

OPENING STATEMENT TO THE SENATE STANDING COMMITTEE ON ECONOMICS

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The floods in Queensland, New South Wales, Victoria and Tasmania and cyclone Yasi have had a material impact on Australia's near term economic outlook. These opening remarks seek to explain Treasury's current estimates of the impact of these natural disasters on both economic growth and consumer prices.

Economic Growth

Based on the latest available information, Treasury estimates that the combined impact of the floods and cyclone Yasi will be to reduce real GDP growth by around ½ a percentage point in 2010-11, with the resumption of economic activity and reconstruction expected to add about ¼ of a percentage point to real GDP growth in 2011-12. The largest negative impact on economic activity should be recorded in the March quarter 2011, which could leave overall growth in that quarter flat or possibly slightly negative. While it's too early to assess accurately the impact of cyclone Carlos, initial reports suggest the disruption to economic activity is small relative to those from the other extreme weather events.

To estimate the impact of the floods and cyclone Yasi on real GDP, Treasury relied on the production-side of the National Accounts, with the primary information source being industry estimates of lost production. Where these were not available, Treasury estimated these production losses on the basis of reports of the geographic extent, duration and severity of flooding and cyclonic activity.

Coal and other non-rural commodity exports

The greatest estimated impact on real GDP is as a consequence of the interruption to Queensland coal production and exports caused by the floods. The direct impact of heavy rains from December on coal production is estimated at 19 million tonnes (valued at \$4.8 billion at pre-flood prices), with cyclone Yasi causing an additional \$200 million loss of non-rural commodity exports.

The impact on coal export earnings will be less than this because of the related increase in global coal prices. Most Australian coal is sold on contract. Nonetheless, it is illustrative to look at recent movements in the spot market, where prices for thermal coal rose 9 per cent in January and for metallurgical coal 38 per cent. While spot prices for both types of coal have since moderated, they remain above pre-flood levels.

The main coal freight lines affected by the floods were the Blackwater and West Moreton lines, together transporting around a third of Queensland's coal exports to port. The Blackwater Line was out of operation for around three weeks and continues to operate below full capacity, while the smaller West Moreton Line remains closed. We understand that neither rail line will be fully operational for some months.

A key uncertainty is when the coal mines in the flood-affected regions will return to full production, with some mines still inundated with water. Recent information though suggests that most of the major coal mines in the region will return to full production before the start of the June quarter.

While the main areas of destruction caused by cyclone Yasi were north of Queensland's major coal mining region, it nevertheless caused the closure of the Dalrymple Bay, Hay Point and Abbott Point coal terminals for around 3 days. The cyclone also temporarily halted transportation of base metals and metal ores, including from the Mount Isa region.

Agriculture

Treasury's estimate for lost agricultural production from the floods is \$1.2 billion, with the additional production loss due to cyclone Yasi estimated to be around \$½ billion. These estimates are broadly consistent with those produced by ABARES, state treasuries and industry organisations.

The January floods mainly affected cotton, vegetable and fruit production, accounting for around 45 per cent of the flood-related losses. Other crops adversely affected by the floods include sugar and grains. Cyclone Yasi had a significant impact on tropical fruit production and has caused additional destruction of Queensland sugar cane, with 87 per cent of Australia's banana supply and approximately a third of Australia's sugar crop produced in the region crossed by the cyclone.

Tourism

Lost value added in the tourism industry is estimated to be around \$400 million, with around three quarters of this due to flooding and the rest attributable to the cyclone. This estimate represents the direct loss of tourism business in the affected regions and therefore does not capture the impact of any diversion of travel to other parts of Australia or overseas.

Reconstruction

The secondary impacts of the floods and cyclone Yasi are expected to add to GDP as assets destroyed by the disasters are replaced. The estimated addition to demand includes the replacement of around 1,000 homes, with a further 6,000 requiring some form of refit and lesser repairs required to another 37,000 (although some of this repair work does not add to GDP, because of the treatment of home repairs in the National Accounts). The bulk of reconstruction spending though will be on replacement and repair of publicly owned assets, such as roads and bridges. For the floods, the Commonwealth Government's contribution to the recovery effort is estimated at \$5.6 billion, of which more than two thirds relates to the restoration of public infrastructure. The Queensland Government has also released preliminary estimates suggesting that the additional restoration and recovery costs from cyclone Yasi could be in the order of \$800 million.

With the economy approaching full employment, it is likely that the increase in economic activity associated with reconstruction and repair will be partly offset by a reduction in other building. The pressure created by reconstruction spending on the real economy will also be reduced by the Commonwealth Government's decision to introduce a flood levy and finance a substantial part of its contribution to the rebuilding of public infrastructure through expenditure cuts and the deferral of infrastructure spending.

Consumer Prices

The floods and cyclone Yasi are expected to add around ½ a percentage point, maybe a little more, to the consumer price index (CPI) in the March quarter 2011. This spike in consumer prices is expected to unwind over future quarters as the supply of fresh produce recovers.

To estimate the impact on consumer prices, Treasury analysed the effects of comparable flood and cyclone events with similar impacts on the agricultural regions affected, using the current expenditure weights of the CPI. Based on this analysis and recent observed price movements, fruit and vegetable prices are expected to increase significantly in the March quarter of 2011, with a broad range of crops affected, including bananas, eggplant, capsicum, beans, grapes and potatoes.

Implications for the Economic Outlook

Although the floods and cyclone Yasi will have significant effects on real economic activity and consumer prices in the short term, they have not materially altered Australia's economic outlook beyond the next couple of quarters.

With the terms of trade at record highs, the outlook continues to be underpinned by strong business investment intentions, particularly in the resources sector. The floods and cyclone had very little impact on the large projects currently under way, and have not altered our expectations for projects that are now under consideration. Indeed, the second of the four large LNG projects planned for Gladstone received a final decision for the \$16 billion US dollar investment in the same week that floods were peaking in other parts of Queensland.

I am sure that Committee members will have many questions for us and we are happy to take them now.

