Secretary to the Treasury

Budget Estimates Hearings – Opening Statement – 29 May 2017

Global outlook

The improving world economic outlook

I told the Committee in March that there were, at that stage, a number of positive signs in the global economy.

Many of these positive signs have continued to develop and global growth is expected to recover over the coming years.

The reasons for this improvement are complex but reflect, I believe, the fundamental continuation of the business cycle, with indications that the long period of growth undershooting forecasts is beginning to come to an end.

Australia's Asian trading partners are forecast to grow strongly.

Chief among these is **China**, where growth gained some momentum over late 2016 and early 2017.

China's announced growth target of around 6.5 per cent or higher if possible in 2017 reflects its need to balance continued growth with economic stability.

While Chinese growth is expected to moderate somewhat over coming years, this will be a good outcome to the extent it reflects action by Chinese authorities to rein in property and financial sector risks.

India's economy has shown remarkable resilience in recent years and is expected to remain the world's fastest growing major economy.

Japan has seen some pickup in growth over the past year, led by the corporate sector, with strong exports and investment related to the 2020 Olympics, and the unemployment rate has fallen to multi-decade lows.

Growth among South-East Asian countries, such as Indonesia, is expected to continue strengthening.

In the **United States**, we continue to see positive economic signs, with the unemployment rate back to its pre-GFC low, while business investment has been improving.

The economic expansion in the US since the GFC is forecast to extend to a decade of continuous – though subdued – annual growth, which should be supported by consumption and housing investment.

The **euro area** and **UK** economies have remained resilient to date since the June 2016 'Brexit' referendum, although the medium-term effects of Brexit will depend on the exact nature of the final agreement between the UK and EU.

Of course, there are other indicators of a strengthening global economy beyond the forecasts for individual countries.

Generally stronger commodity prices have been one reason for optimism, although a more recent retracement for some commodities is a reminder that some of the key forces that drive our nominal economy are highly volatile.

There is also evidence of stronger growth in exports of capital goods, particularly from China, Japan and South Korea, which suggests an improvement in demand for investment goods around the world.

And while monetary policy settings around the world remain accommodative, the US Federal Reserve has begun the process of gradually raising rates.

These positive signs for the global economy are reflected in the Budget's forecasts for global growth of three and a quarter per cent in 2017 and three and a half per cent in 2018.

Economic risks

All that said, there remain risks in the global outlook and it is important that these be given appropriate consideration.

China's economic strength remains finely balanced and has been underpinned by increasing credit intensity with an associated build-up of risks.

These risks have been highlighted by Moody's downgrade last week of their sovereign credit rating for China.

If anything, this downgrade underlines the need for careful management of the debt excesses and the ongoing importance of structural reform by Chinese authorities.

There have been signs that Chinese authorities are increasingly focussed on these issues of economic stability – which is pleasing – but it remains to be seen if these risks can be reined in successfully.

We have plenty of experience in Australia with the challenges in making structural economic changes, so I do not envy my Chinese counterparts their task in such a large and populous nation.

Europe continues to face a range of persistent issues following the GFC and the European sovereign debt crisis, while the 'Brexit' negotiations between the UK and EU are still to play out.

Unconventional or inconsistent policy approaches, or indeed any rapid policy change or uncertainty, can affect the confidence of businesses and consumers and this, in turn, can undermine growth.

At the same time, in many cases bold reform is needed to reinvigorate markets and encourage competition and innovation – so it is a fine balance.

Treasury will continue to watch Europe's economic prospects with great interest.

Of course, as has been discussed widely, a cloud also remains over the **future of global trade** openness.

The rise of protectionist sentiment around the world in 2016 was a real cause for alarm and highlights that consensus around the benefits of trade is not as strong as we might have thought.

A closed off world, in which countries increase the barriers to trade and limit the movement of goods, the exchange of services and the flow of investment, would create real challenges for global economic growth.

There would also be price impacts for consumers and businesses – a consequence that can be forgotten when the focus is put on particular local industries exposed to international competition.

Pleasingly, many governments and organisations are continuing to advocate for the importance of trade openness and Treasury is certainly among these.

Geostrategic risks

Adding to these factors are the geostrategic risks which, though outside the normal field of economic forecasting and analysis, nonetheless substantially shape the economic environment.

Stresses in the balance of strategic power in our region are closely interrelated with the on-going shift in economic balance and this is perhaps starkest in the relationship between China and the United States – and in discussion of our relations with both powers.

As a moderately sized trading economy we prefer a 'rules based' and predictable commercial environment but larger powers expect some latitude in the way the rules apply and also expect that the rules also accommodate their interests.

A such, it is unsurprising that following its rapid growth and absolute size China is seeking to shape economic institutions to reflect its interest – and it is unsurprising that we see some pushback from the US and others.

All that said, it will be the things we control – domestic policy covering human capital, regulation, infrastructure, spending and taxation – that will determine how well we adjust as the world around us changes.

Australia's economic outlook

Rebounding growth in 2017-18

Domestically, our expectation is for growth to rebound in 2017-18.

This follows a year in which weather has had a significant impact on our economic growth – first with weather-related events in the September quarter of 2016, and then more recently with Tropical Cyclone Debbie in the June quarter of 2017.

On top of the loss of life and property destruction wrought by Cyclone Debbie, there has been an impact on mining, agricultural and tourism industries in Queensland and northern New South Wales that is expected to reduce GDP growth by about a quarter of a percentage point in the June quarter.

These events will contribute to **real GDP** growth slowing to around one and three-quarter per cent in 2016-17.

Real GDP is then forecast to rebound to two and three-quarter per cent in 2017-18 and three per cent in 2018-19 – just above the potential rate of growth for our economy.

The lift in economic growth is expected to occur as the drag from mining investment diminishes, growth in household consumption improves and exports continue to grow strongly.

Non-mining business investment is also forecast to strengthen.

Economic performance across the States and Territories continues to vary widely as the impact of shifts away from mining investment and towards resource exports is being felt most acutely in Western Australia and Queensland.

In contrast, New South Wales and Victoria are growing faster than their decade averages.

The continued outlook for growth is no small feat for an economy that has grown for more than 20 years, including through the GFC and more recent international challenges.

Accommodative monetary policy, a lower exchange rate, and a flexible labour market are all helping to facilitate the economic adjustment that has been underway for some time following the peak of the investment phase of the mining boom.

We can now add to these supportive factors our expectation for an improving global outlook.

Stabilising business investment

It is well documented that **falling mining investment** has been a drag on Australia's growth for several years.

This effect is expected to wane over the coming years as the last of the major resource investment projects are completed.

At the same time, non-mining investment will be supported by strengthening domestic demand, solid business conditions and lending rates for businesses at around their lowest since the GFC.

Further, a reduced drag from mining investment should provide a more supportive environment for non-mining businesses to invest, particularly in mining-exposed States such as Queensland and Western Australia.

The combination of stabilising investment in mining and a recovery in non-mining business investment should see **total business investment** flat in 2017-18, before rising solidly in 2018-19.

Of course, this will depend on a recovery in non-mining investment proceeding as forecast.

Supportive conditions have been in place for businesses to invest for some time – but low levels of business investment have been an ongoing challenge nonetheless.

It has also been a challenge for many other countries.

At our annual meeting in September last year my Five Treasuries' counterparts, including UK, Ireland, Canada and New Zealand, discussed this at length.

All countries were seeing a reluctance for businesses to commit to investment and more emphasis on distributing profits to shareholders.

To investigate this further, we have joined with our counterparts in the States and Territories to examine the barriers to business investment in Australia, consulting with large, medium and small businesses as well as peak bodies and unions to understand what is driving their investment decisions.

This work is being led by our new Structural Reform Group with our Sydney and Melbourne Offices playing a key role in giving us better access to business.

Consumption and wages

Household consumption has grown in recent years, but below historical rates with average growth in consumption per capita of just 1.1 per cent since the GFC.

This partly reflects weak per capita income growth over this period.

Consumption accounts for around 60 per cent of GDP and almost half of GDP growth so it is a critical factor in determining the strength of the economy.

We expect household consumption to pick up over the forecast horizon and continue to grow by more than household income, as labour market conditions improve and wages growth picks up. This would result in a further decline in the household saving rate.

Still, there are risks to the real economy around the momentum in household consumption – in particular, a change in households' attitudes toward saving could lead to household consumption being weaker than forecast.

Wage growth has recently been low by historical standards, with the wage price index growing by 1.9 per cent through the year to March 2017.

We expect wages growth to increase as domestic demand strengthens, but in the near term the outlook for wage growth remains subdued, reflecting spare capacity in the labour market.

The near term outlook for inflation is also subdued.

Although full-time employment has strengthened recently, labour market conditions have generally softened after strong employment growth in 2015, with the majority of employment increases over the last 18 months being been in part time employment.

All that said, the **unemployment** rate remains below 6 per cent and indicators such as job advertisements, vacancies and business survey measures suggest labour market conditions will improve.

Employment is forecast to grow by one and half per cent through the year to the June quarters of 2018 and 2019 and the unemployment rate is forecast to decline modestly through the forecast period – consistent with an improving outlook for business and the economy overall.

Housing and dwelling investment

Household balance sheets have been strengthened by a notable rise in the value of housing and superannuation assets since the GFC, with household assets now more than five times higher than household debt.

We should be mindful that **household debt** has grown more rapidly than incomes in recent years, driven in particular by increasing levels of housing debt.

Dwelling prices have increased by 16 per cent through the year in Sydney and 15.3 per cent in Melbourne, though there have been some recent indications that this growth is moderating.

It is also important to emphasise that in other cities and regions, prices have been growing more moderately or declining for some years.

There are a number of complex factors that drive the housing market across both the demand side and the supply side.

For instance, there is no doubt that low interest rates have combined with population growth along the east coast to increase demand and support greater dwelling investment.

At the same time, insufficient land release, complex planning and zoning regulations and public aversion to urban infill have impacted the supply of housing.

Residential construction activity was subdued in the mid-to-late 2000s leading to a state of pent-up demand in the housing market.

But activity has strengthened since 2012 with significant investment in medium-to-high density dwellings.

As the current pipeline of dwelling construction reaches completion over the next two years it is likely that dwelling investment will ease as a share of the economy.

Developments in the housing market will remain a key risk to the outlook, and the Treasury and our regulatory counterparts will be paying close attention to adjustments in the market.

As the steps taken recently by the Australian Prudential Regulation Authority demonstrate, there is a role for sensible and careful measures that can address risks and underpin market stability – and we will continue to focus on these going forward.

Commodity prices and exports

Of course, the other major uncertainty in the economic outlook is around **commodity prices**, where we are in many ways at the mercy of international markets.

The strength in commodity prices over late 2016 and early 2017 – particularly coal and iron ore – came as a positive development and while this cycle may not deliver the 'rivers of gold' of the last terms-of-trade boom, it has nonetheless delivered a temporary boost to national income.

At the Mid-Year Economic and Fiscal Outlook, Treasury took the judgment – supported by market and industry consultation – to assume that prices for metallurgical coal and iron ore would not be sustained at recent levels, and this approach has been continued in the Budget.

This decision has been justified, with prices for both commodities recently falling – and although metallurgical coal prices rose sharply in response to disruptions caused by Tropical Cyclone Debbie, they have since corrected rapidly.

Nonetheless, these price movements remain extremely difficult to forecast.

Recent price increases have translated into higher-than-expected **nominal GDP** in the near term and, along with continued mining production, and in turn strong growth in resources exports, have also contributed to Australia's strong trade position, with five consecutive monthly trade surpluses to date, three of which have been the highest on record.

We expect **exports** to continue to increase strongly in coming years as resource projects reach expected capacity and demand for our tourism and education offerings also drive rapid growth in services exports.

Treasury's approach

In March this year I shared with the Committee some insights from a visit to Horsham in Victoria and I have more recently visited Townsville where I was able to get a first-hand sense of industry and agriculture in far north Queensland.

It was useful to hear first-hand how challenges such as energy prices and infrastructure shortcomings have a direct impact on business and trade in the region.

Pleasingly, I was also able to tour the facilities at James Cook University, where a program of local placements and internships across a range of courses is having great success in attracting quality students to careers based in regional and rural communities.

It is vital that Treasury and government more broadly make an effort to engage widely with different industries and regions to understand how they see the economy moving on the ground.

To this end, we announced on Friday that Treasury will establish a small Perth Office over the coming months as a two year trial.

It is also important that we have the flexibility to apply the feedback we receive – and a little bit of expert judgement – to our forecasts for the economy.

We already do this over the first two years of the forward estimates, combining detailed sectoral models with information gathered through our extensive business liaison program.

Over the past year or so, we have been expending considerable effort in enhancing the resources of our modelling and forecasting areas.

This has included significant recruitment from the private sector, engagement of consultants and interactions with public sector forecasters in the UK, US, Canada and New Zealand.

The Budget and fiscal outlook

Fiscal outlook

On the Budget, forecasts remain for a return to budget balance in 2020-21, with modest surpluses projected over the medium term.

The **underlying cash deficit** is estimated to be $29.4 billion in the coming financial year – a significant step forward after stubbornly remaining at just under $40 billion for several years.

It is then projected to improve to a surplus of $7.4 billion in 2020-21, with an average pace of consolidation across the forward estimates of around 0.6 per cent of GDP.

Continued discipline will be required to maintain the current trajectory and to sustain surpluses beyond 2020-21.

This is underscored by the assessment of the ratings agencies.

While two have now affirmed our AAA credit rating following the release of the Budget, they will continue to closely monitor the cumulative effect of our spending and revenue decisions and outcomes.

As has been widely discussed, this Budget has also increased the prominence of the **net operating balance** by reporting this measure alongside the Underlying Cash Balance.

The net operating balance assists in distinguishing between recurrent and capital spending, and provides better information as to how closely the government is meeting its recurrent obligations from its annual revenues.

The net operating balance excludes new capital expenditure and as such is forecast to be positive from 2019-20, a year earlier than the underlying cash balance.

Of course, much of the Commonwealth's spending on infrastructure projects is paid to the States and Territories, and these payments remain within the net operating balance calculations.

Government debt

While the net operating balance recovers earlier than the underlying cash balance, there is nonetheless an impact on the level of public debt no matter what the money is spent on.

The level of Government **net debt** is projected to peak in 2018-19 at just under 20 per cent of GDP, broadly in line with projections at the mid-year update, albeit slightly higher due in part to changes in market values and some accounting updates.

Net debt is then projected to fall across the medium term to around 8.5 per cent of GDP in 2027-28.

By contrast, the level of **gross debt** will rise across the medium term, reaching $725 billion in 2027-28.

Gross debt is expected to be around $60.8 billion higher in 2026-27 than was projected in the mid-year update, a change driven primarily by the Government's decision to continue to build the assets of the Future Fund.

Revenue outlook

On the revenue side, expectations for higher wage and consumption growth in the coming year, as well as high corporate profitability, have led to an improving trajectory.

Tax receipts are forecast to grow by 4.2 per cent in 2016-17 and by 7.2 per cent in 2017-18.

However, there are a number of trends underlying this positive trajectory that highlight ongoing risks to the sustainability of the Commonwealth's revenue base.

These are partly driven by our high reliance on personal and corporate income tax at a time when wages growth remains low and we face increasing international tax competition.

We are also grappling with a growing black economy, and the Taskforce led by the Chairman of the Board of Tax, Michael Andrew, has recently produced an impressive interim report on this matter.

We need to consider the measures over the coming years that will ensure our revenue base remains sustainable.

Thank you.