March 2017 Senate Estimates

Treasury Secretary's opening statement

Australia's economy continues to perform reasonably well as we transition away from the investment phase of the mining boom, notwithstanding the results in the September quarter which I will touch on later.

We are also well placed to benefit from a pick-up in global growth as countries in the Asian region continue to grow.

As I have indicated for some time, the world economy is improving following a long period of subdued growth and recent indicators seem to be increasingly supportive.

In this environment, we should ensure we are in the best possible position to benefit from an upswing, in particular by maintaining our openness to trade and investment.

But we must also be alive to the risks.

In my last appearance before this committee I touched on a number of uncertainties, including the future of China's growth, the trajectory for business investment and inflation and the rise in protectionist sentiment around the world.

These risks remain.

It is vital that we ensure our own economy is resilient and that Australia's fiscal, monetary and regulatory policies are encouraging greater productivity, competition and innovation.

Getting the settings right at home will help us weather any negative shocks and ensure we can take advantage of opportunities as they arise.

POSITIVE SIGNS

As we enter 2017, **there are a number of positive signs in the global economy**.

Activity in the US has improved after subdued growth in the first half of 2016.

US GDP grew strongly in the September quarter 2016 and momentum continued in the December quarter, and consumption in the US remains robust.

At 4.8 per cent in January 2017, US unemployment is consistent with some measures of full employment.

That said, some uncertainty remains around the outlook in the US which I will touch on in more detail in a moment.

Growth in China remains solid, despite bouts of concern about China's prospects.

Chinese GDP grew at 6.7 per cent in 2016, in line with Chinese authorities' target of '6.5 to 7 per cent'.

Growth in other economies has been higher than forecast of late, including in the UK in the period following the Brexit vote although growth in the euro area is expected to remain subdued.

Revisions to Japanese growth also revealed that activity has been stronger than previously estimated, and India and many South-east Asian economies continue to grow reasonably.

These positive signs have seen private sector growth forecasts revised up for a number of key economies.

While the IMF and World Bank have largely left their forecasts unchanged, this marks a welcome break from the persistent downward revisions to growth forecasts that have occurred in recent years.

Regardless, the IMF and World Bank both expect global growth rates to be higher in 2017 and 2018 than in 2016.

This trajectory is consistent with the forecasts in last year's MYEFO for global growth to pick up to 3 ¼ per cent in 2017, and 3 ½ per cent in 2018, up from 3.1 per cent in 2016.

COMMODITY PRICES

Of particular note has been the dramatic increase in a range of commodity prices in the past year.

This has included significant increases in prices for iron ore and coal, which are Australia's major commodity exports.

While global supply disruptions have clearly impacted coal prices, particularly in China, the forces behind recent strength in the iron ore price are less clear.

It is also unclear how much of the recent movements in commodity markets are driven by temporary or more persistent factors.

This has presented us with some difficulty in framing our forecasts and after extensive consultation we deliberately adopted a prudent approach at MYEFO.

The judgment was made at MYEFO to suspend the practice of using a recent average of commodity prices to underpin the forecasts.

An alternative assumption of a phased reduction in prices from recent levels was adopted for iron ore and metallurgical coal.

The rise in commodity prices is a good example of the kind of positive shifts that can affect the economy, with flow on benefits to businesses in the mining sector and to Government revenue.

If these elevated prices continue, we should prioritise budget repair and ensure that any additional revenue is banked as an improvement to the budget bottom line.

We need to take great care not to fall into the trap of spending unexpectedly higher revenue, should it arise, in a way that would structurally weaken the budget as may have occurred through the early 2000s.

Nonetheless, these shifts in commodity prices are extremely difficult to predict, reinforcing the need to plan for both opportunities and risks from the global economy.

REMAINING RISKS

In this regard, **a number of risks remain** that could impact Australia's economic and fiscal position.

Despite China's continued strong growth, the Chinese economy faces significant medium-term challenges as it transitions to more sustainable, consumption-led growth.

Continued excess capacity in various sectors of the economy and high debt levels in the household sector also represent constraints on growth.

As I have said to this committee in the past, the possibility of a sharp adjustment in China's economy could have flow-on impacts for Australia's economy, particularly our export industries.

Another factor that continues to dampen expectations of growth has been the subdued growth in business investment that has been a feature of the global recovery.

Of course, the other major development in the international economy since my last appearance before this committee has been the commencement of the new United States Administration.

At this stage, it is difficult to gauge the overall impact that the new Administration's policies will directly have on the US economy.

Measures that impact trade have the greatest potential to impact global growth, and of particular importance to Australia will be how potential trade measures impact China, our largest trading partner.

More broadly, the rising protectionist sentiment that I remarked on to the Committee in October has not abated.

The use of temporary trade barriers have been increasing internationally, with such barriers affecting 2.5 per cent of traded products, compared to 1.7 per cent in 2009 and 0.5 per cent in 1990.

As a small and open economy, Australia is dependent on trade and in-bound investment as a driver of economic growth.

It is imperative that we continue to advocate for an open global trading system in order to ensure the benefits of global growth continue to flow through to higher living standards in Australia.

SEPTEMBER QUARTER

Domestically, **the September quarter results show that our economy remains sensitive to shocks**.

The Australian economy contracted by 0.5 per cent in the September quarter.

There were some factors that were likely of a one-off nature, such as the weather-related disruptions in the construction sector.

However, there is no denying that it was a very weak quarter.

We do not believe that this represents the underlying pulse of the economy and anticipate a rebound over the forecast period.

We will be in a better position to judge the very near term outlook when National Accounts for the December quarter are released later today.

Market economists are expecting them to show a rebound.

DOMESTIC OUTLOOK

It remains Treasury's view that **the underlying fundamentals of the economy remain sound but finely balanced**.

While the outlook for real growth was revised down a little at MYEFO, this largely reflected the weaker than anticipated September quarter data.

At MYEFO we expected the economy to grow by 2¾ per cent in 2017-18 compared with 3 per cent at PEFO.

Nominal GDP was expected to rise by a strong 5 ¾ per cent in 2016-17, an increase from previous forecasts because of the recent movements in commodity prices.

These strong gains have offset the impact of slower inflation and wage growth, which would have normally reduced nominal GDP growth.

Nominal GDP growth was expected to slow to 3 ¾ per cent in 2017-18 as commodity prices fall.

We are currently in the process of revising our forecasts for the Budget deliberations.

The broad contours of the economy remain on track, with ongoing strength in mining exports following the mining boom, high levels of dwelling investment activity in the near term and ongoing growth in household consumption.

Business investment has been the missing link in Australia's growth over the past few years, although we have seen an improvement in non-mining investment in the non-mining states.

To better understand this issue, we are working with our counterparts in the state and territory Treasuries to examine the drivers and barriers to business investment in Australia - and we will report to Treasurers on this later in the year.

This will involve directly seeking views from large, medium and small businesses as well as the ACTU and business organisations.

Labour market conditions have also been mixed.

After a period of strong growth in late 2015, employment has slowed over the course of 2016, and all of the increase in employment has been in part-time employment with full-time employment falling over 2016.

Conditions in the labour market are also different across States and Territories.

Overall, the economy has been generating enough jobs to maintain a stable unemployment rate, but there is still spare capacity in the labour market.

All of these factors demonstrate that Australia's economy is still working through a complex transition away from mining investment and towards broader growth, in an uncertain international economic climate.

Given this, we are of the view that Australia's economy is performing reasonably well.

BUILDING RESILIENCE

Nonetheless, **we need to continue to protect the resilience of our economy** to ensure we are prepared for domestic and international risks.

A key part of this process is ensuring that our financial sector is robust.

Treasury, the Australia Securities and Investment Commission, the Australian Prudential Regulation Authority and the Reserve Bank of Australia are continuing to work through the implementation of the recommendations from the Financial System Inquiry.

There is also no denying that the major banks have received a very clear message about the need to improve how they conduct themselves, particularly with regards to their customers.

Another priority is to ensure we have a sustainable and affordable housing market.

There is no doubt that house prices in Sydney and Melbourne have increased significantly in recent years but, as I have noted before, this price growth has not been replicated in all major cities or in regional areas.

Treasury's view remains that the major factor in driving housing affordability is the supply of housing, including the availability of land for development and the infrastructure and services that are in place to support that development.

Treasury along with our state and territory counterparts are putting significant efforts into developing policy approaches to deal with this issue through the Heads of Treasuries forum.

As I have previously noted to this committee, ensuring a sustainable level of household debt and savings in Australia is also a key factor in ensuring our housing market is robust, and we are continuing to monitor this.

Fiscal consolidation must also remain a priority.

At MYEFO the budget deficit was forecast to decrease by $26.5 billion across the forward estimates.

The Commonwealth's level of gross debt is expected to peak at around 30.6 per cent of gross domestic product in 2019-20 – a historically high level that underscores the need for budget repair.

While we have forecast a reasonably steady trajectory towards a balanced budget, this is dependent on the economy continuing to improve in coming years as projected.

If some of the risks to the economy that I have discussed were to eventuate, there would most likely be flow on effects for the budget position.

Ensuring we have a sound fiscal position, as well as strengthening key sectors of the economy such as the housing market and financial system, will position Australia well to confront economic shocks when they arise.

STRUCTURAL REFORMS

Looking to the medium-term, **we also need to undertake the reforms that will support sustained economic growth** in Australia.

It is critical that we get the settings right in our tax system to promote business investment and ensure Australia is internationally competitive.

We have to recognise that we are now in a very competitive environment when it comes to corporate taxation and attracting investment, not just with our regional neighbours but countries such as the United Kingdom and, possible, the United States.

The sustainability of our tax system – particularly our income tax base – is under threat not just from international competition but also from the changing nature of our economy and from some of the more unique features of our system.

Higher taxes and regulatory burdens also increase incentives for tax avoidance and evasion – something the Black Economy Taskforce will look at as it develops a framework for policies to counter unreported economic activity.

Reforms that will drive further competition in our energy, transport and service industries will also be central to boosting Australia's productivity and economic growth into the future.

The Harper Competition Review provided a roadmap for the Government to reform these and other areas, and Treasury is continuing to work on the implementation of these recommendations, in partnership with the states and territories.

Investment in productive infrastructure projects is a further area where governments can support the economy to grow over a longer time frame.

However it is Treasury's strong view that projects need to be carefully considered to ensure they deliver economic benefits that outweigh their expected costs.

And as I touched on earlier, it is imperative that we continue to make the case for openness and the benefits that this will deliver to Australians through cheaper goods and services, greater export opportunities and higher incomes over time.

We must build an economy that is more competitive, more dynamic and more open, supported by quality infrastructure and an efficient tax system, if we want our long period of economic success to continue.

ORGANISATIONAL CHANGE

I previously advised this committee that we would establish a new Structural Reform Group within the Department.

That new Group will commence operation from next Monday with responsibility for competition and industry policy, as well as regional development, energy, environment and workplace relations issues.

The new Group will have a mandate to think and work differently, and I am confident it will drive the Department towards more innovative approaches to difficult policy problems, including how we better manage our economy's transition and its impacts on individuals and communities.

The new Group will include staff in our Sydney and Melbourne offices, where we already do a substantial amount of work on foreign investment, tax and financial market policy development, as well as business liaison to support our economic analysis.

The since opening, Sydney and Melbourne Offices have grown to 44 and 25 staff respectively, and have been instrumental in helping us attract and retain talented staff from the private sector and other backgrounds.

Like many of our colleagues across the Public Service we are facing challenging resource constraints that put pressure on our capacity to meet the demands of Government.

We currently operate with around 800 full time equivalent staff, down from more than 1,000 in 2010 and 2011, but we continue to take on greater responsibility including running and implementing major regulatory and tax review processes, managing the foreign investment process and preparing an increasing number of Parliamentary Bills.

We are also focussed on improving the calibre and impact of our work, from our economic modelling through to the delivery of legislation.

We held a very successful conference in Sydney where staff from across the Department joined with experts from academia and other organisations to discuss how we can continue to improve our modelling capacity.

We are committed to making the Treasury an engine room for policy ideas and advocacy within the Government, to drive debate on the major reforms that will set Australia up for sustained economic success.

As I have said, from tax and spending arrangements, to the way we regulate businesses and engage with other countries, we need to take the steps now that will prepare us for whatever the future may hold – both the good times and the bad.