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Introduction

Good morning. It's a privilege to be appearing here today as the Treasury Secretary, leading an organisation that I have always held in high regard.

While this is my first Senate Estimates opening appearance, I will follow previous practice and speak about global and domestic economic conditions and risks, as well as the budget and fiscal outlook.

Global economic conditions

Let me begin with the global economy.

The May Budget noted that global growth exceeded expectations in 2017, with the global economic cycle better synchronised than it had been for some time.

Nevertheless, global growth has been weaker than expected in early 2018 and has become less synchronised, a view highlighted by the International Monetary Fund in its World Economic Outlook released earlier this month.

Amongst the major advanced economies, significant fiscal stimulus has helped boost growth in the United States in 2018 and strong growth is forecast in the near term. On the other hand, euro area growth was subdued in the first half of the year, while the Japanese economy rebounded in the second quarter of 2018 after experiencing a contraction in the first quarter.

Consistent with the largely favourable global economic conditions, unemployment rates in the United States, euro area and Japan are now at or below estimated full-employment rates. Most notably, the unemployment rate in the United States is now at its lowest in almost 50 years, while in other key economies, such as Japan, Germany and the United Kingdom, unemployment rates are near decade lows.

This suggests that spare capacity in the labour market, which has persisted since the Global Financial Crisis, is being absorbed. There are also some signs of a rise in core inflation in some economies, most notably the United States.

The Chinese economy has moderated somewhat this year, but it is important to note that this is in line with expectations, as authorities have continued their emphasis on deleveraging and rebalancing the Chinese economy.

Amongst other emerging market economies, India recorded strong growth in the first half of 2018 and growth within the ASEAN-5 economies of Indonesia, Malaysia, the Philippines, Thailand and Vietnam, remains broadly based. Growth in our major trading partners remains healthy.

Risks to the global outlook

The strength in the global economy is not without risks. These risks have intensified since the Budget, most notably surrounding trade tensions. Other risks include emerging economy debt, financial market volatility, and a faster-than-expected tightening of monetary policy in advanced economies.

As a result of downside risks being more pronounced or having partially materialised, the IMF recently downgraded its outlook for global growth. The IMF specifically referred to trade measures as a reason for downgrading forecasts for not only the United States and China, but also Australia and South Korea.

Understandably, global trade policy is a key area of focus for Australia and we are monitoring the increasing uncertainty and unpredictability. The US has imposed tariffs on a range of countries, with President Trump last month announcing tariffs on a further US$200 billion of imports from China. A number of countries, including China, have chosen to retaliate, further escalating trade tensions. To date, tariffs arising from recent trade tensions cover just more than 2 per cent of world trade.

While there has been some recent slowing in global trade growth, it is difficult to determine how much of this reflects trade tensions as opposed to other factors. Nevertheless, the potential for further escalation remains and this could negatively impact global growth, especially if confidence is affected.

Another key risk to the global economy is the ongoing pressure that emerging market economies face as major central banks continue to normalise monetary policy.

A modest tightening in global financial conditions is already exposing vulnerabilities across a range of emerging market economies. Amongst the worst affected in recent months are Argentina and Turkey, with the IMF stepping in to support Argentina with a US$50 billion package. The IMF Board will shortly consider increasing this to US$57 billion – the biggest in IMF history.

In recent weeks we have also seen financial market volatility increase in major advanced economies amid an accumulation of concerns, including the issues I have highlighted with respect to monetary policy normalisation and trade tensions.

To date, key Asian emerging markets have remained relatively resilient to the recent volatility in global financial markets, but continual tightening in global financial conditions and the recent increase in the oil price could expose further vulnerabilities.

Over the longer term, broad structural challenges, including demographic change and slower productivity growth, may continue to weigh on the global outlook.

Domestic economic conditions

Moving now to the domestic economy, overall economic conditions have evolved broadly in line with the May Budget forecasts.

There have been two strong quarters of growth released since Budget. As a result, real GDP grew by 2.9 per cent in 2017-18 – slightly stronger than the 2¾ per cent growth forecast at Budget. The recent National Accounts data confirmed the strength already evident in employment data and tax collections.

2017-18 marked Australia's 27th consecutive year of annual economic growth. This is quite an achievement given major economic events during that period, including both the Asian and Global Financial Crises, the decline in the terms of trade of around one-third from its peak in 2011 to its trough in 2016, and the 6 percentage point fall in mining investment as a share of nominal GDP.

Household consumption, public final demand and new business investment all contributed to growth in 2017-18. Despite continued growth in mining and services exports, net exports detracted from growth, partly as a result of an increase in capital imports, linked to the strong growth in business investment.

While still too early to say definitively, the unwinding of the mining investment boom and its associated drag on the economy increasingly appears to have run its course. Business investment grew for the first time in five years and mining business investment picked up in the June quarter with firms investing in machinery and equipment and resource exploration.

Growth in non-mining business investment is consistent with positive results in surveys of business conditions and confidence. While these measures have softened in recent months, over the past year or so business conditions have been around their strongest level since before the Global Financial Crisis and business confidence has generally been above average over the past two years.

There was also an improvement in consumer confidence in 2017-18, coinciding with a strengthening labour market. With income growth expected to pick-up gradually, household consumption is expected to continue to support economic growth. As growth in consumption is likely to continue to outpace income growth in 2018-19, the household saving rate is expected to decline further.

Public final demand was the second largest contributor to real GDP growth in 2017-18. State and local investment grew strongly, driven by infrastructure investment programs. Through Treasury's business liaison program we are hearing that private businesses working on these projects are also investing in new machinery and equipment, further contributing to economic growth.

Exports continue to be supported by the expansion of the mining industry, as key projects ramp-up to full production. Just this month one of Australia's largest liquefied natural gas projects, Inpex's Ichthys project, exported its first shipment of condensate from northern Australia following around A$50 billion of investment in the project.

The labour market too has been a good news story over the past year with the unemployment rate falling to 5.0 per cent in the most recent release for the month of September. This is its lowest level since April 2012. While care should be taken with monthly reads, the unemployment rate has been declining since late 2014.

Pleasingly the underemployment rate, the measure of employed people wanting to work more hours as a share of the labour force, has also fallen.

Following the creation of almost 350,000 jobs in 2017-18, job growth has continued into 2018-19, albeit at a slightly slower pace, with employment increasing by more than 45,000 people in the three months to September.

Strong employment growth has been accompanied by a rise in the participation rate, which remains elevated at 65.4 per cent. Higher participation is consistent with a strong labour market as more Australians are encouraged into the labour force by improved job prospects.

Despite the tightening labour market, wage growth and inflation continue to be subdued by historical standards. And while wage growth and inflation were consistent with the May Budget forecasts, momentum has so far been a little weaker than would usually be expected at this stage of the economic cycle.

Wage growth and inflation are expected to pick-up as economic and labour market conditions continue to be strong.

A tightening labour market is also consistent with what we are hearing through Treasury's business liaison program about skills shortages in certain sectors, such as IT and construction.

Prices for key commodities on the other hand have generally been higher than was prudently assumed at Budget. Combined with the stronger-than-expected real GDP growth, this meant that nominal GDP growth in 2017-18 was above the Budget forecast. Higher commodity prices also resulted in mining profits increasing by 17.8 per cent in 2017-18.

Risks to the domestic outlook

Drought is a challenging fact of life for Australian farmers and its impact on the agricultural sector is a downside risk to the domestic economy that has emerged since Budget.

With dry seasonal conditions across south-east Australia, and much of New South Wales and Queensland experiencing well-below-average rainfall, it is likely that farm production and rural exports will be negatively affected.

Last month the Australian Bureau of Agricultural and Resource Economics and Sciences (ABARES) released its latest forecast for 2018-19 and downgraded the winter crop outlook. This forecast still remains dependent on timely rainfall to support crop development through spring.

Fortunately, we have had some welcome rainfall in recent weeks. However, the Bureau of Meteorology recently noted that 'while some parts of New South Wales and south-eastern Queensland have received very welcome rainfall in the first days of October, rainfall has been below average over much of eastern Australia for so long…that this rainfall event hasn't been enough to break the drought.".

The drought is playing out asymmetrically across the country. New South Wales and Queensland have been amongst the worst hit, with ABARES downgrading their winter crop forecast for these States. Parts of other States are also challenged by drought conditions.

On the other hand, Western Australia had experienced more favourable weather conditions and the State's Wheat Belt region was on track for a record winter crop. However, liaison by our Perth office suggests that recent frosts and a dry September may jeopardise this.

Another key risk to the domestic economy is the apparent tightening of credit conditions, which could constrain consumption and investment growth. There are a number of factors that are contributing to this tightening.

Interest rates in some wholesale funding markets have increased in recent months. Three of the big four banks have responded to these funding costs by raising rates on existing housing loans. Additionally, some business loans are priced off these wholesale rates and therefore some businesses have already experienced an increase in interest rates.

There is also some evidence of a modest tightening in lending standards by banks, which could be limiting access to credit for some borrowers who may previously have been able to borrow. This tightening could in part be a response to the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, but also likely reflects deliberate actions by the Australian Prudential Regulation Authority over recent years to improve lending standards in the financial sector. The Reserve Bank of Australia commented on these tightening lending standards in its recent Financial Stability Review.

Despite this modest tightening, I want to emphasise that financial conditions overall remain expansionary. Funding costs and interest rates generally remain low, total credit growth is around its recent average and competition amongst banks for new borrowers remains fierce.

Housing prices have recently softened from their peak, driven by declines in Sydney and Melbourne. This is unsurprising as it follows the steep increase in housing prices between late 2012 and 2017. And while housing construction picked up in the first half of 2018, this moderation in housing prices and a recent drop-off in approvals may lead to a gradual softening in activity. Nonetheless, levels of activity are expected to remain elevated.

State and Territory economic conditions

In addition to this national picture, I wanted to briefly share some insights into economic conditions across the States and Territories.

I met with my State and Territory counterparts prior to the recent meeting of the Council on Federal Financial Relations and it was pleasing to hear most States and Territories reporting strong or improving economic conditions.

Despite the moderation in the Melbourne and Sydney housing markets and the drought that I mentioned earlier, New South Wales and Victoria still continue to grow strongly.

In addition, the Western Australian economy appears to be improving off the back of some strengthening in the mining sector. Not only is mining investment picking up in order to maintain production capacity of iron ore and liquefied natural gas, but there are also new projects, in particular for lithium, which will support markets for battery manufacturing.

Queensland, South Australia, Tasmania and the Australian Capital Territory all reported sound economic conditions.

The Northern Territory economy continues to bear the brunt of the winding down of construction on the Inpex Ichthys liquefied natural gas project as it moves into its production phase.

The messages I received from my State colleagues correspond with what we are hearing through Treasury’s ongoing business liaison discussions, including through our State offices, and what we are seeing in the economic data.

Budget update and fiscal outlook

Moving on to the budget and fiscal outlook, the May Budget included a continued improvement in the fiscal position and brought forward a projected return to balance to 2019-20, with sustainable surpluses projected from 2020-21. This was the 6th Budget update to project surpluses from 2020-21.

The 2017-18 Final Budget Outcome last month confirmed a better than expected outcome for that year. At $10.1 billion, just 0.6 per cent of GDP, the underlying cash deficit is at its smallest since the Global Financial Crisis. Compared to the 2017-18 Budget, receipts came in higher than expected, while cash payments were lower.

Monthly financial statements for the first few months of 2018-19 were recently released and while care should be taken interpreting monthly reads, they suggest improvements are continuing into 2018-19, particularly for individual and company income tax receipts.

These early signs are promising, but the full update to the economic and fiscal forecasts will be in the Mid-Year Economic and Fiscal Outlook.

While recent outcomes add confidence about the fiscal outlook, continued fiscal discipline remains critical. Continuing budget repair consistent with the fiscal strategy is key to ensuring that debt turns around and Australia is adequately prepared should there be any adverse surprises in the domestic or global economic outlook.

Standard and Poor’s recognised the improvement in the Government’s budget position and acknowledged the Government’s “ongoing, repeated commitment to fiscal consolidation” and “successive budgets that have aimed to restrain spending and raise revenues demonstrate this commitment”.

The tangible result was that Standard and Poor’s reaffirmed Australia’s AAA credit rating last month and revised their outlook for Australia from negative to stable. Australians should be proud that our country is currently one of only ten in the world to have a ‘AAA’ or equivalent rating from all three major credit rating agencies.

Royal Commission

Unfortunately, there is no pride to be taken in the conclusions of the Interim Report of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry.

Treasury has supported the work of the Royal Commission by providing, at the Commission's request, background papers ahead of the hearings. Treasury has also made submissions to the Commission following the hearings into financial advice, small business lending, superannuation, and on key policy issues. Submissions will also be made on the Interim Report and insurance.

The Interim Report recognises the central role of sound and resilient banks and the importance of the financial system to the Australian economy. It is, however, rightly critical of some of the players in that sector. Conduct was found, too often, to have failed to meet community standards. Too often personal interests or gain was put before the interests of customers, and legal compliance has been used as an excuse for not doing what is right.

Many of the problems highlighted by case studies related to occurrences several years ago. Many of the issues are already being addressed either by the market, the regulators, or the Government. But it is clear that once the Royal Commission hands down its Final Report, due by 1 February, that there will be more work to do. As well as raising a wide number of policy issues, the Interim Report has also put on the table the need for simplification of the law.

Treasury has already established a dedicated Taskforce to support the Government in addressing major issues arising from the Commission, including questions raised in the Interim Report. Expressions of interest in joining the Taskforce were sought internally on 19 September and it started on 11 October. In addition to providing advice to the Government ahead of and following the Commission's Final Report, the Taskforce will be responsible for developing a plan to implement the reform agenda that follows.

This is clearly an important body of work and ongoing resourcing will be sought in the usual way.

Conclusion

I will conclude by re-iterating it is a privilege to be the Treasury Secretary.

I started on the first of August and pay tribute to John Fraser, my predecessor, for his achievements as Secretary.

Using the results of the 2018 APS Census as an indicator, Treasury improved on many measures compared to the 2017 Census including:

- Workplace diversity – 75 per cent of respondents believe Treasury is committed to creating a diverse workforce, up by 11 points from last year. Respondents rated our commitment to Indigenous employment 18 points higher than in 2017
- How we develop and engage our staff – an increase by 10 points from 2017 in staff who believe their manager openly demonstrates a commitment to performance management and development
- Recognition for innovation – an increase by 5 points from 2017 in respondents who believe employees are recognised for coming up with new and innovative ways of working
- Our overall engagement score remains high, with 89 per cent of staff saying they are proud to work at Treasury, a score which is 17 points higher than the APS average

These provide a good indication of the impacts in Treasury during John's leadership. I too aspire to leading Treasury to new heights and to continue to deliver excellent analysis and advice to government by the smart and hardworking individuals who comprise our staff.