DR STEVEN KENNEDY PSM

SENATE ESTIMATES OPENING STATEMENT - OCTOBER 2019

Good morning. It is a privilege to appear before this Committee for the first time in my capacity as the Secretary to the Treasury.

Today, as is the usual practise, I would like to give the Committee an update on global and domestic economic conditions, before turning to an update on the fiscal outlook.

GLOBAL ECONOMIC CONDITIONS

Over the past year global growth has slowed. Several major economies, notably Germany and the United Kingdom, as well as close trading partners in our region such as Korea and Singapore, have recently experienced negative quarters of growth. There has been little growth in global trade volumes this year, and manufacturing activity in a number of economies has weakened noticeably.

As a result, the IMF and the OECD have recently revised down their outlook for global growth over the next couple of years. Forecasts for global growth in 2019 are for the slowest rate of growth since the Global Financial Crisis. That said the forecasts for global growth in 2020 is for a pick up to the region of 3.0 to 3.4 per cent which is still reasonable.

At play have been a number of factors, chief among them the ongoing, and still evolving, trade tensions between the United States and China. There is no doubt that trade tensions are having real effects on the global economy, which you see in trade data from the US and China. The IMF estimates that trade tensions could reduce world GDP by about 0.8 per cent by 2020.

But trade tensions are not the only story. There are a number of other factors, including Brexit, financial stability concerns in some economies, the ongoing turmoil in Hong Kong, and geopolitical and economic difficulties in a number of emerging market economies.

Combined, these factors are leading to an increased level of uncertainty around the outlook for the global economy.

Concerns around global trade have been further compounded by a downturn in the global electronics cycle - which has led to particularly poor trade outcomes in the East Asia region - as well as a downturn in automotive production.

Central banks and governments across the world have responded to slowing global growth to support their economies. A large number of central banks, including our own, have loosened monetary policy this year. And some countries, including South Korea and Thailand, have also provided more supportive fiscal policy.

DOMESTIC ECONOMIC CONDITIONS

Here in Australia growth slowed in the second half of 2018 before growing more strongly in the first half of 2019. The June quarter National Accounts showed real GDP grew by 1.4 per cent through the year to the June quarter, and in year-average terms the economy grew by 1.9 per cent in 2018-19.

A number of factors, which are temporary, have contributed to recent weakness in the economy.

Household consumption, the largest component of the economy, grew by 1.4 per cent through the year to the June quarter. A couple of factors are contributing to slower consumption growth. Household income growth has been modest, with strong growth in employment outcomes partly offset by weak wage and non-wage income growth.

In more recent years, the decline in housing prices has also played a role.

This can directly affect spending via reducing confidence and increasing borrowing constraints.

The recent downturn in the housing market has had other, more direct, impacts on the Australian economy.

Dwelling investment has fallen, as expected, by around 9 per cent over the past three quarters and continued weakness in residential building approvals suggests that dwelling investment is likely to continue to fall through 2019-20.

Low rates of housing market turnover have led to significant falls in ownership transfer costs, which is a small component of GDP associated with the transfer of assets. Ownership transfer costs detracted 0.3 percentage points from total economic growth in the year to June 2019.

Turning to business investment, in 2018-19 mining investment fell by almost 12 per cent, detracting around 0.4 percentage points from real GDP growth over the year. Most of this fall reflects the completion of a number of large LNG projects that had been holding up activity.

Non-mining business investment was weaker than expected in 2018-19. This is consistent with an easing in business conditions and confidence.

Despite the recent weakness in household consumption and investment, there are reasons to be optimistic about the outlook.

Recent data have shown early signs of recovery in the established housing market. Combined capital city housing prices have risen for the past three months for which we have data. Housing market turnover and auction clearance rates have also picked up.

In addition, the recently legislated personal income tax cuts and declines in interest rates are providing support to disposable household incomes. We expect this to flow through to increased consumption.

Although we have some indicators of consumption available for the September quarter, which have not shown a particularly large improvement, these are only partial. And it is difficult to know what these indicators would have been had the tax cuts not been implemented.

We will continue to assess the data on consumption as it becomes available, but it is worth noting that even if households initially use the tax cuts to pay down debt faster, this will still bring forward the point at which households could increase their spending.

The substantial investment in mining production capacity continues to boost exports and there remains significant demand for our education and tourism services. In addition, the prospect for mining investment is positive. We expect mining investment to grow this year for the first time since the peak of the mining construction boom.

Public sector spending has made a substantial contribution to economic growth in recent times, contributing 1 per cent to real GDP growth in 2018-19 and an average of 1.1 percentage points per year over the past four years. This compares with an average contribution of 0.8 percentage points over the past 20 years.

Unfortunately, dry weather conditions have generally persisted in drought-affected areas. The drought conditions being experienced across large parts of Australia have weighed on domestic activity, with farm output directly detracting around 0.2 percentage points from real GDP growth in 2018-19, consistent with the PEFO forecast.

As a result, the latest forecasts from the Australian Bureau of Agricultural and Resource Economics and Sciences (ABARES) predicted that the farm sector will continue to experience weakness, with the gross value of farm production expected to fall by nearly 5 per cent in 2019-20.

Despite modest economic growth overall, labour market outcomes have been very positive. Employment growth has continued to be strong, increasing by more than 300,000 over the past year.

While we have seen strong growth in employment, the unemployment rate has been broadly flat. This is because near-record rates of people are being drawn into employment and the labour force.

We have seen a step up in participation in particular parts of our labour market — for those in older age cohorts and for women returning to the labour market after having children. While strong employment growth is very welcome, it does give rise to an issue that is not unique to Australia, that of recent low productivity growth.

Labour productivity growth in Australia has slowed from an average rate of 1.5 per cent annually over the past 30 years to just 0.7 per cent annually over the past 5 years. Noting this rate is higher than all the G7 countries.

There is no single explanation for the slower rate of productivity growth, and we are unsure of how much of the current slowing is cyclical and how much is structural. This is an area of ongoing analysis and research in Treasury and elsewhere.

We do know that business investment is important to supporting productivity growth, with capital deepening – that is having more capital available for each worker — accounting for around ⅔ of labour productivity over the past 30 years in Australia.

Given historically low interest rates around the world it is somewhat of a puzzle that business investment has not grown faster. Partly this could reflect that the rates of return businesses use when looking at the viability of new opportunities, so called 'hurdle rates', have remained high despite lower interest rates. The currently uncertainties surrounding the global economy and significant technological advancements may be contributing to this.

Structural factors may also be at play — it is not clear what business investment looks like in a world where more than two-thirds of our economy is now services based.

Another issue in the Australian context is also one shared globally. In Australia, as elsewhere, inflation rates have remained subdued. In part this is related to slower wage growth, which has been slower than forecasters around the world expected. And while no-one has come up with a complete explanation, there are a range of explanations that go some way to shedding light on the phenomenon.

One factor that may be affecting the relationship between unemployment and wage growth in Australia is that the traditional relationship between spare capacity in the labour market and the unemployment rate may be changing. One tangible way we can see this is that the rate of underemployment, which typically moves with the unemployment rate, has not declined to the same extent as the unemployment rate in this cycle as it has in the past.

A number of other long-running changes in the labour market may also be affecting the relationship between unemployment and wage growth. An increasing concentration of economic activity in services industries, the effects of demographic and technological change and globalisation may also have played a role. Ultimately, it is difficult to draw firm conclusions on the effect of these structural factors on wage growth, given these factors have been occurring over a long timeframe and yet slow wage growth globally is a more recent phenomenon.

With these uncertainties in mind, the pace of the pick-up in wage growth, and its relationship to the labour market, is likely to continue to be different than in previous economic cycles.

FISCAL OUTLOOK

Turning now to the fiscal outlook, last month the Government released the 2018-19 Final Budget Outcome. This showed the Budget was broadly balanced, with an underlying cash deficit of $690 million. This was an improvement of $13.8 billion compared with the estimate at the time of the 2018-19 Budget.

In the light of discussions at the IMF Annual Meetings, which I attended last week, on fiscal stance and its impact on growth, I thought it may be useful to make a couple of remarks about the interaction of medium term fiscal frameworks, discretionary fiscal actions, and structural reforms.

Medium-term fiscal frameworks are designed to deliver sustainable patterns of taxation and government spending. As is the case in Australia, they usually also look to minimise the need for taxation.

Medium-term fiscal frameworks reflect an assessment that apparent short term economic weakness or unsustainably strong growth are best responded to by monetary policy. Within a medium fiscal term framework, automatic fiscal movements will still assist in stabilising the economy. For example, revenues will weaken and payments strengthen when an economy experiences weakness - these automatic movements are called automatic stabilisers. Allowing these automatic stabilisers to work is entirely consistent with a medium term fiscal objective.

In an open economy such as Australia's, a medium-term fiscal framework in concert with a medium term monetary policy objective has long been held to be the most effective way to manage the economy through cycles.

In periods of crisis, there is a case for further temporary fiscal actions. It is important to consider separately broader policy objectives and temporary responses to crisis, as confusing these objectives can lead to unintended consequences. The circumstances or crisis that would warrant temporary fiscal responses are uncommon.

The case for structural reform is ever present. Improvements in employment and wages, and in the profitability of businesses are the most obvious and important drivers of this case. The most important long term contribution to wage growth is labour productivity.

The presence of weak global and domestic growth, low interest rates, and heightened global trade and geopolitical tensions, has elicited a discussion of fiscal responses and structural reform and an interweaving of the two issues.

For example, calls for additional infrastructure expenditure as part of supply side or structural reform and to assist in stimulating the economy sound straight forward but in practice are difficult to achieve. The timing requirements of fiscal stimulus are hard to give effect to while ensuring large projects are well planned and executed, and cost and capacity pressures are managed. There are some opportunities though, usually related to smaller

projects and maintenance expenditure. The Commonwealth and State Governments are currently actively exploring these opportunities.

In developing policy we need to be mindful of the particular circumstances present in the economy. A feature of the current weakness in the global and domestic economy is heightened uncertainty among consumers and businesses.

Given this uncertainty, medium term fiscal and monetary policy frameworks can play an important role in contributing to a stable and predictable environment that is supportive of growth.

ORGANISATIONAL PRIORITIES

Before finishing up and moving onto questions, I would like to briefly take the opportunity to highlight to the Committee some of the current organisational priorities for Treasury.

The Council on Federal Financial Relations recently agreed a program of work to boost Australia's productivity in the areas of transport, health, skills and environmental regulation. Treasurers also agreed to continue work on the areas identified by the Productivity Commission in its *Shifting the Dial* report. This work will complement existing Australian Government initiatives to boost productivity through public infrastructure investment and reforms to vocational education, health, and regulation.

An important part of the Government's regulatory reform and productivity agenda is the Deregulation Taskforce. The role of the taskforce is to identify and remove unnecessary regulatory barriers to investment, job creation and economic growth. Initial areas of focus announced in September include: reducing the regulatory burden for food manufacturers who want to export; getting major infrastructure projects up and running sooner; and making it easier for sole traders and micro businesses to employ their first person.

Just as one example of why this is important, the taskforce has found that food manufacturers currently have to deal with approximately 200 pieces of legislation administered by 30 different agencies governing the movement of goods in and out of Australia, as well as multiple audit requirements, duplicated certification and a lack of recognition of prior compliance.

Within Macroeconomic Group, a new Centre for Population was established on 1 July 2019 and formally launched by the Minister for Population, Cities and Urban Infrastructure on the 4th of October 2019. The aim of the new Centre is to provide a central, consistent and expert perspective on population issues, which will help all levels of government understand population changes right across Australia, and how to plan for those changes into the future. The Centre will release an annual National Population Statement, the first of which will be released in 2020.

In Markets Group, the Financial Services Reform Taskforce Division is working closely with our law design and retirement income teams as well as with ASIC, APRA, the Office of Parliamentary Counsel and other key stakeholders to implement the recommendations of the Royal Commission into financial services. Implementing these recommendations will dominate Treasury's legislative program to at least next year.

As recommended by the Productivity Commission, the Government announced in late September a review of the retirement income system. The review, which will cover the current state of the system and how it will perform in the future as Australians live longer and the population ages, will be conducted by an independent three-person panel. This panel will be chaired by Mr Michael Callaghan and includes Ms Carolyn Kay and Dr Deborah Ralston as panel members, with Treasury providing secretariat support to the panel from within Fiscal Group. A consultation paper is scheduled for release in November this year, ahead of a final report to Government by June 2020.

These major pieces of work take place alongside Treasury's ongoing priorities, which in coming months will include preparing the 2019-20 MYEFO that will include an update of the economic and fiscal outlook.

Thank you for the opportunity to provide this update.