BUDGET UPDATE

PETER MUNCKTON – CHIEF ECONOMIST

WEEK ENDING 29TH MARCH 2022

Key points

- **The Budget forecasts are reasonable, although conservative;**
- **Despite the strong economy, the deficit is not projected to narrow much over the next year;**
- **If the economy remains strong some fiscal tightening is likely to be required;**
- **Independent of the Budget, I have changed my cash rate view;**
- **I now expect the first rate hike in June, with the cash rate to be 0.75-1% by year-end.**

Budget overview

On face value this Budget had it all. There was something for the economists (smaller budget deficit, a downgrade to the debt profile). There was also something for those who work in the 'real' economy (fiscal support for those facing cost of living pressures). And there was also something that can be placed in the bucket of 'boosting productivity' (infrastructure spending).

Hard-nosed economists would have preferred to see a smaller budget deficit at a time of rising inflation concerns. But that was always going to be a big ask in an election year. Governments should provide support to low-income earners at a time of major challenges to their household budgets.

But the next Budget (and it could be later this year) really should be less generous. The economy is currently not in need of extra support. Extra infrastructure projects right now will just bid up the price of materials and workers at a time when both are already getting costly.

The big picture is that Government (both federal and state) spending has become a bigger part of the economy. At the same time, our tax base is too narrow (over reliant upon income tax) and our total tax take too small to fund the extra spending. The result is ongoing budget deficits. At some stage soon we need to decide about whether we want governments to spend less or tax more.

The one proviso about smaller budget deficits is that the economy continues to perform strongly. An extremely low unemployment rate, strong business capex spending, backlog of orders in residential construction, a mountain of infrastructure work and strong export performance by our farmers and miners all provide confidence that it should.

But the global economy is being hit by a major negative supply shock (from COVID and the Russia-Ukraine War). And global interest rates could rise substantially on inflation concerns. This means there is a risk that economic growth does slow faster than expected. Maybe not next financial year (2022-23) but potentially the year after. If that does happen further fiscal support may again be required. Hopefully debt levels (compared with GDP) are lower the next time fiscal stimulus is required.

The Budget has few immediate implications for monetary policy. An economy with an inflation rate likely to be above 4% and an unemployment rate likely to be under 4% does not need a cash rate of 0.1%. I now loom for the first cash rate move to be in June, with a year-end target of 0.75-1%.

Economic forecasts

The picture that the budget paints is a good one. Strong economic growth, a very low unemployment rate and inflation peaking over the next couple of quarters before declining. GDP growth is expected to be 3.5% next financial year and 2.5% the year after. The unemployment rate drops to 3.75% and remains there. Inflation is expected to be 4.25% by mid this year, declining to 3% by mid next year

I do think the risks are that inflation might be higher than what the Treasury is forecasting next financial year. They believe that the reduction in the fuel price levy will take some of the heat from inflation. It will. But there is plenty of inflation in the pipeline. And Government taxes is only one part of the oil price.

I am also more optimistic on the economy. And think the unemployment rate could decline further (the main obstacle will be matching workers with the right jobs).

An important set of assumptions are the commodity price forecasts. The Treasury has taken the conservative path and assumed that the terms of trade (which is mainly driven by the price of our commodity exports) declines sharply in coming months. I don't mind conservative commodity price forecasts (it means you potentially underestimate revenue growth). Certainly a quick decline could occur if there is an imminent resolution to the Russia-Ukraine war.

But the politics to get a resolution in that war quickly are tough. As will be the determination on when to ease sanctions. Commodity prices were rising even before events in Eastern Europe because of strong global demand and under investment in the supply of many commodities over recent years.

So there are reasons to think that the decline in the terms of trade assumed by Treasury is not as steep as they have forecast. That would be good news for our national income growth (and therefore government revenue growth). But higher prices for longer would also be one factor keeping inflation more elevated than Treasury forecasts.

The one potential negative factor for commodity prices is China. Treasury is forecasting about 5% growth over the next 3 years for China. That would be pretty close to the Chinese Government forecast. But a slowing housing sector and rolling lockdowns to try and beat Omicron means the risks to this forecast is to the downside.

One final note. Treasury forecasts assume modestly positive real wages growth over the next couple of years. As noted I think the risks to their inflation forecasts are to the high side. But I also think the risks to their wages forecast (3.25%) is biased upwards. What happens to real wages growth will play an important role in how high interest rates is able to rise in this cycle.

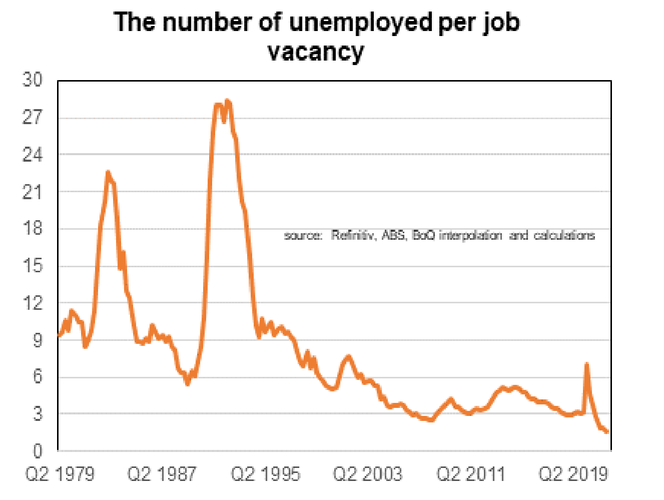
Medium-term economic projections

The Budget assumes that medium term (2- to 5- years') economic growth will be around 2.75%. This assumption matters because a stronger economy means higher income growth. And higher income growth makes it easier to repay debt.

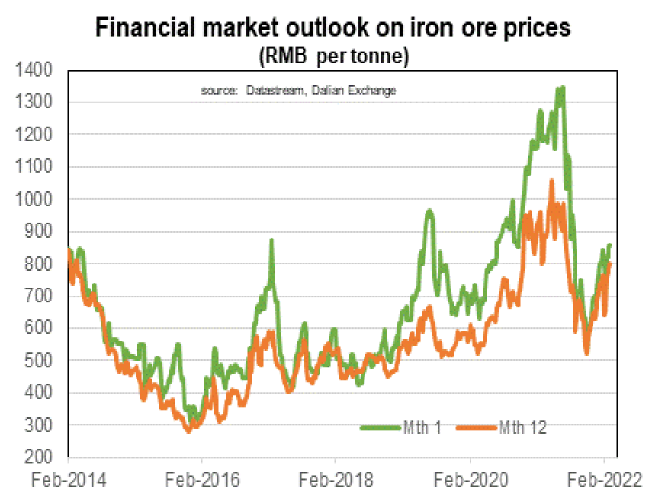
How strong growth is over the medium term is a function of the pace of population and productivity growth. Treasury (or more precisely, the Centre for Population) forecasts that population growth will be rising by around 1.25% in the medium term. This is below the Pre-COVID rate which is reasonable but above the pace seen in the 1990s.

The more debatable assumption is that productivity growth will be around 1.5% (its 30-year average). In more recent years productivity growth has been 0.5-1%. Stronger investment should mean stronger productivity growth. But productivity growth has been low globally for some time. And it might be tough to get substantial productivity increases if concerns that globalisation is coming to an end is true.

A strong economy means strong jobs growth. And this should mean a 50-year low in the unemployment rate and higher wages growth.



Iron ore prices are high. And are expected to stay high for much of the next year.



Stance fiscal policy: Less is more

Over the 1990s and 2000s fiscal policy took a back seat to monetary policy in running the economy. But that has changed. During the pandemic interest rates had already fallen to such a low level that even lower interest rates would be of only marginal benefit. Governments' needed to step in and underpin domestic incomes and boost demand.

What the stance of fiscal should be (the size of the budget deficit/surplus) right now is more art than science. A simple guide is to look at the change in the size of the actual budget deficit/surplus as an indication of how much money the government is adding/subtracting from the economy. Right now that indicates that the deficit is projected to be $78b next financial year. Sure this is a $20b improvement from what was expected just a few months ago. But it is only an improvement of just $2b from this financial year despite a rip-roaring economy.

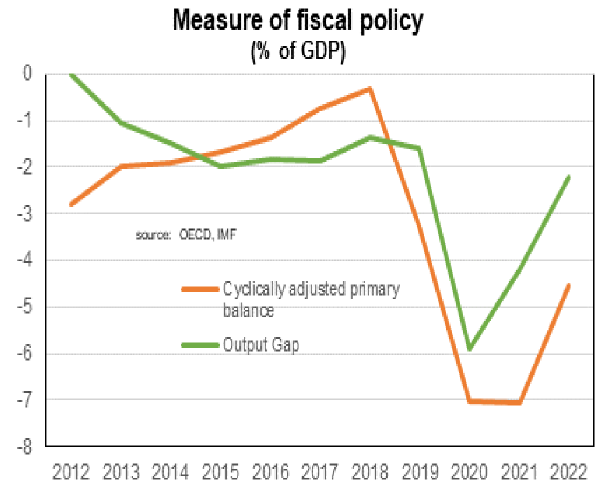
But even if the government does nothing changes in the economy significantly impact the budget. In a strong economy (such as now) a low unemployment rate reduces government payments and boosts taxation (both reduce the deficit). There are measures that abstract from these movements to look at what the 'underlying' position is (in the jargon, the structural budget balance). According to Treasury figures right now that indicates the structural budget deficit next financial year will be about 3% of GDP. When the unemployment rate was in the 5's in 2017-19 the structural deficit was under 1% of GDP.

Given the strength of the economy the structural budget should at least be closer to balance. With an unemployment rate in the 3's and an inflation rate in the 4's fiscal policy (as well as monetary policy) does not need to be providing much support to the economy.

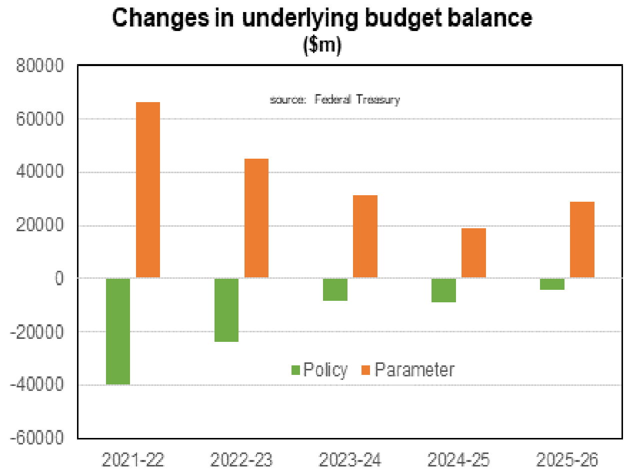
To be fair it would be unusual to see a serious burst of budget tightening just before an election. And budgets are more than just a policy to fine tune economic growth. Fiscal policy is an important tool for governments to help low income earners and small firms adapt to big economic changes. And right now the economy is facing its toughest inflation challenge in at least 30-40 years.

So I understand why the government has not significantly tightened fiscal policy in this budget. But assuming (as the government has) that the economy keeps travelling in the same direction in coming months tightening of fiscal policy will be required in the next Budget.

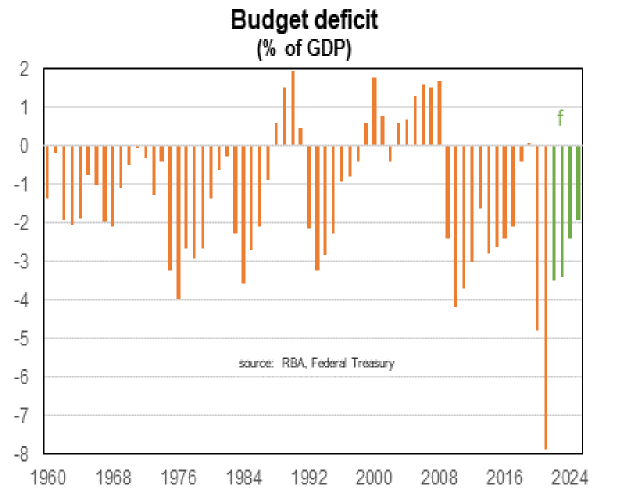
Fiscal support is strong given the strength of the economy.



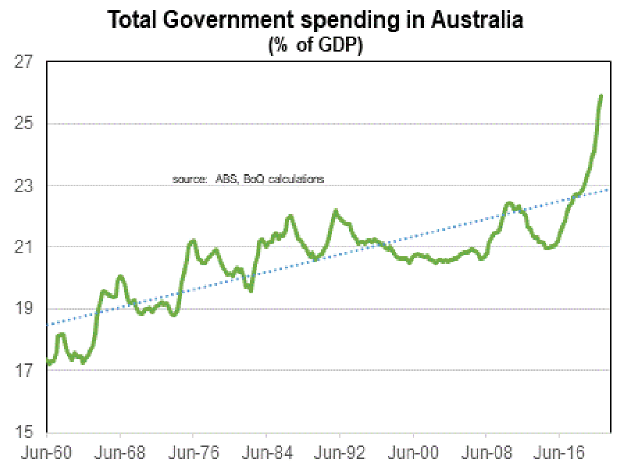
The better economy is boosting the budget, although the government is giving some of it back.



Budget deficits have been very big in recent years. And they still are quite big



Governments have become an increasingly important part of the economy over recent years.



Size of Government debt and deficits

The deficit for 2022-23 is projected to be $78b (3.4% of GDP), compared with $80b this financial year (3.5% of GDP). These deficits are quite wide by historical standards. The deficit is projected to still be 1.6% of GDP by 2025-26 despite an extremely low unemployment rate (although a sharp drop in commodity prices is expected).

By far the biggest driver of the improvement in the deficit is improvement in the parameters (underlying budget drivers). With the unemployment rate near fifty year lows and the terms of trade near record highs the budget will naturally be in pretty good shape. Both in this Budget and the last the Government took the opportunity provided by the improved economy to spend more money and cut taxes. A fair proportion of that additional largesse is designed to be short term and be automatically removed (although that can be easier said than done). But some of the additional spending (particularly from previous budgets) have been permanent. This includes extra funding for defence, aged care and the NDIS.

Low interest rates has meant that interest payments have not ballooned despite the recent run of large budget deficits. Rising interest rates will mean that interest payments are almost certain to rise. But the Australian Government has done well in fixing a good portion of its debt at a low level of interest rates (see below).

A rule of thumb used by economists is that a deficit is affordable for governments if interest rates is below national income growth. Of course this changes if there is a sudden increase in interest rates (or a sudden fall in national income). In any event having a deficit that might be affordable does not mean you should be running one. Governments increased the size of the budget deficits in the 1970s just at the time when demand in the economy was high and facing a supply shock from higher oil prices.

The size of Government debt needs to be lower

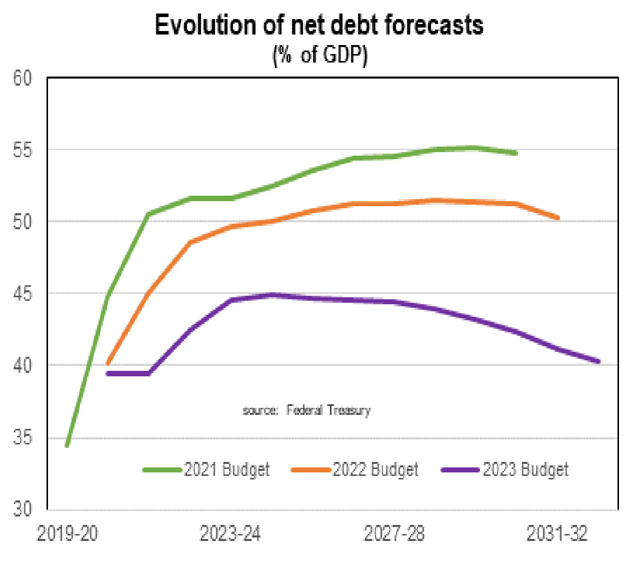
The Australian Government has moved from a net asset position in the 2000's to having Government debt equal to around 40% of GDP, peaking at 45% of GDP in 2024-25. Some deterioration of the deficit over that time should have been expected. The 2000's were the beginning of a massive terms of trade boom. Together with strong national income growth it led to an unexpectedly substantial boost to revenue growth. Subsequently the Government has faced a GFC, the ending of a massive mining boom and a pandemic.

Australian Government debt is still low by global standards. And it is below the 55% of GDP peak that was predicted a couple of years ago. If Australia maintained its current debt-to-GDP ratio it would be sustainable. The problem would come if there was another significant economic downturn. Typically debt to GDP ratios rise by around 30% during recessions. That would get us closer to the levels currently seen in some European countries (although in a recession there debt may also rise). Australia is a (relatively) small economy, one that is heavily influenced by changes in volatile commodity prices. This means that Australia's Government debt position needs to be strong by global standards.

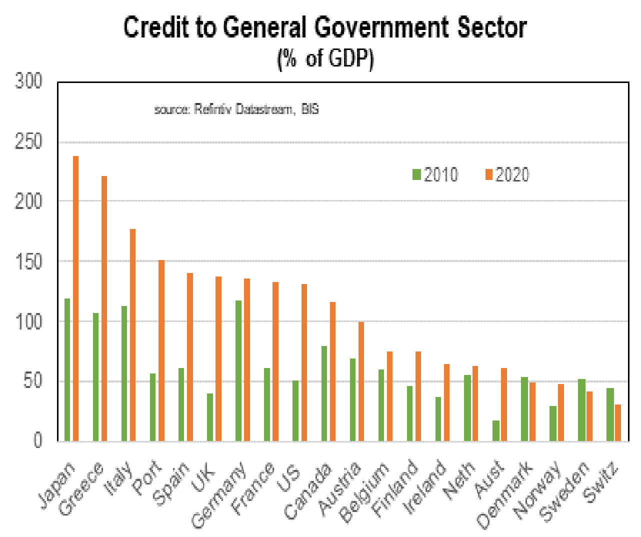
Ideally Australia's debt should be lower before entering the next recession (that hopefully is some way down the track). Making significant cuts to the size of the debt pile won't be easy. Post the second world war the massive reduction in debt was achieved by constraining government spending (significantly helped by lower defence outlays), very strong national income growth and financial repression (interest rates were kept artificially low). The Budget surpluses in the 1980s were helped by asset sales. The surpluses in the 2000's were underpinned by the largest mining boom in Australia's history.

Allowing more of the benefits from the strong state of the jobs market and high terms of trade flow through to the budget bottom line would help. The hope is that productivity growth will increase, boosting national income growth and be used to repay debt. We first need to achieve the stronger productivity growth.

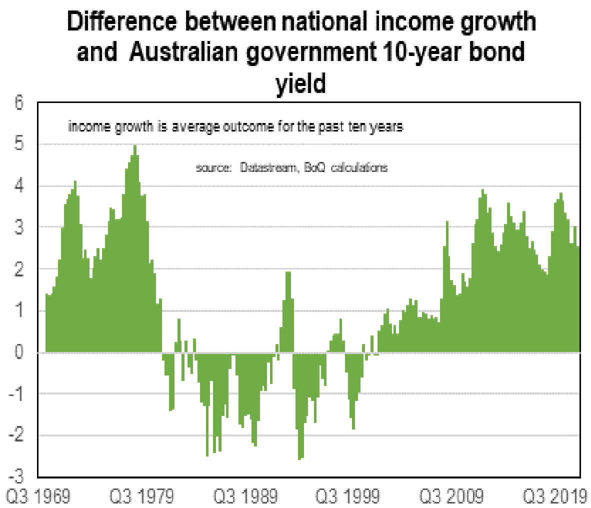
Lower deficits has meant lower debt forecasts.



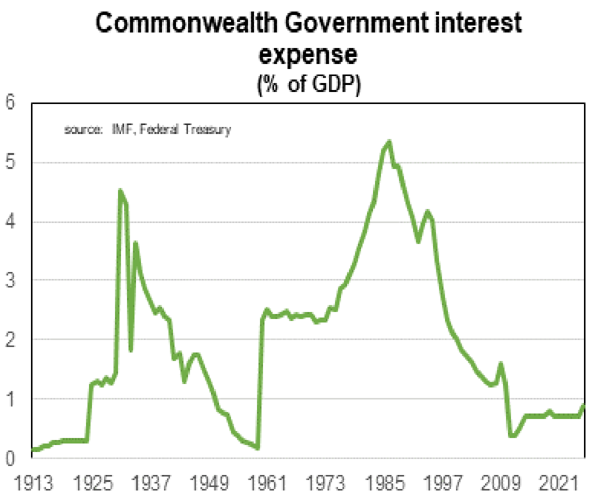
Australian Government debt is low by global standards although not as low as it used to be.



Income growth being in excess of interest rates has meant that deficits have been affordable.



Interest payments are currently low by historical standards. But that might be changing



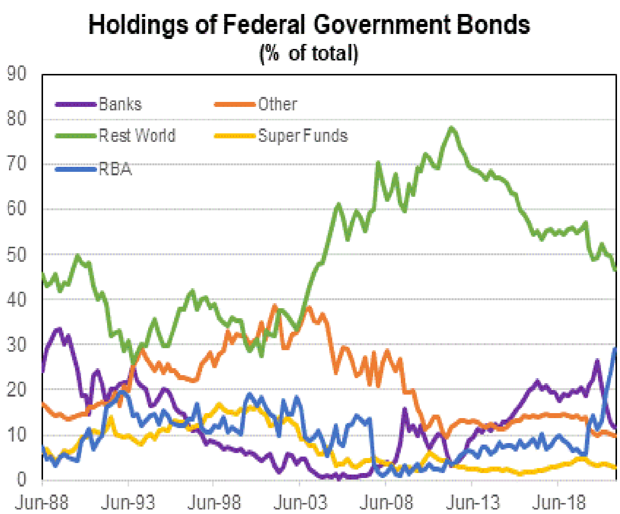
Funding the deficit should be straightforward

The Government will have few concerns about funding its budget deficit despite the RBA ending its bond-buying program (known as Quantitative Easing, or QE). A strengthening currency due to rising commodity prices may attract foreign buying. Higher interest rates might attract more attention from banks (they need to hold a certain proportion of federal and state government bonds for regulatory purposes). Australia still has one of the highest credit ratings.

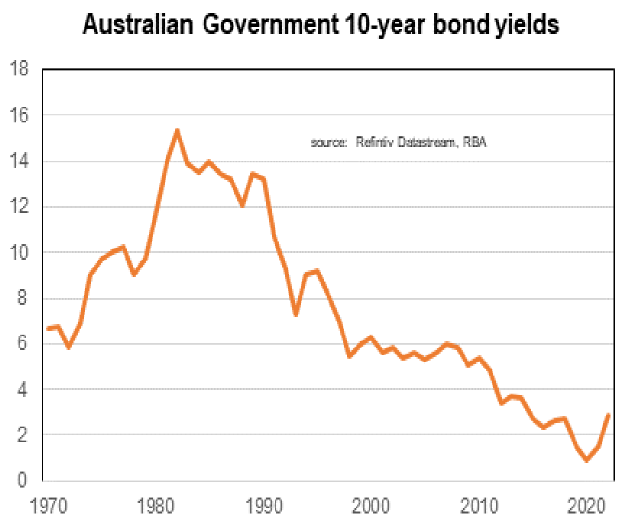
The body that manages government debt issuance (AOFM, or Australian Office of Financial Management) has done a good job locking in low interest rates on the debt that has been issued over recent years. Australia has less debt maturing over the next 3 years than other big economies such as the US, Japan and Germany.

But Australia also has a lower proportion of debt locked in for over 10 years. Mostly that has been for good reasons. Until recently Australia's government bond market was relatively small due to an extended period of strong budget results. This led to the AOFM keeping its debt issuance at 10 years or less to help the development of the Australian financial markets.

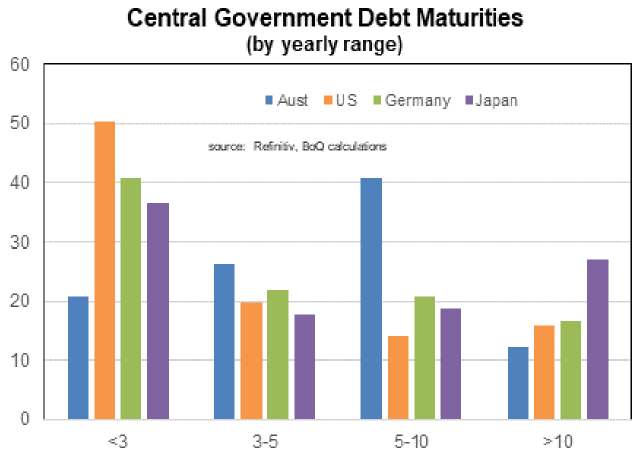
There will be a need to replace RBA buying.



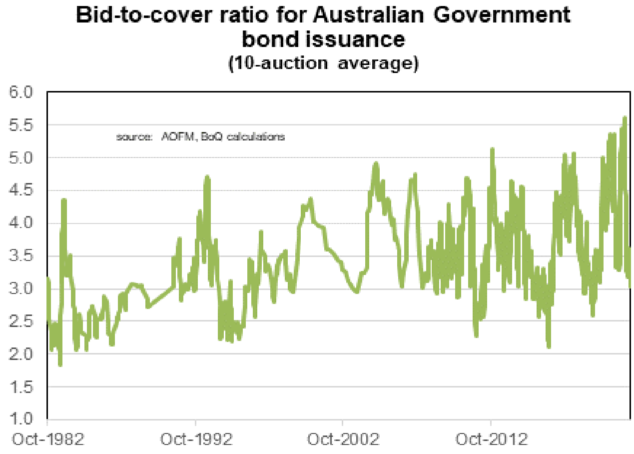
Bond yields have been very low. That is changing.



Australia has relatively little debt maturing in under 3 years.



Demand for new Government debt issuance remains high.



Spending programs

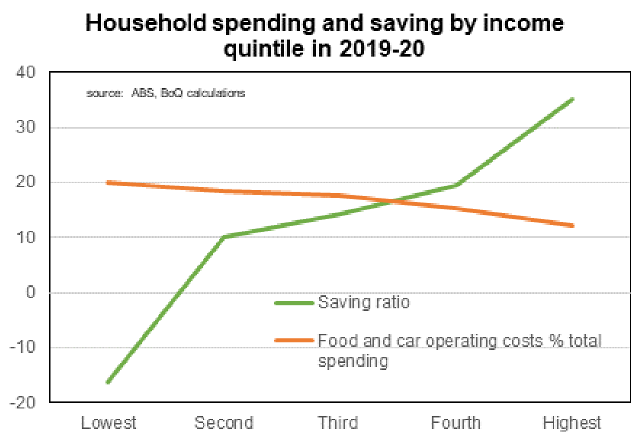
Total government spending in this budget is projected to be over $625b. Welfare spending (such as pensions and unemployment benefits) chews up the biggest part of Federal Government spending. This budget has benefitted from the extremely low unemployment rate.

Most of the major spending decisions from the Budget were pretty well flagged in advance. There is more transport infrastructure spending, as well as funds for water infrastructure. There is the cost of living payments to low income earners (including pensioners). Also more spending on defence (including on Cyber).

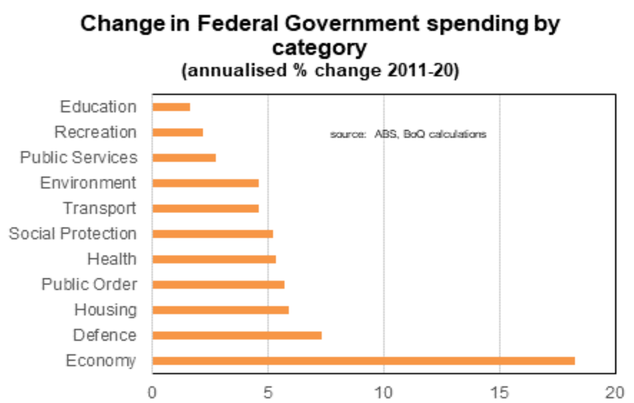
I don't quibble with the Government deciding to spend more money (and cutting taxes) to protect low- and middle-income earners from the rise in the cost of living. Hopefully higher inflation will only be a short-term phenomenon (as assumed in the budget) and so the cost of living assistance will also be only short term. If inflation lasts longer the Government will need to decide whether and by how much they continue to support low-income earners (at a big budgetary cost).

There is always a focus on the 'quality' of spending. One part of that discussion is the proportion of funds directed towards investment spending. The Budget indicated there will be more spending on a range of infrastructure. It is likely these projects will not be started for some time given the current shortage of workers and materials. In any event net capital investment by the Commonwealth Government is equal to about 0.5% of GDP (Federal Government businesses do more). This level should not surprise. Outside of defence infrastructure spending is mainly a state responsibility.

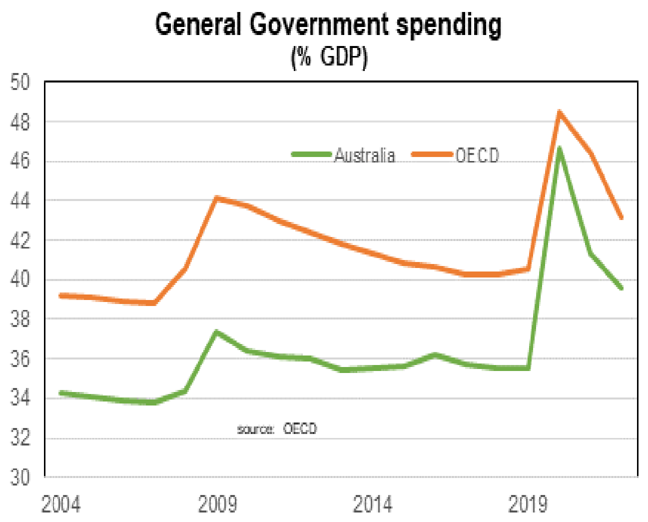
The cost of living squeeze is hitting low-income earners the hardest.



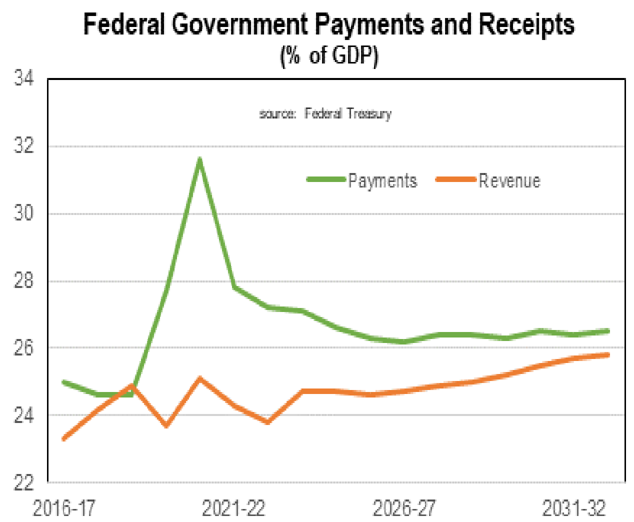
Spending has been strong in a number of areas over the past ten years.



Government spending in Australia is a smaller part of the economy compared to peer countries.



Government revenue is forecast to get back to its pre-COVID level. But payments are projected to remain above that level.

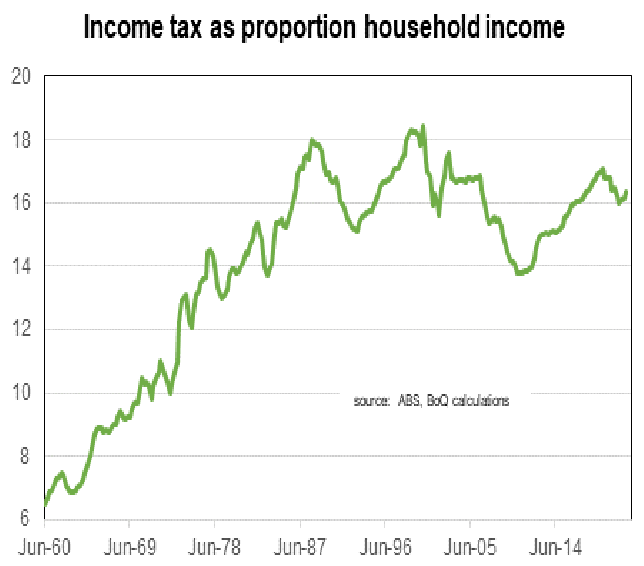


Taxation

This Budget has benefitted from plenty of extra revenue, a result of higher jobs growth and a strong terms of trade (high commodity prices). Government revenue has essentially returned to the path it was on pre-COVID. Tax changes announced in this budget include a one-off increase in the tax offset as well as a 6-month cut to fuel excise (there was also help to small business, including incentives for them to boost digitisation).

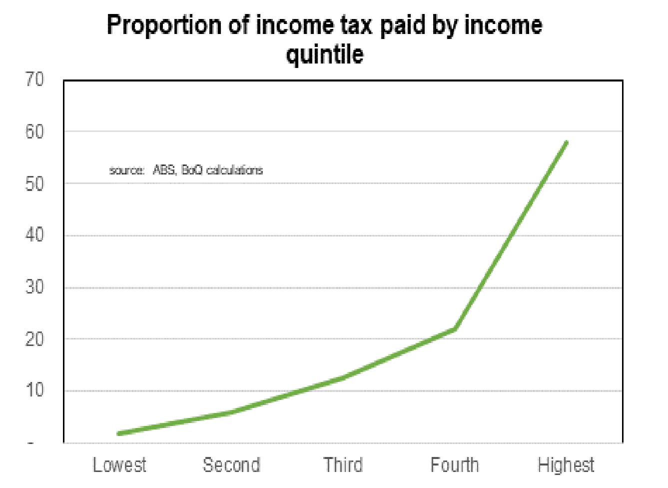
A big fiscal question is whether deficits in the future get reined in by lower spending or higher taxation (assuming that they do). Another is the over reliance on income taxes. But there is very little political appetite for higher taxes on spending. Ditto higher taxes on wealth post the 2019 election. Taxation reform though is currently not on the political agenda.

Tax has taken a smaller share of household income in recent years.

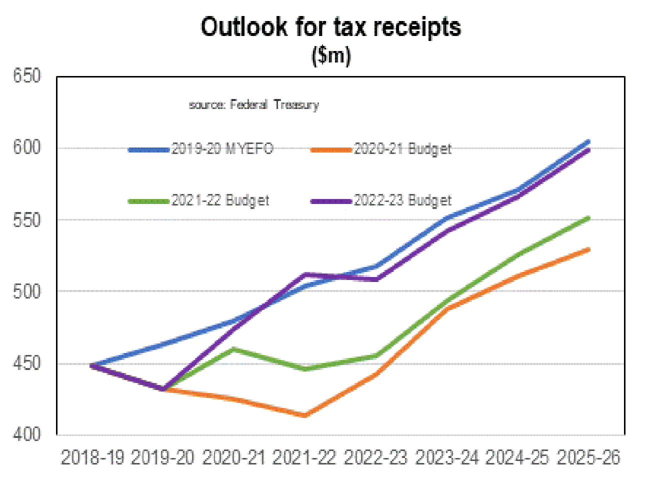


Income taxes are the major source of government revenue in Australia.

The bulk of income tax is paid by high-income earners.



The revenue outlook has improved significantly over the past year



Monetary Policy Implications

Short of an extreme shift in the stance of fiscal policy (either big spending/tax cutting or savage spending cuts/tax rises) this budget always was going to have limited immediate implications for monetary policy. The unemployment rate will shortly be in the 3's and the inflation rate will soon be in the 4's. In that economic environment a cash rate of 0.1% is not right regardless of the stance of fiscal policy.

Fiscal policy does matter in terms of how high the cash rate will go in this cycle. Federal Treasury has made an argument that the removal of economic supportive provided by fiscal policy should be 'tapered' to allow interest rates to 'normalise'. Maybe. But having fiscal policy too supportive at the wrong time means that monetary policy needs to do more work (ie, interest rates would need to head higher).

Given the current state of the economy and the inflation risks, I have bought forward the timing of my view of when the cash rate needs to be hiked (now June, previously November). I was waiting for the Q1 CPI data (27th April) to make the move but the inflation risks (particularly post the Russia-Ukraine War) are increasingly evident. I expect the movement in the cash rate to 1% (currently 0.1%) to be pretty quick (potentially by year-end). This Budget had no impact on my cash rate views for this year.

We live in interesting times.

Regards

Peter Munckton
Chief Economist
Bank of Queensland