022, driven by a post-pandemic rebound in consumer spending, with people returning to eating out, travelling and other activities that were previously restricted. This additional spending added to the earlier rebounds in many other sectors, including construction and professional services, and ongoing strength in the care economy.

To meet this demand, employers hired almost 500,000 additional workers, and the unemployment rate fell to around its lowest level in almost 50 years. This has had the welcome benefit of bringing more people into employment, particularly younger people and the long-term unemployed, who can struggle to find work.

Notwithstanding these very positive labour market outcomes, the big shifts and changes seen through the pandemic and its aftermath have put a strain on economies around the world. Globally these first appeared in goods supply chains, with many struggling to keep up with wild swings in demand. This was then followed by substantial disruption in commodity and energy markets as a result of Russia's invasion of Ukraine. These supply pressures are now easing.

Demand is also easing with global growth set to slow considerably in 2023. High inflation, sharply rising interest rates, and a tightening in financial conditions associated with recent banking sector strains are all putting a strain on households and prompting businesses to delay or scale back their investment plans. The risks to the outlook are tilted to the downside. Overall, we are expecting the pace of global growth in 2023 and 2024 to be the weakest in 2 decades, outside the GFC and COVID-19 pandemic.

There have been some positive developments in the global economy, most particularly a positive boost from the re-opening of China's economy, after pandemic restrictions were lifted in December last year. China is now expected to grow by 5¾ per cent in 2023, significantly faster than the Chinese government's growth target of 5 per cent.

The Australian economy is not immune to these global challenges, but it is well placed to navigate them. Household spending has been supported by the record low unemployment rate, strong labour force participation, and rising nominal wages growth.

However, as expected in the October Budget, momentum is now starting to moderate. The economy likely reached a cyclical peak in the September quarter last year, and is now transitioning to a more balanced position between supply and demand. This transition will be challenging for many people. Interest rates have risen sharply, and are likely to remain elevated for a time, and inflation is unlikely to return to the RBA's target band quickly.

High domestic inflation and rising interest rates are squeezing household incomes and weighing on consumer spending. This is now clear in the data we track, with retail sales volumes falling 0.6 per cent in the March quarter.

The impact of rising interest rates and elevated inflation differs markedly across households. For example, some households carrying a large mortgage or with limited savings are likely to be finding conditions challenging. Furthermore, high inflation environments can be more challenging for those on low incomes, particularly if inflation is concentrated on essential products such as food, energy and the cost of housing. The indexation of government payments to inflation will provide some protection.

There are some signs that activity in the established housing market, that is the buying and selling of houses and apartments, has stabilised. But housing construction has not yet worked through its cyclical downturn.

There are still a large number of dwellings under construction, almost 240,000 in the December quarter, which is currently supporting activity.

However, approvals for new buildings have fallen significantly over recent months. After the current pipeline of work is completed the downturn in approvals will mean fewer housing starts. This will naturally flow through to construction work done, and we expect dwelling investment to contract 2½ per cent this year, by a further 3½ per cent in 2023-24 and 1½ per cent in 2024-25. We then anticipate a strong cyclical recovery.

The slower pace of growth in domestic demand is projected to take GDP growth from 3¼ per cent in 2022-23 to 1½ per cent in 2023-24. But not all parts of the economy are expected to slow down. The re-opening of the international border is driving a significant increase in inflows of international students and visitors. This is flowing through to services exports, and we now expect net exports to provide a positive contribution to growth in 2023-24.

The faster than anticipated recovery in migration is also materialising in the labour market, through stronger employment.

While the near-term outlook is for subdued economic growth, the cycle is expected to turn in the second half of the forward estimates. Economic growth is expected to strengthen in 2024-25 as policy settings loosen, inflation returns to target and positive real wage growth continues. The economy is forecast to expand by 2¼ per cent in 2024-25 and 2¾ per cent in 2025-26, largely driven by a recovery in household spending. Further, the continued recovery in population growth and market expectations of interest rate cuts are expected to spur investment in new housing, which will reinforce the expected rebound.

Inflation

Inflation remains a key challenge for macroeconomic policy.

Multiple compounding supply disruptions, combined with the rapid recovery in domestic demand, have resulted in the peak in inflation in the December quarter.

For most of the last year inflation has predominantly been driven by tradeable goods such as fuel, food, and manufactured products. COVID-related disruptions to supply chains and spending patterns were quickly followed by Russia's invasion of Ukraine, resulting in the price of tradeable goods rising steeply over 2021 and 2022. This shift dramatically reversed the trend of steady or declining import prices prior to the pandemic.

The disruption to domestic energy prices has been particularly pronounced. Dramatic increases in global energy prices flowed into wholesale markets, and then combined with temporary disruptions in domestic electricity supply. As a result, energy price rises directly contributed around ½ a percentage point to annual inflation in the December quarter of 2022.

Goods inflation has eased as the impact of supply shocks has waned. Indeed, the prices of some products such as furniture, clothing and appliances are now falling. But we are moving into a new phase of the cycle. Price pressures are broadening somewhat, as the direct shocks to energy and other input costs flow across the economy and domestic input cost increases are passed into final prices. This has led to a pick-up in services inflation and marks the beginning of a return to more usual inflation dynamics, where domestic costs are the main driver.

The rental market is currently very tight. National vacancy rates are at a near record low of just above 1 per cent and advertised rents are growing at 10.1 per cent as of April 2023. The lift in advertised rents will gradually flow through to average rental costs, as existing lease agreements are renewed.

The Government's decision to increase Commonwealth Rent Assistance will help support the most vulnerable households.

After falling sharply in the early part of the pandemic, demand for rental housing has increased sharply over the past 18 months. This is partly a result of local residents choosing to live in smaller households, for example adult children moving out of their parents' home. We estimate that in September 2022, these adjustments had increased the number of households in the country by 130,000, when compared to pre-COVID trends.

The increase in demand for housing from local residents has been compounded by the return of overseas migrants post COVID. Treasury now expects net overseas migration to be 400,000 in 2022-23 and 315,000 in 2023-24, a cumulative increase of 245,000 since the October Budget.

It is worth noting that even with the faster recovery in migration, net overseas migration is expected to still be cumulatively lower than anticipated prior to COVID, by around 75,000 people at the end of the forward estimates period.

The upgrades to the forecasts for net overseas migration reflect both an increase in temporary migrant arrivals and lower temporary migrant departures. The single largest group of temporary arrivals is international students, at 48 per cent of arrivals over the forward estimates.

The influx of migrants will support demand for housing investment, particularly medium and high-density developments. This activity is expected to be a driver of the cyclical upturn in the economy as well as providing additional supply into the dwelling rental market.

Cost of Living package

To provide support for households and relieve some of the pressure many people are under, the Budget outlined a Cost of Living package worth \$14.6 billion over the forward estimates, \$3.6 billion of which is for the 2023-24 financial year.

Our analysis shows that the direct, measurable impact of the package will be a reduction of $\frac{3}{4}$ percentage points to headline inflation in the June quarter 2024. The most significant policy within the package is the Energy Price Relief Plan. This is projected to reduce headline inflation by $\frac{3}{4}$ of a percentage point in June 2024. Of this $\frac{1}{2}$ of a percentage point comes from the electricity and gas price caps that were introduced in December 2022. A further $\frac{1}{4}$ of a percentage point will come from the rebates provided to lower income households.

Average national retail electricity prices are now forecast to rise by around 10 per cent in 2023-24, lower than the November 2022 estimate of 36 per cent without the Government's intervention. Retail gas prices are similarly expected to see a much smaller increase as a result of these interventions; a 4 per cent increase in 2023-24 compared to the October Budget projection of 20 per cent.

By providing households with some relief from current pressures, consumers will have more money than they otherwise would have to spend on other goods and services. But we think this offsetting effect is small. The \$3.6 billion package in 2023-24 is modest when compared to the overall size of the economy, \$2.3 trillion. We also think this indirect channel will work with a lag, and so it will not add to demand when inflation is at its highest.

The reduction in headline inflation from the direct impact of the Cost of Living package will also reinforce other disinflationary channels in the economy. First, the reduction in headline inflation reduces the indexation of CPI-linked payments, which will dampen the price-income feedback loop.

It will also assist in keeping inflation expectations anchored more broadly, which will flow through to business pricing decisions and wage setting arrangements.

In the near term, annual inflation is expected to fall to 6 per cent through the year to the June quarter of 2023.

Inflation is then projected to moderate further to $3\frac{3}{4}$ per cent through the year to the June quarter of 2024. Moving through 2024-25, pressures are expected to ease further to $2\frac{3}{4}$ per cent in the June quarter of 2025, as the economy cools and price and wage-setting dynamics normalise.

Labour market

Growth in the supply of labour associated with a strong participation rate has helped Australia avoid extreme labour shortages and the unsustainable wage growth seen in some other countries over the past two years.

Notwithstanding the increase in labour supply, the labour market remains tight. The ratio of employment to population and the participation rate are both near record highs. Although it has drifted up slightly this year, the unemployment rate remains close to its recent near 50-year low. It has been pleasing to see the underemployment rate fall over the recent past, which implies a larger proportion of people are able to work their preferred hours.

Strong employment growth has lifted prospects for cohorts who face barriers to the labour market. Youth unemployment has fallen well below its pre-pandemic level, long-term unemployment remains low and the female participation rate remains at near-record highs. As tightness in the labour market eases, it is important that we maintain these gains for these groups.

As part of our forecast update we reviewed the underlying dynamics in the labour market. We found that for a number of cohorts, their participation rate has lifted over the past 10 years. This was particularly the case for prime working aged people. Upgrades to the structural participation rate projections partly reflect the influences of trends in educational attainment, as well as increased access to childcare and paid parental leave arrangements that strengthen workforce attachment.

We are also projecting a further lift to participation as a result of the upgraded profile for migration. Migrants are typically younger than the resident population, and as a result have a higher participation rate on average. Overall, the structural participation rate has been revised up by 1¼ per cent in 2032-33 (¾ of a percentage point) since the October Budget.

Although we are now more optimistic about the participation rate in the long run, the labour market is expected to go through a cyclical downturn in the near term. As part of this, we expect the participation rate to moderate from its cyclical highs, and for the unemployment rate to rise.

Wages

Consistent with a tight labour market, nominal wage growth has picked up in recent quarters and is expected to rise further.

Growth in the Wage Price Index is expected to reach 3¾ per cent through the year to the June quarter of 2023 and 4 per cent through the year to the June quarter of 2024. This would be the fastest nominal wage growth since 2009.

There are no signs of a wage-price spiral developing and medium-term inflation expectations remain well anchored. And it is usual for wages growth to accelerate during an upswing in the economic cycle.

Part of the recent uplift is explained by administered wage decisions. As a technical assumption, Treasury has assumed that the Fair Work Commission employs the same approach as last year in its upcoming minimum wage decision.

Beyond administered wages, market sensitive individual agreements have been the biggest contributor to the pick-up in aggregate wages to date, but momentum is expected to soften as the labour market eases.

A lift in public sector wages growth and the re-negotiation of multi-year enterprise bargaining agreements over the next couple of years will partially offset this. Public sector wage outcomes over the COVID-19 period weighed on aggregate wage outcomes.

Positive annual real wage growth is expected to return by the March quarter of 2024, increasing to $\frac{3}{4}$ per cent by the June quarter of 2024. As the labour market moderates and inflation eases, growth in nominal wages is forecast to fall back to a cyclical trough of $3\frac{1}{4}$ per cent through the year to the June quarter of 2025.

Increasing the rate of productivity growth is important to sustaining stronger wages growth over the medium term.

Commodity prices

Following internal analysis and consultation with market analysts, participants and other government bodies, we have updated both the glide path and long-run anchor prices for commodities (iron ore, thermal coal, met coal and natural gas). This comes following a series of significant and interrelated shocks that have affected global commodity markets in recent years, the impact of which is expected to persist.

Treasury's forecasts reflect a technical assumption that these prices will return to a conservative assessment of their longer-term fundamental levels. We have maintained this general approach and recommended an update to the assumptions. Individual glide paths have been adjusted 12 times since 2016-17, with longer-term price assumptions for metallurgical coal last adjusted in the 2021-22 MYEFO.

There are three key factors that have driven global commodity markets in recent years. The Russian invasion of Ukraine, major weather disruptions in key commodity-producing regions around the world and the significant global inflationary episode since the pandemic.

Russia's invasion of Ukraine has seen a restructuring in global commodity markets, in particular a significant reduction in global gas supply and forced restructuring of global oil trade flows.

In addition, Australia is the world's largest coal and iron ore exporter, with Brazil our nearest competitive exporter for iron ore. Major weather disruptions in Australia's coal producing regions and other major disruptions to iron ore production in Brazil, have reduced both the level and reliability of supplies to global commodity markets.

Lastly, the global mining sector has not been immune to the sustained period of cost inflation seen around the world. Input prices for the Australian coal sector, for example, have increased by around 15 per cent since 2021. Strong cost inflation has built in a materially higher cost base across the industry that is expected to result in structurally higher prices over the medium term.

Consistent with these findings, we are now assuming a four quarter glide path from current price levels to the long-run anchor and we have revised up the anchor price for all four commodities. To ensure they remain prudent, we have assessed the new anchor points against market expectations. In all cases our anchors are at the bottom of the range of forecasts from market analysts and other government bodies.

Fiscal outlook

There has been a large improvement in the near-term fiscal outlook.

The underlying cash balance is now expected to be in surplus in 2022-23. The improvement in the fiscal outlook reflects the Government's decision to return most of the large tax upgrades that have occurred in this and the previous budget.

Company tax receipt upgrades account for around 60 per cent of the revenue upgrade across the next two years. Across the forward estimates, personal-income tax collections represent around half of the upgrade, demonstrating the benefits of full employment.

From 2020-21 to 2021-22, as a proportion of GDP, the budget deficit contracted by around 5 percentage points. This is a record contraction. From 2021-22 to 2022-23 the budget deficit is forecast to contract by 1.5 percentage points. This is the largest two-year contraction on record.

The effects of the substantial consolidation in the budget position over the past two fiscal years will still be flowing through the economy in the year ahead.

Further, the small widening in the deficit in 2023-24 partly reflects Treasury's prudent approach to projecting commodity prices.

The medium-term fiscal outlook has improved significantly since the October Budget but remains challenging. The underlying cash deficit is expected to narrow from around 1.3 per cent of GDP in 2025-26 to just under 0.5 per cent of GDP in 2032-33 compared to 1.9 per cent projected in October.

The surplus in 2022-23 and smaller deficits across the budget projection period reduces debt accumulation and interest payments – as lower interest payments today reduce the deficit, which reduces debt accumulation tomorrow and so on. Gross debt-to-GDP is expected to fall from the COVID-19 peak of 39.3 per cent of GDP in 2020-21 to 32.3 per cent of GDP in 2033-34. Compared to the October Budget, interest payments will be 0.6 percentage points of GDP lower in 2032-33.

While these developments have improved the fiscal position, the underlying cash balance is still expected to remain in a structural deficit over the medium term. The challenge presented by an ageing population has not gone away and will need to be tackled to ensure sustainable outcomes into the long term. This budget takes some steps to reduce the structural deficit through the NDIS sustainability framework but there is more work to be done.

PwC

I will conclude with some brief comments on the PwC matter.

The Tax Practitioners Board investigated Mr Collins, from PwC, and found that he had failed to act with integrity, as required under his professional, ethical, and legal obligations, and terminated his tax agent registration for a period of 2 years. In addition, the Tax Practitioners Board ordered PwC to take steps to ensure it manages conflicts of interest appropriately. The Tax Practitioners Board published these findings and actions in January 2023.

The Tax Practitioners Board's tabling of emails in Parliament on 2 May 2023 which were uncovered during its investigation has highlighted the significant extent of the unauthorised disclosure of confidential Commonwealth information and the wide range of individuals within PwC who were directly and indirectly privy to the confidential information.

In light of these recent revelations and the seriousness of this misconduct, Treasury referred the matter to the Australian Federal Police (AFP) to consider commencement of a criminal investigation. Following consultation with the AFP, I issued a public statement on 24 May 2023 about the referral of the matter to the AFP.

Treasury is not able to comment further on the AFP referral or on the specifics of any other potential action so as to not prejudice those options. Evidence that we give today will be careful to avoid prejudicing any police investigation.