Opening Statement to the Economics Legislation Committee

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Secretary to the Treasury

Thank you for the opportunity to make an opening statement.

International economic conditions

The global economy continues to face headwinds. While growth in the United States remains strong, growth in other advanced economies has been weak. In its most recent update, the IMF upgraded its expectation for growth in the United States this year by 0.5 percentage points to 2.7 per cent, reflecting supportive financial conditions and wealth effects from stronger equity prices. In contrast, conditions in the euro area are softer, particularly in Germany, where conditions in the manufacturing sector have been challenging. Political and policy uncertainty is also weighing on growth in the euro area.

China's economy expanded by 5 per cent last year. Chinese export growth was stronger than anticipated. In part, this reflects some firms in the United States bringing forward orders in advance of expected increases in tariffs under the new Trump Administration. We expect growth to ease this year, as the structural weakness in the Chinese property sector continues alongside weak consumer demand.

Global disinflation has continued, although it seems to have stalled in some economies. Much of the disinflation experienced so far has been driven by declining inflation in goods prices. The disinflation in goods prices reflects the normalisation of supply chains following the disruptions through the pandemic and the decline in energy prices following the surge induced by the Russian invasion of Ukraine. In contrast, prices for services have continued growing relatively quickly in some economies.

The escalation in trade tensions is creating significant global policy uncertainty. This may dampen business investment, including in Australia, which will pose risks to both growth and employment.

Domestic economic conditions

The Australian economy grew by 0.8 per cent over the year to the September quarter. Weaker economic conditions among some trading partners resulted in weaker exports of commodities and some services. Private demand contributed around half of a percentage point to growth.

Household consumption has been soft as a result of cost-of-living pressures, interest rate settings and declining real household incomes. More recently, we have observed that household disposable incomes have begun to grow again and data for the December quarter suggest that growth in household spending has lifted alongside consumer confidence. In the Mid-Year Economic and Fiscal Outlook (MYEFO), household consumption was expected to increase by 1 per cent in 2024–25 and 2 per cent in 2025–26.

There is uncertainty regarding the speed and timing of the response of consumption to higher disposable incomes. Households had earlier reduced their rate of savings to deal with cost-of-living pressures. More recently they have begun to increase this rate. It may take longer than expected for households to build their savings buffers to a point where they feel confident to increase spending.

We have seen the beginning of a recovery in dwelling investment. Construction of new dwellings has been facing significant capacity constraints. Supply disruptions had caused a rapid increase in the prices of building materials. Difficulty finding skilled labour and tighter financial conditions were also factors constraining the building of new dwellings.

More recently, with supply having normalised, inflation in the cost of building materials has eased, and in some cases, prices have fallen. Labour constraints, while still present, are also beginning to ease. This is reflected in recent inflation outcomes where inflation in the price of new dwellings for owner occupiers has fallen significantly. Through last year, dwelling approvals increased and are now at levels similar to those immediately prior to the pandemic.

New public final demand grew by 4.3 per cent over the year to the September quarter. This strength reflected spending on demand-driven programs, such as Medicare, as well as state and Commonwealth electricity rebates. In the September quarter, public investment was particularly strong. This was largely due to spending on defence equipment, and increased activity in major road and renewable energy projects.

Business investment expanded by 1.5 per cent over the year to the September quarter. Business investment in the non-mining sector grew by 5.4 per cent. Business has looked to add capital as it has added new workers. This has prompted investment in new machinery and equipment, computer software and AI, renewable energy projects and data centres. In contrast mining investment contracted by 10.3 per cent over the same period, reflecting a weaker outlook for the commodity sector. We expect business investment to slow over the coming year as major mining projects reach completion and the momentum in non-dwelling construction slows.

Below-average global growth and, in particular, lower growth in the Chinese economy has affected demand for Australia's mining exports. This weakness has been reflected in volumes and prices. Since the start of 2024, iron ore prices have declined by 23 per cent, while metallurgical coal prices have declined by 43 per cent. We expect demand for commodities to remain weak, given the outlook for China.

Inflation

In the December quarter 2024, inflation moderated to 2.4 per cent. Measures of underlying inflation suggest that there has been a broad easing of inflationary pressures. Trimmed mean inflation eased to 3.2 per cent over the year to the December quarter.

Much of the easing in inflation, until recently, reflected disinflation in goods prices. Services inflation, which had tended to be more persistent, has begun to decline. Rent inflation has fallen a little faster than we had been expecting. We have also passed the peak in insurance inflation. Growth in insurance premiums moderated for house, home contents and motor vehicle insurance as a result of easing reinsurance, replacement and repair costs.

Population

Net overseas migration (NOM) peaked in 2022–23 and is expected to continue to decline over the forward estimates. Thus far, the reduction in NOM has been driven by declining migrant arrivals, in line with what was expected in our Budget forecasts. However, departures continue to be lower reflecting our relatively strong labour market. Overall, population growth peaked at 2.5 per cent in the September quarter 2023 and fell to 2.1 per cent over the year to the June quarter 2024.

Labour market

The labour market has remained strong despite the slowdown in economic activity. Employment growth has been robust and the participation rate and employment to population ratio are at record highs. The unemployment rate has risen from its post-pandemic trough of 3.4 per cent and has remained around 4 per cent in recent months.

The unemployment rate has not risen as much as would have been expected given the historical relationship with economic activity. Going into the most recent period of the economy slowing, the number of vacancies per unemployed person was around record highs. This meant the economy began slowing while job seekers still had greater opportunities to find jobs. As the economy slowed, vacancies were being filled faster than new vacancies were being created, which has helped sustain strong employment growth and kept the unemployment rate low.

Nominal wage growth has been supported by generally tighter labour market conditions. The Wage Price Index (WPI) grew by 3.2 per cent over the year to the December quarter 2024. With inflation normalising and unemployment steady, we expect wage growth to remain around this rate in the near term.

Financial markets

The Australian dollar has depreciated against the US dollar over the past four months, as have many other currencies, and is trading at the lower end of the range it has traded in over the past ten years. On a trade-weighted basis, the Australian dollar has depreciated by half as much as it has against the US dollar.

The depreciation in the Australian dollar late last year reflected a repricing of the US dollar after the Federal Reserve communicated some caution around future easing in monetary policy. Investors have also responded to the policy agenda of President Trump by seeking out higher risk US investment assets. This has been reflected in recent increases in global bond yields, as investors react to the pro-business policy agenda of the Trump Administration. These investment inflows into the US have added to demand for US dollars, which has put pressure on a broader range of currencies, including the Australian dollar.

Australia's trade exposure to China has also placed some pressure on the Australian dollar. The prospect of US tariffs on Chinese exports have exacerbated existing concerns about how weak Chinese domestic demand, and the ongoing property downturn in China, could flow through to already weak Chinese demand for Australian exports.

The flexible exchange rate is an important institutional feature of our economy. When there are adverse global shocks, the depreciation in the Australian dollar helps cushion the full effect of global events on the Australian economy.

Recent trade tensions

The use of tariffs, trade restrictions and subsidies has become more common and widespread in recent years. According to the IMF, restrictions on investment and the trade of goods and services have grown sixfold over the past 15 years.

It is not new for countries to put restrictions on trade and investment for important, but limited, national security reasons. Export controls are in place for weapons or new technologies. Scrutiny is placed on foreign investment in critical infrastructure and systems that are vital to the operation of the economy for similar reasons.

Nonetheless, when it comes to the use of tariffs more broadly, for a medium-sized economy such as Australia, there is overwhelming evidence that the use of trade restrictions imposes costs on our consumers and businesses.

Tariffs directly increase the prices businesses and consumers pay for imported goods. Many of these goods are used as inputs into the production of other goods and services. Ultimately, tariffs can push up a broader set of prices across the economy and reduce economic growth. If Australia were to impose tariffs, we would bear nearly all the cost given our size and inability to affect the world prices of the goods we import.

Cutting tariffs has provided substantial benefits to the Australian economy. Firms in sectors that are more trade exposed are typically the most productive in an economy because these firms face more intense competition, so they need to keep finding ways to remain competitive by innovating and finding productivity improvements. Firms that are protected by tariffs have less incentive to compete, which reduces their need to drive productivity improvements.

Even small tariffs create inefficiencies and costs for businesses and ultimately higher prices for consumers. In this light, the Government's 2024-25 Budget reforms to abolish around 500 nuisance tariffs will lower costs and contribute to productivity.

It is important that, should trade tensions escalate around the world, Australia's response is responsible, rigorous and effective, even if tariffs are applied to our exports. It will seem counter intuitive to many but responding to tariffs or trade restrictions with similar measures will only make matters worse.

Australia has already shown how to respond successfully to trade restrictions. We took a well calibrated approach when China imposed restrictions on Australian exports of barley, coal, wine, and lobster, among other goods. Producers in the targeted industries were adversely affected, but governments did not compound the economic cost by implementing retaliatory tariffs or barriers that would have harmed Australian consumers and businesses.

And in many cases our exporters found alternative markets. In the case of barley, by 2022, Australia accounted for 95 per cent of Mexico's imports of barley. We also increased our exports of barley with other parts of Latin America, and coal exports with Southeast Asia.

Australia's diplomatic engagement with China was subsequently successful in having the restrictions lifted. Trading has resumed in all markets and importantly Australia has not compromised its principles.

Part of setting Australia up for success in an increasingly uncertain global economy is making sure we do not cut ourselves off from the world. But there are things we can do at home to build our resilience including implementing and maintaining policies that underpin our market-based economy, and ensuring fiscal policy is sustainable while investing appropriately in our defence and security. As a medium-sized open economy, a trading nation, this will ensure we are best placed to weather any major global shocks.

Thank you for the opportunity to provide this opening statement.