



Treasurer
of the Commonwealth of Australia



**Press Conference
Parliament House, Canberra**

**Wednesday, 6 December 2006
12 noon**

SUBJECTS: September Quarter National Accounts, NSW financial position, economic impact of the drought, WA housing prices, Senator Vanstone, federalism, stem cell research, industry policy, Qantas

TREASURER:

The September Quarter National Accounts show solid growth in the Australian economy, although we are now beginning to see the impact of severe drought. The economy grew by 0.3 per cent in the September Quarter to be 2.2 per cent through the year growth. However, farm production fell 10 per cent and the ABS National Accounts feature article on the impact of the drought on agricultural production suggests that the drought will directly subtract about 0.5 in overall growth in 2006-07.

The ABS notes the production of wheat, barley and canola could fall by over 60 per cent. And agricultural income fell over 51 per cent in the September Quarter. If you abstract farm production the economy grew at 0.6 per cent to be 2.6 per cent higher than a year ago. So what we are now seeing is we are seeing continuing growth in the Australian economy but it is now being buffeted by severe drought. And in effect we have two separate economies - strong growth in the non-farm sector but a very, very severe downturn in the farm sector. When you see agricultural incomes fall 51 per cent in one quarter you really are beginning to see the severe impact of drought.

Household consumption continues to grow moderately, increasing 0.7 per cent in the September Quarter and household incomes grew more quickly than consumption as households benefited from tax cuts and increases in family benefits.

Dwelling investment is starting to recover after a mild slowdown. Although business investment was down in the quarter it is stronger through the year and new business investment is very high, well above its 30 year average. For the first time, but as expected, mining production increased significantly in the September Quarter. Exploration expenditure is very strong and we may be starting to see the first signs of increase in volumes coming out of the mining sector. Of course over quarters to come the increase in mining volumes will be offset somewhat by a fall which we expected in agricultural exports which are really going to start kicking in.

In fact in these quarters with agricultural exports are up mainly because of de-stockings. As farmers begin to de-stock, slaughter livestock you actually get first of all a lift in exports, and of course as the herds run down, you would expect in the quarters to come you will get a fall in volumes.

The household consumption chain price index was moderate increasing 0.5 per cent in the September Quarter. This is significantly below the Consumer Price Index whereas the one-off effects of fuel and fruit prices moved (inaudible) Consumer Price Index we would expect that to come down in the early part of next year.

Compensation of employees is very strong, driven by an increase in the number of people in the job market. As you know we have had an increase of 245,000 jobs this year and the profit share is now at an all-time record. The profit share of the economy is now at an all-time record.

So what we are seeing here is outside of the farm sector, what you are seeing is a strong economy with very strong job creation, with strong corporate profits now moving through a business investment cycle and developing exports. What you are seeing in the farm sector is severe drought dropping production, a collapse in agricultural income and that sector beginning to show up in the overall National Accounts. But the overall National Accounts show an economy which is now in its 16th year of continuous growth moving into investment picking up with exports and beginning to take advantage of global opportunities.

JOURNALIST:

Treasurer, should we be concerned about the wellbeing of our friends in New South Wales?

TREASURER:

Well in New South Wales the State Final Demand contracted 0.3 per cent. Through-the-year growth in State Final Demand in New South Wales is 0.8. So that is pretty weak. They had a negative quarter this quarter, a small positive last quarter and I believe a negative quarter the quarter before. So you are seeing differences emerge in the economy but you would have to say that State Final Demand was weaker in New South Wales than in any other State.

JOURNALIST:

Is that your fault or Morris lemma's?

TREASURER:

Well, if all of these things were my fault presumably you would see the same thing happening in all of the other states as well. I don't know, maybe they are served by bad media (inaudible).

JOURNALIST:

That can't be it.

TREASURER:

I think what happened in New South Wales is that New South Wales bet the bank on the property market and property prices went up and there had to be a correction. I said over and over and over again, you couldn't have that level of price increases being sustained. And of course when the correction came, it was hit harder than other states. I think that is what has happened in New South Wales.

JOURNALIST:

What would the appropriate response be to that, Treasurer? I mean...

TREASURER:

In New South Wales?

JOURNALIST:

...if markets go up and down is that the New South Wales Government's fault? Is there something they

should, should they have been intervening (inaudible)?

TREASURER:

Well I tried to, I think the new capital gains tax they introduced and then forced to take away was a classic example of a response which was wrong headed and at the wrong time and I said so. Now, you were just coming into a slow-down of the property market, they decided to put a new capital gains tax on investor housing. So fortunately for them, they have now withdrawn it but it was mis-guided policy at the time.

JOURNALIST:

Treasurer, does this shed any light to you on why it is that we have got very strong employment growth and apparently fairly subdued outlook growth?

TREASURER:

Well I think what has happened is that over the course of this year there has been a very significant increase in the number of jobs, that may well have been reflecting the stronger growth we had say, 12 months ago or 18 months ago. Employment generally lags. Now you are seeing a bit of a down-turn on huge employment. But I would expect after you have seen a little bit of a correction in the employment market, after the effects of the drought pass through the system, which we hope they do, then you are going to see GDP picking up again in say 2007-2008 and then output per unit will be higher.

JOURNALIST:

Mr Costello are you concerned that with some areas of weakness in the economy such as New South Wales, such as the farm sector, that three consecutive interest rate rises could be damaging over the year ahead?

TREASURER:

You mean three past consecutive interest rate rises?

JOURNALIST:

Yes.

TREASURER:

Look, there is no doubt that that has affected consumer sentiment. Consumer sentiment is below its long-term average. There is no doubt about that. It has had an effect. One of the other things that we are seeing, whether it is that or not, is we are seeing people are beginning to save a bit more. So the point about monetary policy is it is designed to work towards an inflation target and you would have to say that the effect of those interest rate rises, which is subdued sentiment, moderated demand, get the housing market a bit more subdued than otherwise the case is working towards that goal.

JOURNALIST:

Can the economy then absorb another rate raise in the new year?

TREASURER:

Well, what I am saying to you is that whilst there is still solid growth in the non-farm economy there is a very severe downturn in the farm economy and overall the Australian economy is more subdued than we have

been for some time.

JOURNALIST:

Is that downward pressure on the farm sector enough to put pressure on the Reserve to actually leave rates?

TREASURER:

When you are setting monetary policy you are setting it for the whole economy. You can't have one interest rate in the suburbs and another interest rate out in the regions or on the farms. We are one country, we have one monetary policy, one bank. And the art is to set your sail for the overall economy.

JOURNALIST:

What impact is (inaudible) talking about (inaudible)?

TREASURER:

Well direct, this is a very important point. The ABS National Accounts suggest that drought will directly subtract 0.5 but of course the effect will have indirect consequences as well. So, for example, the direct effect is that the farmers' production is cut. The indirect effect is the transporters don't transport as much rural produce. The wholesalers don't store as much in wholesaling. That is only the direct effect. The effect once it takes into account the indirect effects will be greater than that.

JOURNALIST:

What indications are you getting so far about what (inaudible) in the current financial year?

TREASURER:

Well the consequence of all of this is that the upside surprises that we had in previous years will no longer be there. And as the terms of trade moderate and turn down, we will be in a world of downside surprises.

JOURNALIST:

Can you (inaudible) downward surprises?

TREASURER:

Wouldn't be much of a surprise if I told you now, would it? I can't take the fun out of (inaudible)...

JOURNALIST:

What's the effect of, as you say .05 directly on the economy, what effect will this have as budget preparations begin, in terms of expenditure available?

TREASURER:

Well what we didn't forecast in May this year was the collapse of the spring rains. What has really happened here is that we had nearly no spring rain and the consequence of nearly no spring rain was that the crops weren't (inaudible). Our cropping, and I gave you the figure before, is down enormously. The ABS is saying that the production of wheat, barley and canola could fall over 60 per cent. So nobody forecast the almost complete collapse of the spring rains. Then that affected crops directly, but in say broadacre pastoral, who hadn't really recovered from the 2002 drought, it meant that the pastures didn't come back, so we now see

de-stocking of the livestock, farmers reducing their herds. The most immediate part of that is firstly it brings meat prices down and boosts exports. Once the de-stocking is done, when they move back into re-stocking it will move the meat prices up and exports down, so this has all developed since May and although the non-farm economy is quite strong, you are now seeing the overall economy affected by significant drought.

JOURNALIST:

You mentioned that the indirect consequences will be larger than (inaudible) is that going to be double that?

TREASURER:

Well I will update that for the mid-year review.

JOURNALIST:

Treasurer you mentioned the impacts of the property market problems in New South Wales (inaudible) what's gone on. There was a big fall in State Final Demand in WA and it is still going through a property boom, have you got a warning for people over in the West for what's happening in terms of property prices in the long term?

TREASURER:

Well in WA State Final Demand fall 3.4 per cent for the September Quarter but it was still up

7 per cent over the year so you get a huge run up as they did in June, it comes back a bit in September but it is still very strong over the course of the year. My assessment in relation to Western Australia is that whilst non rural commodity prices are high, essentially minerals, there is still going to be a lot of money in Western Australia but those prices will turn down. They will turn down in the years ahead and you will see a correction in Western Australia as a consequence. Markets I think in Western Australia or in Perth, I think the property values have gone up something like 30 per cent.

JOURNALIST:

45.

TREASURER:

45 is it, ok more. You can't sustain that year after year. It doesn't happen like that. There will be a correction and it is always advisable to factor that into your thinking.

JOURNALIST:

Mr Costello, the productivity fell by 1 ½ per cent in the September Quarter and it is only showing 0.7 per cent growth for the year as a whole. Why do think this is and does it concern you?

TREASURER:

Well I think that the productivity has also been affected by the drought, the downturn particularly in relation to rural Australia, you would expect that. But I think that once you abstract that, you see that productivity growth continues to grow. We are in a flatter cycle now than we were during the productivity period of the late 1990s. It underscores the importance of continuing economic reform.

JOURNALIST:

Treasurer, do you think the speculation about Senator Vanstone's future on the frontbench is helpful to the Government and do you think she deserves to stay on the frontbench?

TREASURER:

I don't think it is helpful, no. I think she is a very valued colleague. She packs a punch and she has got a big following out there in Australia and I have really enjoyed serving with her and I think she is one of those people that brings a constituency to the party and a lot of colour to the Parliament.

JOURNALIST:

Mr Costello you talked a lot about federalism, (inaudible) and things like that. The new Opposition Leader Kevin Rudd is talking about a new federalism, his basic line is that if the states and the Commonwealth work together it is better for consumers. What's your response to him?

TREASURER:

Well, if he develops a proposal I will comment on it then. But if his proposal is that it is the Commonwealth's obligation to make up for State failings I don't see anything new in that. The Commonwealth has its area of responsibility, I think we discharge it. The states have their areas of responsibility - I think in significant respects, they don't. Let's think of the Queensland hospital system and Dr Death. There was obvious failure in the Queensland hospital system. Should the Commonwealth fix that up? I think the Queensland Government ought to fix it up. In fact, you can't say that because a level of government proves to be inadequate for the task, therefore we will absolve it from responsibility. It has to be held to accountability in its area, just as the Commonwealth has to be held to accountability in its area. I don't think in our lifetime you are ever going to see a unitary state. Do not believe that under our Constitution the states will ever be abolished, so whilst the states are there you have got to try and make this system work more responsibly.

Now can I make this point. We put in place the biggest reform of federal financial relations probably since the *Uniform Tax Acts* of 1942, we gave the states all of the GST. It was a growth income, it is increasing year by year, it is giving them a windfall. The idea of that was that once they had a growing source of revenue they would be held accountable in their areas of responsibility. No State did better out of that deal than Queensland, and to say to a State like Queensland which is now benefiting from growth revenue in GST year after year, you can have the revenue but we won't ask you to be accountable for your area of responsibility is nonsense. I don't know if that is what Mr Rudd is saying, nobody knows what Mr Rudd is saying. But if we ever see a proposal I will comment on the proposal when I see it. Is he proposing, for example, to take the GST revenue back from the states? I don't know. But whilst the GST revenue stays with the states and we talking about something like \$34, \$35, \$36 billion per annum, taxpayers are entitled to get something for it, some responsibility.

JOURNALIST:

Isn't it the case Treasurer, that the COAG process has essentially bogged down and is becoming an opportunity for the states to gouge more money above their GST allocation?

TREASURER:

You see that was the old game. That was the game pre-GST. Pre-GST what used to happen was the states came to Canberra and they asked for financial assistance, which Canberra gave them. There was no guaranteed entitlement, you have got, everything changes with the GST, the states used to come to Canberra when I was first Treasurer and they would ask for financial assistance. With no legal requirement, didn't even have to be the same amount as last year. There was no growth factor and we said, that is all

going to change, the GST which is a growth revenue as of law will be given to the states. That is now producing this growing windfall. And some State leaders never actually moved into the modern age, they still kept acting out the old script under the new regime. The new regime is designed to give a growth revenue to the States and to hold them accountable for it. That is what real federalism is about.

JOURNALIST:

On the stem cells issue do you think your vote may sway a few undecideds and produce a no-vote proceeding?

TREASURER:

My belief is that there is probably more support for that Bill in the Reps than there was in the Senate. I conscientiously thought about it; I read the Lockhart review very carefully, I indicated the way that I am going to vote for the reasons I gave. But I do not know that these speeches sway colleagues that much to be frank. I think they all make up their own minds. And I do not think you can lobby or strong arm people on issues like these. These are matters of conscience and I think my colleagues will make up their own minds according to their individual conscience systems.

JOURNALIST:

You voted for stem cell research in 2002, why this time around do you think this one has gone too far?

TREASURER:

In 2002 I voted for the proposal that embryos that were created for IVF and were not going to be used but were going to be destroyed could be used, in my view, for research. They were going to be destroyed in any event and I thought some good could come out of that if embryonic stem cell research could be done. This Bill in my view is different. This is a Bill to allow the creation of cloned embryos for the purpose of research and for legislated destruction. The way I saw it IVF embryos were created for the purpose of life and cloned embryos were created for the purpose of death and I think that is a big difference.

JOURNALIST:

Peter Costello, Kevin Rudd's talking about industry policy going back a couple of decades, do you think it is possible that if the drought gets worse and it begins to impact on regions in much bigger ways, do you think that the rationale for industry policy in regions could begin to grow?

TREASURER:

When people talk about industry policy they are not talking about agricultural policy. In fact Kevin Rudd said when he was talking about industry policy he was talking about manufacturing...

JOURNALIST:

On manufacturing and regions you think?

TREASURER:

Well, he was talking about manufacturing not talking about growing canola crops or wheat for farming or meat or wool, he is talking about industry policy as an arm of manufacturing policy. Yes, I agree with your assessment. He is certainly going back to the pre-Paul Keating days. You have got to understand this is the throwback. This is right back to the pre-Hawke and Keating days. You see, this is where the Labor Party

goes to the fork in the road and walks down both ways. On the one hand they would like to say 'we are modern and we embrace the Hawke and the Keating reforms, but on the other hand we would like to return to the Stone Age to the pre-Hawke and Keating age with industry policy. Which is code for being anti-economic reform. So, when I heard Mr Rudd say that, I realised he had walked to the fork in the road and one leg wants to go down one side and the other wants to go down the other side and he is not going to find he can get far going down two roads.

JOURNALIST:

Why does the Government continue to throw money at the TCF and automotive industry if you do not agree with industry policy?

TREASURER:

Because Alan that was part of the adjustment in the trade-off for the reduction in tariffs. Now, under our changes I think the tariffs on nearly everything will be five per cent by 2010 and there is one little area, it might be footwear or something, and it will still be at 10. But, we have worked assiduously, since 1996 to keep those tariffs coming down. I think they were about 20 per cent in 2000 for cars and TCF and they will come down to five. There are adjustment packages in there but the important thing is to get the tariff coming down in an orderly way. And bear this in mind, they had to be done against the votes of the Opposition. And one of the advantages that Hawke and Keating always had is the Opposition used to vote with them on these things. When we sought to continue the reduction of the tariffs it had to be done against political opportunism.

JOURNALIST:

Is there a very specific requirements laid out in the *Qantas Sale Act* about who can own Qantas and under what conditions? Is it possible under your powers, your broader powers under foreign investment guidelines about the national interest, is it possible to knock out the shareholding interests if it meets those very specific requirements set out in the Act?

TREASURER:

The *Qantas Sale Act* prescribes that Qantas must have majority Australian ownership. That's specific to Qantas and specific to that Act. It also limits the percentage that any one owner can take. That Act will have to be complied with. Over the years Qantas has sought to lift those limits in that legislation. It has not been successful and that Act will have to be complied with. Separate to that is the *Foreign Acquisition and Takeovers Act* that requires notification where there is a change in controlling interest and any bidder for Qantas will also have to comply with that particular Act and if an application is made it will be decided on its merits.

JOURNALIST:

Mr Costello, with regards to the drought, would you say that country Australia is now in the recession in which you had foreshadowed?

TREASURER:

Well, it could get worse. We now have a situation where farm production fell 10 per cent in the September quarter. Where wheat, barley and canola could fall over 60 per cent. Where agricultural incomes fell 51.7 per cent. That is in the September quarter. We are now in the December quarter and it could get worse. And you would have to say if your income fell 51.7 per cent it would be very serious. You would consider that a crash.

JOURNALIST:

A depression?

TREASURER:

Well, you know, I do not want to get lured into these sorts of words but it is a very, very significant fall in income and a very, very significant fall in production. I make this point – if the overall Australian economy contracted by 10 per cent we would know it.

JOURNALIST:

Mr Costello, on Qantas can I just clarify with you – aviation is a sensitive sector, does that mean that even if private equity does not take a controlling interest that it is something that we would still have to consider under the FIRB...

TREASURER:

Because it is a sensitive sector, under the Foreign Investment Policy and under the *Foreign Acquisition and Takeovers Act* they have responsibility to notify in relation to controlling interests and they will be applied if anybody wants to make an offer they will be obliged to notify and they will have to go through the processes.

JOURNALIST:

Treasurer, if they met the ownership requirements of the *Qantas Sale Act*, and just as a matter of law, it is possible that they could still not satisfy the national interest...

TREASURER:

All I am saying, I am not going to give advisory opinions on hypothetical applications I am just going to make one point here. There are two laws anybody who wants to make a bid has to comply with. Well, there are actually more but there are two in relation to foreign investment. They must comply with the *Qantas Act*, they must comply with the *Foreign Acquisition and Takeovers Act* and then there are a whole lot of other things of course that one must comply with, including the competition laws. Now, I am not giving advisory opinions, I am not saying how this will be administered, I am just saying that anybody who wants to bid for Qantas will have to comply with Australian laws. And if an application is received then it will be dealt with on its merits. And I cannot pre-judge these things, you have got to decide it if an application is made. That is the legal position. Right, thank you very much.

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