

Senate estimates – opening statement

Since I last appeared before the Committee there have been significant developments, both globally and here at home.

As we have known for some time, the Australian economy is in the midst of a challenging period. Global weakness and uncertainty continue to have an impact domestically. And the economy is adjusting slowly to the end of an unprecedented boom in the resources sector.

Given the magnitude of these challenges, the Australian economy has performed relatively well. This good performance in large part reflects the dividends of past reforms, together with movements in the exchange rate, interest rates and wages all supporting the transition.

That said, growth remains below trend and the unemployment rate remains too high. Our key economic obstacle in the near term is a lack of demand.

The global economy continues to struggle to regain sustained momentum. Growth remains uneven and well short of the average rates seen prior to the global financial crisis.

Yet again, the IMF revised down its forecast of global economic growth in its October 2015 World Economic Outlook. The Fund's forecast for global growth in 2015 was cut to 3.1 per cent from 3.3 per cent, reflecting lower growth forecasts across a wide range of advanced and developing economies. The IMF now also expects a more tepid pick-up in economic activity over the coming year, with the forecast for 2016 reduced to 3.6 per cent from 3.8 per cent. This was the IMF's fifteenth downgrade of the global growth forecast in four years.

Even relative to these lower forecasts, the view at the recent IMF World Bank Annual Meetings in Lima was that downside risks to the global economy have increased. There are particular concerns about slowing growth in emerging market economies.

Advanced economies are recovering. But progress has been patchy. The United States is a bright spot and is providing some impetus to world 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.

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

Foremost is the fundamental shift from a Chinese economy that has over-invested and under-consumed to an economy that now must spur consumption to drive growth. By contrast, the developed countries have, in the broad, over-consumed but under-invested. Rectifying this imbalance will not be easy and will take some time and we should continue to expect a lot of volatility in financial and other markets along the way.

Second, there is the prospect of normalisation in US monetary policy from near zero interest rates. At the same time, accommodative monetary policy settings are still prevalent elsewhere.

A third transition relates to the very soft commodity prices – at this stage, it is very difficult to see when this softness will be reversed and to what extent.

Chinese authorities continue to pursue a more balanced and sustainable growth pattern with greater reliance on consumption and services. This is likely to affect other countries, particularly through the impact on commodity prices.

The IMF indicated that while its forecast for China's growth was unchanged, it now appears that the Chinese slowdown is having a greater impact on the rest of the world than previously thought. Weaker growth in Chinese demand for raw materials is compounding the impact of abundant supply on commodity prices, as seen in recent renewed weakness in a range of energy and industrial prices.

The Budget forecast of Chinese GDP growth is 6¾ per cent in 2015 and 6½ per cent in 2016. This is broadly in line with the IMF's forecasts, for growth of 6.8 per cent for 2015 and 6.3 per cent for 2016. The Chinese government announced its 2015 growth target of 'around 7 per cent' in March and has emphasised that this takes into consideration what is needed to ensure ample employment. The official target for 2015 is to generate 10 million new jobs.

There has been continuing weakness in traditional drivers of Chinese growth, with recent major data releases pointing to continued softening conditions in investment, exports and industrial production, while retail sales and employment growth remain stable. The value of Chinese imports fell by around 20 per cent through the year to September, one of the steepest falls since the global financial crisis. This partly reflects lower commodity prices. The rate at which exports are falling slowed by more than the market had expected.

Uncertainty about the timing of the US Federal Reserve's normalisation of monetary policy continues to drive financial market volatility, particularly affecting emerging market and developing economies. There are concerns that this normalisation, once it begins, could lead to capital outflows from these economies.

Emerging market economies, in particular, 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.

When the US does begin raising interest rates, investors are likely to shift their 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.

Among the ASEAN-5 economies, growth is increasingly uneven. Growth in Malaysia and Indonesia is expected to slow this year, affected by the fall in commodity prices. Prospects for Thailand remain clouded due to political uncertainty, while strong growth is forecast for the Philippines and Vietnam which are benefiting from the oil price windfall.

In Indonesia growth remained at a five year low of 4.7 per cent through the year to the June quarter of 2015.

The Malaysian Ringgit is one of the worst performing currencies in the region, depreciating by more than 20 per cent relative to the US dollar over the last 12 months. Recent falls have been driven by lower global commodity prices and a stronger US dollar.

The Philippines is expected to be one of the fastest growing economies in the world in 2015 – shrugging off its image as the ‘sick man of Asia’. Since President Aquino took office in 2010, the Philippines’ sovereign credit rating has been upgraded to ‘investment grade’.

The timetable for a return to democracy for Thailand has been delayed until late 2016 or early 2017.

The recent downturn in commodity prices has been a drag on the economies of commodity exporters, particularly emerging market exporters. However, lower oil prices in particular are likely to be a net positive for global growth.

The fall in oil prices over the past year is also continuing to suppress inflation globally.

But the weakness in inflation pressures generally across a wide range of economies points to significant spare capacity as a consequence of the lacklustre world recovery since the global financial crisis. And measures of the financial market longer-term inflation expectations in a number of major economies have fallen to relatively low levels, suggesting doubts about the prospects for sustained recovery.

More generally, I also see the build-up of debt globally as a major risk to the global outlook. Seven years after the global financial crisis debt continues to grow. Global debt has grown by \$57 trillion, raising the ratio of debt to GDP by 17 percentage points. Debt in China has roughly quadrupled since the start of 2007.

Government debt is unsustainably high in some countries. Since 2007, global government debt has grown by \$25 trillion.

These high levels of global debt are an important reminder of why it is an immediate priority for Australia to repair the fiscal position. We need to address Australia's structural budget problem through greater expenditure restraint.

As I noted earlier, the Australian economy has performed well given it is adjusting to the end of an unprecedented boom in the resources sector at a time when the global economy continues to struggle to regain sustained momentum.

The construction phase of the resources boom peaked in 2012-13. Investment in the sector is estimated to have fallen by around 15 per cent last financial year and is expected to fall by more than 25 per cent in each of the next two years.

Most of this decline in resources investment reflects the successful completion of large construction projects. Low commodity prices are also playing a role, weighing on investment in machinery and equipment as miners pursue efficiency gains to lower costs.

As projects are completed, rising export volumes will help to cushion the impact of the decline in investment. Resource export volumes rose 8.2 per cent over the past year with growth expected to continue in coming years, led by LNG.

The economy is also transitioning to broader-based drivers of growth. Many elements of the transition are unfolding as expected, supported by the adjustments we have seen in the exchange rate, interest rates and wages.

The lower dollar has underpinned a 7.3 per cent increase in services exports over the past year. Tourism has responded particularly well. China has now become our second largest source of tourists, after New Zealand, with a record 951,300 Chinese short-term arrivals in the past year. Another area of strong growth is the export of financial services, which experienced its fourth consecutive year of double digit growth in 2014.

Low interest rates continue to support the economy and in particular the housing market.

Growth in dwelling prices remains elevated, supported by low interest rates, population growth and investor activity. Price growth remains particularly strong in Sydney and Melbourne, up 16.7 per cent and 14.2 per cent through the year to September 2015 respectively. Supply has been responding positively, with dwelling investment rising by 7.4 per cent over the year to the June 2015 quarter.

In response to concerns about investor lending growth, APRA has put in place macro-prudential measures. While it will likely take more time for the impact of these measures to become fully apparent, there are signs that banks have been responding to APRA's measures and reported investor lending growth has recently slowed a little.

With interest rates at historic lows and approvals and financing remaining strong, dwelling investment is expected to continue to grow solidly over the next few years.

Developments in household consumption will have an important bearing on the strength of the economy overall. Consistent with the outlook at Budget, household consumption rose

by 2.5 per cent over the past year. To support consumption at a time of modest income growth, households have been saving at a slower rate. The savings rate fell to 8.8 per cent in the June quarter compared with a peak of 11.7 per cent in 2012.

More recent data suggests household consumption has continued to grow in the September quarter. Nominal retail turnover rose by 0.4 per cent in August, and is 4.5 per cent higher than a year ago. Annual growth has been driven by household goods retailing, consistent with the strength in the housing market. Both the ANZ and Westpac measures of consumer sentiment have strengthened over the past couple of weeks.

While many elements of the transition are unfolding as expected, surveys of business investment plans released since Budget have remained very soft. This is consistent with Treasury's discussions with business but, if anything, I have detected a little more optimism on investment intentions in some areas in the past couple of months or so. The key message that we are hearing is that businesses want to see a sustained uptick in demand before they invest in new capacity and equipment.

There remain very significant differences in the economic conditions and outlook amongst the States and Territories. In meetings with my State and Territory counterparts, there seems to be somewhat stronger conditions in New South Wales and Tasmania, while South Australia remains relatively subdued, and Western Australia and Queensland continue to bear the effects of the exit from the mining investment boom.

While weak investment plans are a risk to the outlook there are some positive signs for the economy as a whole. The NAB Monthly business survey points to positive conditions and confidence in the non-mining economy. In particular, non-mining conditions strengthened notably following the release of the Budget in May and this has been sustained. Conditions are currently at some of the highest levels since the global financial crisis. Profitability has been strengthening and capacity utilisation has also been rising to be around its long-run average levels.

Investment in the services sector grew by 12 per cent in 2014-15, the fastest growth in almost a decade.

The labour market has held up remarkably well considering the extended period of below trend growth. Employment fell in the month of September but grew 2.0 per cent over the past year, close to the highest annual rate in over four years. Forward looking indicators of job creation suggest this positive momentum could continue with ANZ Job ads up 12.8 per cent over the past year.

The unemployment rate remained steady in September at 6.2 per cent, as falling employment was offset by a fall in the participation rate. Notwithstanding the fall in

September, the participation rate remains elevated as people have re-entered the labour force, encouraged by the strengthening labour market.

For the Budget, it is nominal GDP that matters and volatility in commodity prices and slow growth in wages present further risks to the outlook.

Despite global volatility, commodity prices are tracking broadly in line with Budget assumptions. Iron ore prices fell sharply in early July following extreme volatility in Chinese equity markets but bounced back relatively quickly. Since then, iron ore prices have been relatively steady and in line the Budget assumption of US\$48 per tonne, however metallurgical and thermal coal are both down by more than 10 per cent.

However, as we saw earlier this year, slowing growth in China and broader global uncertainties have the potential to result in sharp falls in commodity prices.

Wage growth is around historic lows in both the public and private sectors as governments across the country focus on expenditure restraint and businesses look to contain costs. While this provides welcome support for the labour market at a time when GDP growth is below trend, continued low growth in wages will weigh on the outlook for incomes.

We are closely monitoring these risks and developments as we prepare the Mid-Year Economic and Fiscal Outlook, scheduled for release in December.

While the key challenge in the near term is a shortfall in demand, the challenge over the medium term is to maintain growth in living standards. As I have been saying for some time now, in the context of lower commodity prices and an ageing population, this will require an improvement in our productivity growth performance.

The primary determinant of Australia's future productivity performance will be decisions made by businesses to pursue productivity gains. The role of government is to establish the economic enablers to support private enterprise to make productivity improvements and to remove impediments to market flexibility.

This is the responsibility that is shared between the Commonwealth, the States and the Territories – and is a major message of the Harper Review.