Opening statement – October 2017 Senate Estimates

Most of the economic news since we last met has been positive, consistent with our forecasts of a strengthening in global and Australian growth over the next few years.

Most of the major developed economies have been growing above their potential for some time and we have also seen significant improvements in their labour markets.

While inflation is still low, the better economic performance and outlook has encouraged some adjustment away from the extraordinary monetary policy settings in place since the Global Financial Crisis in some countries. This is a good thing.

And emerging economies are doing well.

Global trade growth has picked up and there are signs of stronger business investment around the world.

This global backdrop is supportive for Australia and it is occurring at a very opportune time.

The adjustment to the huge decline in mining investment — fully 5 percentage points of GDP since the peak of the mining boom in 2012-13 — is near complete.

I would like to reflect on the adjustment that has occurred since the peak in commodity prices in 2011 and mining investment in 2012.

The decline in investment and commodity prices since their peaks has been a major headwind, constraining income and demand and resulting in job losses in major regional economies. And it occurred against a global backdrop that was mostly unfavourable.

Positive global outlook continuing to firm up

Global economic growth has continued to improve as forecast at Budget.

Major international organisations have raised their forecasts for global growth, reflecting improvements to the outlook for growth in both advanced and emerging economies, particularly the Eurozone and Japan.

China's GDP has seen strong results in the first three quarters of 2017, growing at 6.8 per cent over the year to the September quarter and on track to meet the Chinese Government's official growth target of 'around 6.5 per cent' for 2017.

That said, the Chinese authorities are being a little more open about their concerns as to debt levels and credit expansion especially in the shadow banking sector.

Growth outcomes in Japan have also been much stronger than expected, with the Japanese economy expanding at a rate of 1.6 per cent through the year to the June quarter, marking the sixth consecutive increase in quarterly GDP and the country's longest expansion since 2005-06.

Over the longer term, Japan faces some significant economic challenges related to demographics and public debt levels, and we will continue to monitor these.

Outside of Asia, advanced economies are seeing stronger industrial production, business investment and tightening labour markets.

In line with our Budget forecasts, the United States economy has continued to grow solidly, with the economy growing by 2.2 per cent through the year to the June quarter 2017. This has been underpinned by a rebound in consumption and a strengthening labour market – with the US unemployment rate now at a sixteen-year low.

As the US economy has strengthened, the Federal Reserve has gradually raised interest rates. In September it also announced plans to begin reducing its balance sheet, marking the unwinding of unconventional measures implemented in response to the financial crisis.

The Fed has stressed that it will proceed gradually and that progress is dependent on continued strength in the US economy and inflation rising to target.

The euro area economy has also seen improved performance this year, growing at a rate of 2.3 per cent through the year to the June quarter 2017.

Economic and geopolitical risks

As far as risks to the global outlook go, they are better balanced than they have been for some time, although the Korean peninsula is one particular source of uncertainty at the moment.

While any escalation in tensions is concerning, we should remember that global and regional economies have experienced significant shocks and volatility over the past decade.

Australia has weathered these periods, with our open and flexible economy standing us in good stead.

The potential for economic shocks emanating from China should also not be dismissed.

Chinese authorities face significant challenges as debt levels have grown rapidly since the GFC, raising the risk of a painful adjustment. These risks were highlighted just last month by Standard & Poor's downgrade of their sovereign credit rating for China. This followed Moody's downgrade earlier in the year.

Having said this, based on discussions with my Chinese counterparts, they are alive to the risks and, importantly, they have room to manoeuvre. China has a high domestic savings rate, and the government maintains strong control over the financial system, as well as an adequate level of foreign exchange reserves.

Political risks in the euro area appear to have diminished, notwithstanding unfolding developments in Spain. Brexit negotiations represent an ongoing source of uncertainty. High levels of public and private debt in some euro area countries could pose another risk as the European Central Bank begins to normalise monetary policy.

While, as always, there are risks in the global outlook, the greatest impact we can have on our own circumstances will come from getting our own house in order.

We can lead by example, by remaining open, pursuing structural reforms that make our economy stronger and more flexible, and ensuring that our fiscal policy is credible.

Australia's economic outlook

The Australian economy has now completed its 26th year of continuous growth.

Against the headwinds of adverse weather conditions in late 2016 and more recently Cyclone Debbie, GDP grew solidly by 1.8 per cent in real terms through the year to the June quarter.

Australia's economy as a whole expanded 1.9 per cent in 2016-17. This is above the Budget forecast of 1¾ per cent and highlights the continued resilience of the Australian economy as it moves towards more balanced growth.

As the drag from falling mining investment has diminished we have seen private demand contribute to growth at the same time. As a result, we are seeing a more balanced expansion of the economy. This is expected to continue.

Correspondingly, real GDP growth is forecast to rebound to 2¾ per cent in 2017-18 and 3 per cent in 2018-19.

Looking across the States, for the 2016-17 year, State final demand rose by around 2 per cent or more in all States except Western Australia, where demand fell as mining investment continued to decline.

At the most recent Heads of Treasuries meeting in September, we were encouraged by the fact that most states and territories reported strong or improving economic conditions.

We were particularly pleased with reports of increasing business investment activity in New South Wales and in Queensland, where new private business investment is up almost 9 per cent over the year.

South Australia and Tasmania also cited higher business investment as a driver of improving economic conditions in their States.

Business investment

Earlier this year I spoke to you about the challenge of lower-than-expected business investment, despite favourable business conditions.

Since that time businesses have reported an improvement in conditions. Business conditions are now at around their highest level since early 2008 and non-mining business investment has begun to pick up.

New business investment grew by 1.5 per cent over the year to the June quarter, the first positive through-the-year growth since the end of the mining investment boom. Business investment grew by over 4 per cent in the non-mining states and the level of investment appears to have begun to stabilise in the mining states after substantial declines over recent years.

It is encouraging to see that business investment is now growing and adding to the support that public investment has been providing to the economy.

We expect business investment to continue to strengthen, supported by increasing demand and low financing costs.

Later this week a report into business investment will be delivered to the Commonwealth and State Treasurers meeting in Sydney following extensive consultation with small, medium and large businesses around the country.

Treasury led this work to understand why business investment was underperforming relative to expectations.

We met with the CEOs and CFOs of the top ASX-listed companies and the Chief Executives of peak industry bodies, while Kate Carnell led consultation with SMEs.

Labour market

In addition to the recovery in business investment we have seen more positive signs in the labour market. It is good to see firms increasing investment and employment.

After some weakness in 2016, employment growth has picked up strongly this year, supported by the continued expansion of the economy and subdued wage growth.

Overall, we have now seen employment grow by over 280,000 since the beginning of the year, with growth in all States and a recovery in the mining states of Queensland and Western Australia.

The unemployment rate has edged down slightly in that time as the strong increases in employment have been met by higher participation rates.

On a variety of measures wage growth continues to be low.

For example, the Wage Price Index increased by 1.9 per cent through the year to the June quarter 2017, which remains the lowest rate of growth since the start of the index in 1997. Moreover, low wage growth has been broad-based, with wage growth low across states and industries.

As I said when I appeared before this committee in May, we haven't un-invented the business cycle.

Just as wages slowed in response to the period of slower growth and slack in the labour market in recent years, we expect that a period of stronger growth and falling unemployment will lift wages in the next few years.

This process will take some time and this is reflected in our forecast profile for wages.

A stronger cyclical backdrop doesn't necessarily mean we can assume an immediate return to rates of wages growth experienced in earlier times. Indeed, we are not forecasting this.

But we do expect that as the cyclical constraints that have weighed on the economy recede wages growth will accelerate. This will be assisted by inflation and inflationary expectations moving higher.

As for the real component of wage gains, the part that's above and beyond wages keeping pace with inflation, gains in productivity are the ultimate driver of those gains. On that score, Australia is well placed. Productivity growth has held up relatively well in Australia since the GFC in contrast to many other developed economies. This bodes well for gains in real wage growth over time.

This is why it is so important for us to focus on productivity-enhancing policies. Based on recent work that we have done in Treasury it is clear that average real wages are higher for businesses with higher labour productivity.

Inflation

In line with the subdued growth in wages, inflation remains low, albeit a little higher than 12 months ago. Over the year to the June quarter, CPI inflation rose by 1.9 per cent, broadly in line with our Budget forecasts.

Household consumption

Household consumption continues to grow in line with expectations, with an expected recovery in income growth and a strengthening labour market likely to support stronger consumption over the forecast period.

We continue to expect household consumption growth to outpace income growth, resulting in further declines in the household saving rate.

However, we will continue to monitor these conditions for changes in households' spending and saving behaviours.

Housing market and dwelling investment

The housing market is another sector which we will be monitoring closely.

In recent times, Australia has experienced one of the largest booms in housing construction since Federation, supported by record low interest rates and strong population growth.

Since June 2014, dwelling investment has constituted around 11 per cent of our economic growth.

Much of this has been driven by an unprecedented increase in the construction of high-rise apartment blocks in our east-coast cities. As a proportion of GDP, medium and high density housing construction is now 1.7 per cent, more than double its long-run average.

Housing market activity also continues to be characterised by some quite stark regional differences. Over the past three years, dwelling price growth in our capital cities has been around double that of regional areas. Also, as the east-coast states have experienced strong growth in investment and prices, the market in Western Australia has been much weaker.

However, as noted at Budget, forward indicators of housing construction, notably for apartments appear to have peaked.

The most recent national accounts show that dwelling investment grew by 1.6 per cent in 2016-17, which is less than we expected at Budget.

We expect that residential construction activity will decline moderately over the next few years, although an elevated pipeline of building work will underpin the sector. Strong population growth in our east-coast cities will also support housing demand going forward.

Victoria continues to have the fastest growing population of all the States and Territories, growing at around 2.4 per cent through the year to the March quarter 2017. New South Wales and Queensland each had population growth of about 1.6 per cent through the year to the March quarter 2017.

Over the past few months, dwelling price growth has moderated in our east-coast cities. After years of strong price growth, this is desirable.

Household debt

The state of household finances is an issue that is getting close attention in Australia and that is understandable – but it should be placed in context.

Several considerations should provide some comfort to those concerned about household debt levels.

While household debt has risen over recent years, interest rates have also fallen.

The net result is that the share of household disposable income going to interest payments is currently around its long-term average.

Many households have taken advantage of low interest rates to build substantial mortgages buffers, currently equivalent to over 2 ½ years of scheduled repayments at current interest rates.

And the distribution of that debt is concentrated in high income households, with around 60 per cent of debt held by households in Australia's top two income quintiles – households that are best positioned to service that debt.

More broadly, any assessment of the sustainability of Australia's household debt position requires consideration of the assets that those households hold against their debt. We shouldn't just think about one side of the household balance sheet.

The Australian household sector's asset holdings are considerable, at around five times greater than its debts – Australian households may have over $2 trillion in debt, but they also hold over $12 trillion in assets.

That said, asset values can always fall (and often do) while debt values generally don't, squeezing net worth in the process.

And perhaps more importantly, around 75 per cent of household assets are in housing and superannuation.

The fact that households need homes to live in, that it takes time to sell properties, and that superannuation is 'locked away' until retirement means that these assets cannot easily provide liquidity to households during periods of financial stress.

It's also the case that higher debt levels have made households more sensitive to any increase in interest rates in the future.

The Reserve Bank will be mindful of this when thinking about domestic monetary policy, though global monetary conditions can also impact upon the wholesale funding costs of Australian banks.

For these reasons, Australian financial regulators are alive to the risks presented by household sector debt, and will continue to closely monitor and enforce sound lending practices by Australian financial institutions

Macroprudential policies

House price growth has moderated recently and there are welcome signs of moderation in investor and interest-only residential lending activity.

However, it is too soon to make a final assessment of the impact of APRA's March 2017 macroprudential measures on lending.

These measures included maintaining the growth limit on investor loans first introduced in December 2014 at 10 per cent and limiting the flow of new interest-only lending to 30 per cent of total new lending.

Treasury and regulators will continue to be vigilant in assessing developments in the financial system and the adequacy of policy settings for maintaining financial stability.

While banks' progress against these measures has been positive, regulators will need to think carefully about whether future efforts to maintain financial stability should lean against cyclical excesses or address structural risks within the financial system.

Commodity prices and exports

The economy has benefited from an increase in the prices of some of our major commodities in the past year. This has provided a strong boost to profits in the mining sector. It has probably also helped support the signs of stabilisation in the mining states.

In the Budget, Treasury made the judgement – supported by market and industry consultation – to assume that the prices of iron ore and metallurgical coal would decline over time.

This has been prudent, with the prices of these key bulk commodities falling from these elevated levels over the year.

Budget update and fiscal outlook

Against the backdrop of positive outlooks for both the domestic and global economy we remain on track to return to budget balance in 2020-21, as expected at the May Budget.

Since the Budget, we released the Final Budget Outcome for 2016-17 which showed that the outcome for the underlying cash balance and net operating balance were better than expected in May, and significantly so – an improvement of $4.4 billion in cash terms and $6.6 billion in net operating terms.

Payments came in lower than expected to the tune of $1.2 billion. Part of this reflects the strength in the domestic labour market and the economy more broadly, which led to lower employment services and training related payments.

Receipts came in $4.1 billion higher than expected at Budget on the back of higher tax and non-tax receipts. Company tax, GST, and superannuation fund tax receipts were all higher due to stronger than expected outcomes from tax assessments. Non-tax receipts from the Pharmaceutical Benefits Scheme and Future Fund were also higher than expected at Budget.

Of course, the Fiscal outlook will be updated later this year in the 2017-18 Mid-Year Economic and Fiscal Outlook following the release of the September quarter national accounts in December.

Conclusion

So to conclude, we haven’t un-invented the business cycle and while there are some risks, the Australian economy has evolved broadly in line with our expectations in the 2017-18 Budget.