

# TREASURY EXECUTIVE MINUTE

Minute No.

14 January 2011

Deputy Prime Minister and Treasurer

## UPDATED EFFECTS OF THE RECENT FLOODS ON THE MACROECONOMIC FORECASTS

**Timing:** At your convenience, this updates the estimates in Executive Minute No. 20110019.

### Recommendation/Issue:

- That you note the updated estimates of the floods' impact on forecasts of GDP growth and inflation.

Noted

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### KEY POINTS

- The spread of the floods to southeast Queensland, particularly Brisbane, has increased the estimated effects of the floods on GDP growth.
- Southeast Queensland accounts for roughly half of the state's production and employment so the floods will increase the overall loss of production, particularly from the non-mining, non-agricultural sectors, compared with the earlier estimate.
- It also appears increasingly likely that the disruption to the mining sector will be more drawn out, and much larger, than early industry estimates.
- The first preliminary estimate of the effects of the floods on GDP (based largely on the effects of the floods in the Darling Downs, Bundaberg and Fitzroy areas) was that GDP growth would be between  $\frac{1}{4}$  and  $\frac{1}{2}$  of a percentage point lower in 2010-11, with our point estimate towards the lower end of the range.
- The extension of the floods to southeast Queensland (and northern NSW) and the upward revision to the expected falls in coal exports is likely to push that estimate further to between a range of  $\frac{1}{2}$  and  $\frac{3}{4}$  of a percentage point, with the bulk of the negative impact occurring in the March 2011 quarter.
- The updated estimates for the key areas of economic activity that are likely to be affected are:
  - coal production – lower by about \$4 billion to \$5 billion;
  - crop production, particularly horticultural, broadacre, sugar and cotton – lower by about \$1 billion;
  - retail trade, including related activity such as wholesale trade, transport and storage and financial and other service sectors – lower by about \$2 billion;
  - manufacturing – down by around \$500 million;

- construction – lower by around \$300 million; and
  - tourism – down by about \$300 million to \$400 million.
- As noted in previous minutes these estimates will continue to evolve as more information comes to hand.
  - Typically, we would expect that the reconstruction activities (particularly rebuilding and repairing houses and infrastructure) would add a substantial amount to GDP growth over the latter part of 2010-11 and into the following year. However, with the economy operating close to capacity (the unemployment rate is only 5 per cent nationally and 6 per cent in Queensland) there is expected to be less than normal scope for any net increase in GDP growth. That said, rebuilding will provide some fillip to activity – to the tune of several billion dollars – during the latter part of 2010-11 and into 2011-12.
  - The wider spread of the flood affected areas is unlikely to change the near-term inflation estimates provided earlier. Fruit and vegetable prices, which account for around 2 per cent of the CPI basket, are likely to spike by around 15 to 20 per cent, leading to a temporary 0.1 to 0.3 percentage points increase in inflation in the March quarter which is expected to be largely unwound in the June quarter.
  - More importantly however, rebuilding pressures may see skilled labour shortages emerge during the rest of 2010-11 and into 2011-12, particularly in the construction sector, and this could place more sustained pressure on prices and wages, and perhaps interest rates.
  - There are risks in both directions in the estimates of the economic effects. In particular, it is possible that the loss in coal production could be even greater than in the current estimates. The current estimates are broadly in line with the impacts of the 2009 floods, but things could turn out to be worse than that.
  - On the other hand, the near-term boost from rebuilding could be greater than expected, if there is enough spare capacity to handle it. More likely, however, bottlenecks will quickly emerge and the rebuilding effort will be spread over several quarters.
  - An important influence on the GDP and inflation effects will be the extent to which increased government spending associated with the floods is accommodated within the existing budget envelope. A net increase in overall government spending at a time of strained supply capacity, may temporarily moderate the GDP impact, but would add to underlying pressures on wages and prices, and on interest rates.

[This content has been redacted under Section 22]

General Manager  
Domestic Economy Division