

Senate estimates – Economics committee

Opening statement

The global economy continues to struggle to regain sustained momentum. Overnight, equity markets outside of the US fell again. Ongoing weakness in oil and other industrial commodity prices has resulted in falls in related stocks. But financial stocks have been amongst the weakest in major equity markets in recent days as concerns about negative spill overs from credit market developments to banks increasingly come to the fore. Safe haven demand has seen government bond yields in the major economies retreat. The Australian dollar has remained relatively resilient in the face of this financial market volatility.

Economic growth remains uneven and well short of the average rates before the global financial crisis.

Advanced economies are recovering. But progress has been patchy. The United States continues to provide some impetus to global growth. Though, even here, there are some concerns about the impact of a stronger US dollar and a difficult global environment on their outlook. Expectations for the euro area and Japan have improved, although questions remain about how robust and sustainable these recoveries will be.

Emerging market economies, which have driven global growth for more than a decade, are slowing. This is partly driven by Brazil and Russia, which are experiencing significant economic distress and creating spill overs to their respective neighbours.

Growth is also slowing in the South-East Asian region, which has lost some momentum due to weak global demand and slower trade.

The IMF's January Update to the World Economic Outlook contained a further downgrade to global growth forecasts, the seventeenth such downgrade in five years. The downgrade was 0.2 percentage points in both 2016 and 2017 largely reflecting a weaker outlook for Brazil and some steadying in growth in the United States.

The 2015-16 MYEFO forecasts also contained a downward revision to global growth forecasts. This is consistent with subsequent downward revisions by the IMF and the OECD. Despite the revisions, global growth is still forecast to accelerate to 3½ per cent in 2016 and 3¾ per cent in 2017, up from an estimate of 3 per cent in 2015. Australia's major trading partner growth is also expected to continue to exceed global growth at 4 per cent in 2015, 2016 and 2017.

The global economy is being affected by some significant global transitions.

Foremost is the fundamental shift underway in the Chinese economy from investment-led growth to a greater reliance on consumption and services. Second, global commodity prices and particularly global energy prices continue to remain soft as the substantial increase in supply has been met by weaker demand. And third, there is the beginning of gradual normalisation in US monetary policy from near zero interest rates and the resulting divergence in monetary policy settings with accommodative monetary policy still prevalent in many economies.

Chinese authorities continue to pursue a more balanced and sustainable growth pattern with greater reliance on consumption and services.

In 2015, China's real GDP grew by 6.9 per cent. While this is the lowest annual growth rate in twenty-five years, it was in line with the Chinese government's target of 'around 7 per cent for 2015'. It is also in line with the MYEFO forecasts that GDP in China will grow by 6½ per cent in 2016, slowing to 6¼ per cent in 2017.

The Chinese government is expected to announce a GDP target for 2016 at the National People's Congress in March and has recently renewed its commitment to doubling GDP and doubling per capita income from 2010 levels by 2020. This would require an average growth rate of around 6.5 per cent a year for the next five years.

There has been continuing weakness in the traditional drivers of Chinese growth, with recent major data releases pointing to continued softening conditions in investment and industrial production. This is evident in the fall in the value of Chinese imports of around 8 per cent through the year to December 2015. While this partly reflects lower commodity prices, import growth has been negative since November 2014, although the rate of this fall has been moderating for the last few months. Export growth has also fallen slightly in US dollar terms, although yuan-denominated data showed growth in exports through the year to December.

Indications of the transition underway in the Chinese economy are the signs of strength outside the traditional drivers of the Chinese economy, with retail sales growing at around 11 per cent through the year and final consumption contributing

around two thirds of total GDP growth for 2015. Survey measures point to continued strength in the non-manufacturing sectors of the economy.

Also, it should be noted that while the Chinese stock market has been volatile, falls since mid-2015 reflect the reversal of large gains in the first half of 2015. Share prices remain above their level for most of 2014.

In January, the IMF indicated that while its forecast for China's growth remained unchanged, it now appears that the Chinese slowdown is having a greater impact on the rest of the world than previously expected. This partly reflects the change in composition in the Chinese economy, as it moves from construction and investment to a greater reliance on services and domestic consumption, which tend to be less import-intensive. The impact of China's transition is being felt in many economies, which are exposed to the slowing in Chinese investment and moderating growth of Chinese industrial production.

This is contributing to weaker global trade and putting downward pressure on commodity prices. Weaker growth in Chinese demand for raw materials is compounding the impact of an abundant supply of commodities such as oil, iron ore and coal, as seen in recent renewed weakness in a range of energy and industrial prices.

While lower commodity prices continue to drag on the economies of commodity exporters, including Australia, historically the global economy has tended to benefit from lower commodity prices.

The falls over the past year seem to have had a stronger than usual negative impact on some oil exporting countries and on exploration activity, with only a limited boost to activity in oil importing nations. Commodity price falls are still expected to have a positive impact on global activity, however questions remain about the likely size and timing of this boost.

Even within our own region, low commodity prices are having different impacts on exporters and importers. Among the ASEAN-5 economies, falls in commodity prices are contributing to a slowdown in Indonesia and Malaysia, while the Philippines, Thailand and Vietnam are benefitting.

The fall in energy prices over the past year is also continuing to suppress inflation globally. There is also significant spare capacity globally as a consequence of the lacklustre world recovery since the global financial crisis. Longer-term measures of inflation expectations in a number of major economies have fallen to relatively low levels, suggesting doubts remain about the prospects for strengthening global growth.

In the context of sustained low inflation, it is expected that monetary policy will remain accommodative for the next few years, even in countries where rates rise from historically low levels.

Markets continue to price in a much slower rate of future increases in interest rates than the US Fed itself has indicated. Uncertainty around the timing of future rises may trigger further market volatility and capital outflows, particularly from emerging market economies.

Emerging market economies have accumulated large amounts of debt in recent years and are most vulnerable to sudden shifts in market sentiment, such as changes in future expectations for US monetary policy.

As the US raises interest rates, investors may seek to shift their fixed income funds back to the US. First order impacts may include currency and financial asset depreciation, as well as additional scrutiny on the capacity of emerging economies to repay US dollar denominated government and corporate debt. Governments and businesses in emerging economies may find it more difficult to raise capital or to roll over existing debt.

Australia continues to push ahead in the face of these global headwinds.

As set out in the MYEFO, the outlook for the Australian economy remains positive and the economy is continuing to transition away from mining investment-led growth to broader-based drivers of economic activity.

Reports from the States and Territories indicate that activity remains strongest in New South Wales, Victoria, Tasmania, the Northern Territory and the Australian Capital Territory; is softer but still in line with expectations in Queensland; and is weakest in Western Australia and South Australia.

The winding down of the construction phase of the resources boom is unfolding broadly as expected and will continue to detract significantly from growth over the forward estimates. Mining sector activity is transitioning towards production and the economy is already benefitting from rapidly rising export volumes. This will continue as Australia's LNG export capacity comes online. Mining export volumes are expected

to increase 25 per cent over the next three years. This is on top of a 25 per cent rise in the preceding three years.

Commodity prices have responded sharply to the increases in supply from Australia and elsewhere.

Iron ore spot prices have fallen around a third since the 2015-16 Budget where it was assumed prices would remain at US\$48/tonne. They are currently in line with the MYEFO assumption of US\$39/tonne. Ongoing concerns over Chinese growth suggest volatility will continue to be a feature of the iron ore market. Still, Australian exporters are well placed. While prices fell steeply in 2015, the volumes of Australia's iron ore exports to China grew 10.8 per cent and are forecast to remain strong.

In addition to higher export volumes, the lower exchange rate has helped cushion the impact on mining revenues from falls in US dollar commodity prices. The exchange rate remains close to the MYEFO assumption of US72 cents.

The key development in commodities markets that affect Australia since MYEFO has been the fall in oil prices which have fallen by around one third with the Malaysian Tapis oil benchmark currently around US\$36/barrel.

Australia's burgeoning LNG sector is changing the way oil price movements impact on the Australian economy. The price received for Australia's LNG exports are contractually linked to the price of oil which together with Australia's crude oil exports is pushing Australia towards being a net exporter of oil and gas. This will fundamentally change the impact of oil price declines on Australia from being a net positive to a net negative development for the economy as a whole. If the LNG sector

folds out as expected, oil price declines will detract from the terms of trade and nominal GDP towards the end of the forward estimates.

Oil price declines are welcome developments for households and businesses that rely heavily on oil as an input cost. While fuel costs have not fallen as far as oil prices they have fallen. Petrol prices fell by around 6 per cent in the December quarter 2015 and have fallen another 8 per cent so far in the current quarter. This is providing some support to disposable incomes and household consumption while also lowering costs for businesses in the manufacturing and transport industries.

Consumption growth was solid in the September quarter 2015, increasing by 0.7 per cent. While growth in retail trade was flat in December 2015, this followed a number of strong months in the lead up to the Christmas period. Consumption is expected to improve, with the MYEFO forecast being for growth of 2¾ per cent in 2015-16 and 3 per cent in 2016-17.

The consumer is navigating a difficult environment. Volatility in global equity markets has seen consumer confidence fall below its long-run average after improving steadily towards the end of last year.

Additionally, house price growth has been moderating after three years of very strong growth. The slowdown is most evident in Sydney and Melbourne, where dwelling prices have appreciated the most over the current housing cycle. Auction clearance rates have also fallen from the peak of over 80 per cent in April 2015 to just below 60 per cent over recent months. Moderating price growth will provide less

impetus to household wealth and potentially lead some households to save more than expected.

Still, low interest rates and a solid pipeline of approvals and finance commitments are expected to support a continued contribution from dwelling investment to economic growth over the next few years.

The outlook for non-mining business investment is more subdued than forecast at Budget. The pace of the pickup in non-mining business investment remains a key source of uncertainty. Survey measures point to positive business conditions and confidence in the non-mining economy with profitability well above its long-run average. This is not a new development with business surveys picking up on these trends for much of the last 18 months. This provides me with some confidence that the transition underway will continue to improve.

The services sector is leading the way. Business investment in the services sector grew by around 5 per cent in 2014-15, the fastest growth in seven years. However, recent indicators suggest that conditions may have retraced some of these gains. While it is true that the services sector has a relatively low capital intensity, the services sector accounts for about 70 per cent of the Australian economy and historically makes up a much larger share of business investment than the mining industry.

There has been a strong rise in tourism which is clearly benefitting from the lower Australian dollar but also more fundamental factors owing to a rising middle class in Asia.

The transition in the economy from capital-intensive mining investment to labour-intensive services sectors is evident in the strength and composition of employment growth. The labour market has performed better than expected with employment growth of 2.6 per cent through the year to December 2015. Strong jobs growth in the services sector has helped drive the unemployment rate to 5.8 per cent - its lowest rate since October 2013. Importantly, the nation's youth have also benefited from improving labour market conditions with the youth unemployment rate falling sharply in recent months. While still too high, the youth unemployment rate decreased to 12.1 per cent in December 2015 and is now almost 2.5 percentage points lower than the peak in November 2014.

In regard to the fiscal outlook, nominal GDP is what matters for tax revenue. While the real GDP outlook is only somewhat weaker than Budget, falling commodity prices and moderate inflation led to significant write-downs in nominal GDP at MYEFO.

Modest inflation conditions are expected to continue in the near term. The recent falls in petrol prices will contribute to lower headline consumer price inflation. A gradual pick-up in inflation is expected with some tentative signs of the lower exchange rate passing through to domestic prices.

Wage growth in Australia has been moderate with firms looking to constrain costs.

In the medium term, it is the economy's ability to produce goods and services that will sustain growth. Rapid population growth in Australia stemming from strong net overseas migration has helped lift the economy's productive capacity over the past decade. This came on the back of our relatively strong economic performance and

low unemployment compared to other countries. But as economic growth has softened, recent net overseas migration outcomes have come in lower than expected, lowering expectations for population growth.

The MYEFO contained updated Treasury estimates of potential GDP in light of downward revisions to Australia's population and updated labour force data. Potential GDP growth is now estimated to be 2¾ per cent compared to 3 per cent in the Budget.

This underlines the need for productivity enhancing reforms such that growth in living standards can be maintained.

In summary, as it stands, the economy is on the track set out at MYEFO, but faces continuing global headwinds.