Opening Statement

Senate Economics Legislation Committee

John A. Fraser, Secretary to the Treasury

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Since I last appeared before the Committee, the Australian economy has continued to evolve broadly in line with the track set out in the 2016-17 Budget.

The economy has now completed its 25th year of continuous growth as we transition from the boom in mining investment to broader drivers of activity. This is a very positive outcome and one that has occurred notwithstanding the challenges facing the global economy.

The global backdrop

I recently returned from the US where the Treasurer attended the Annual Meetings of the IMF as well as a meeting of G20 Finance Ministers and Central Bank Governors. Discussions there focused on the current state of the global economy and the risks in the years ahead.

Prior to the meetings, the IMF released its October World Economic Outlook (WEO). Following previous growth downgrades earlier this year – in January, April and July – the IMF's forecasts were unchanged from its July WEO update.

No further growth downgrades could be seen as a positive sign for the world economy. But as I noted in my previous appearance before the Committee, the outlook for global growth remains subdued and downside risks remain across both advanced and emerging economies.

The US economy continues to recover, despite some caution following weaker-than-expected activity in the first half of 2016. Unemployment remains low and is helping underpin consumption, while rising median incomes are another positive sign. And, while I never thought I'd be welcoming this, there has also been some upward movement in US core inflation since the beginning of last year. In addition, average US hourly earnings rose slightly in September, with the annual rate of growth picking up to 2.6 per cent through the year. If this continues, it would be a welcome development.

Looking at the broader financial market picture, while conditions in global markets have improved recently, there are ongoing vulnerabilities in this area. High levels of corporate debt, particularly in emerging markets, could magnify the effect of any sudden shifts in investor confidence and add to bouts of financial market volatility. In addition, household debt is an issue for the world and for Australia. According to the OECD, Australian households are the fifth most indebted in the OECD – based on household debt as a share of net disposable income.

Since the Budget we have seen the outcome of the 'Brexit' referendum, which resulted in a period of heightened financial market volatility. This volatility has since receded, notwithstanding that the British pound is trading substantially below its value immediately prior to the referendum. In the short to medium-term, the economic effects of Brexit are likely to be limited to the UK and, to a lesser extent, the rest of Europe. While there have

been encouraging signs, it will take some time before we can be more definitive about the impact of Brexit.

Turning to China, its economy grew by 6.7 per cent through the year to the June quarter 2016. This is the weakest growth rate since the March quarter 2009, although it is in line with the Chinese authorities' target of '6.5 per cent to 7.0 per cent for 2016'. The indications are that the Chinese government is seeking a balance between providing short-term support for the economy and putting in place medium to long-term reforms to rebalance their economy. Fiscal policy is expected to play the primary role in supporting growth in the short-term, with China expected to run a large deficit this year. There are concerns about debt in China which, according to the Bank for International Settlements, is at 255 per cent of GDP as at the end of the first quarter of 2016. This debt is linked to China's state-owned enterprises and its growing financial sector, which is increasingly large, interconnected and opaque. While China's rebalancing presents opportunities for Australia, the possibility that it may not proceed smoothly remains a key risk to the global outlook.

Global inflation is another issue we are continuing to watch. It has been weak since the financial crisis – with headline inflation below zero in Japan and near zero in the euro area – and is below the targets of many central banks. In part, this reflects cyclical weakness as the global economy continues its slow recovery. But it has the potential to further shift down inflationary expectations in the current environment, ultimately resulting in higher real interest rates.

Another issue facing the global economy is a rise in protectionist sentiment that has the potential to slow the momentum of trade liberalisation. This could further weaken already

low global trade growth. The fact that the outlook is increasingly threatened by inward-looking policies and stalled reforms was also noted at the recent IMF meetings in the US. IMF members also committed to take steps to address these concerns.

Open trade and investment have allowed people to enjoy higher standards of living than would have otherwise been the case. Sadly, it appears that we have failed to convince people of the benefits of international trade and microeconomic reforms. This is somewhat understandable, given that individuals can sometimes be left behind by such reforms. Nonetheless, we need to continue to make the case in this area and ensure everyone has the opportunity to benefit from open markets.

And over the medium-term, ageing populations in advanced economies and low global productivity growth are likely to weigh on global growth. For example, the OECD estimates that almost all of its member countries have experienced a slowdown of productivity growth since 2000. Although our recent productivity performance is encouraging, Australia is no exception to this trend and we need to continue our efforts to lift productivity growth.

The Australian economy

Despite the global backdrop, Australia's domestic outlook remains largely positive.

The June quarter national accounts showed that GDP grew at 3.3 per cent through the year to the June quarter above estimates of potential growth.

The June outcome also provided the first estimate of 2015-16 growth, which showed real GDP growing by 2.9 per cent – a stronger outcome than the 2½ per cent growth forecast in the 2016-17 Budget.

This stronger growth was the result of larger than expected contributions from net exports, public final demand and dwelling investment. These factors, together with steady growth in household consumption, more than offset the impact of declining mining investment. In particular, new public sector investment and consumption contributed 0.8 per cent to GDP growth through the year to June 2016 – with further State government investment in the pipeline. While this is a positive outcome, private investment – as in other countries – is the missing link and continues to detract from growth, as mining investment continues to fall.

Growth in incomes has been less positive with nominal GDP expanding at a more modest rate in 2015-16 – at 2.4 per cent. This is the result of a fall in the terms of trade and subdued domestic wage and price growth.

Since the 2016-17, Budget commodity prices have remained relatively resilient. While the iron ore spot price has fallen slightly since Budget, metallurgical coal has more than doubled with thermal coal prices also significantly higher. The price of tapis crude oil is also currently somewhat higher than the Budget assumption. If sustained, higher commodity prices will have a positive impact on nominal GDP. That said, these prices are volatile and remain a key uncertainty for the outlook for nominal GDP.

Stepping back from the changes since Budget, Australia's terms of trade remain lower by around a third since their peak in the September quarter of 2011. So while the quantity of

our exports has increased, the decline in commodity prices since their peak means Australians are effectively unable to buy as many imports for a given quantity of exports – resulting in a decrease in our purchasing power.

More broadly, low wage growth, along with our falling exchange rate and low interest rates continue to support the transition in the economy towards the non-mining sector.
This transition has been evident in the labour market with solid employment growth coming from the services industries, mainly within the private sector. The unemployment rate has also declined from 5.8 per cent in June to 5.6 per cent in August 2016, consistent with our Budget forecast of 5¾ per cent. However, at the same time, underemployment has grown. And there has been significant growth in employment coming from part-time workers.

Across Australia, there are notable differences in economic performance between our regions. New South Wales and Victoria are experiencing the strongest performance, whereas conditions are softer in the other states. State final demand in Western Australia and Queensland has weakened significantly with the winding down of mining investment. Conditions are also mixed in the Territories, with state final demand falling in through the year terms in the Northern Territory and rising in the Australian Capital Territory.

These differences are reflected in the labour market outcomes across the States and Territories. The trend unemployment rate is lowest in Victoria and New South Wales, amongst the states. In Queensland and Western Australia, unemployment has increased since the heights of the mining boom and is above the national level. For example, trend unemployment has risen in WA from just over 4 per cent at the end of 2011 to over 6 per cent now. In addition, South Australia and Tasmania are currently experiencing the

highest unemployment rates, with unemployment more than 6½ per cent in both states. In the Northern Territory, trend unemployment is low at 3½ per cent despite the end of the mining boom. And in the ACT trend unemployment is just over 3½ per cent, around its ten year average.

Strong mining sector investment through the 2000s is now driving continued growth in commodity exports. The commodity export mix is also changing and liquefied natural gas, or LNG, is expected to become Australia's second largest export over the next few years behind iron ore. The decline in mining investment is expected to continue to detract from economic growth. But it is expected that other areas of the economy will pick up – although there is uncertainty over the exact pace and timing of this.

A lower Australian dollar is also underpinning a rise in our services exports as we take advantage of a growing middle class in Asia. This has helped fuel an increase in our exports of tourism and education.

Turning to some of the sectoral story, activity in the housing market remains strong. This has been underpinned by a shift towards medium to high density dwellings, particularly in New South Wales, Victoria and Queensland. That said, some indicators in the housing market including house price growth have moderated since last year.

Housing investment growth is expected to ease as a record number of dwellings reach completion, but the level of housing investment is expected to remain high. Consistent with significant increases in supply, aggregate rental rates in major capital cities have been falling over recent months, driven primarily by significant declines in Perth and Darwin,

and to a lesser extent in Brisbane. Similarly, residential property prices have fallen in Perth and Darwin over the past year. This is in contrast to strong price growth in Sydney and Melbourne over the past few years.

We are alert to the downside risk that strong construction levels, tighter lending standards and rising construction costs could lead to activity declining more quickly than expected once the large construction pipeline is complete – particularly in the high-rise apartment market. We are continuing to monitor the housing sector including through our business liaison program.

Another issue to monitor is private debt, including by households, which has grown in Australia as recently flagged by the IMF. We are also conscious that credit ratings agencies are focusing on household debt as well as corporate and government debt.

With the majority of household debt taking the form of residential mortgages, risks to the housing market become important. The majority of mortgage debt is held by wealthier, high income – households with the greatest ability to make repayments. In addition, some of the high rate of household savings in recent years has been channelled into building up buffers in mortgage offset and redraw facilities which, in aggregate, currently constitute around two and a half years' worth of mortgage repayments. Nevertheless, we need to be cognisant of risks masked by this aggregate picture. There could be pockets of the community who have taken on too much debt or remain vulnerable to changes in financial and economic conditions. With so much debt funding housing assets, we need to continue to ensure that the quality of mortgage lending remains high.

In summary, the Australian economy is performing broadly as expected. Looking ahead, I expect the economy to continue to be supported by low interest rates and the lower exchange rate.

While we are doing reasonably well, we are not guaranteed a strong future. If we want to grow faster and improve living standards, we need reforms that will boost productivity. And we need to undertake fiscal repair.